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To:
Financial Conduct Authority
12 Endeavour Square
London
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DP23/4 - Regulating Crypto Assets Phase 1: Stablecoins

Coinbase Global, Inc. with its UK subsidiary CB Payments Ltd. (together, **Coinbase**) appreciates the opportunity to respond to the Discussion Paper on the regulation of non-systemic stablecoins (the **Discussion Paper**) published by the Financial Conduct Authority (**FCA**).

Coinbase started in 2012 with the idea that anyone, anywhere, should be able to send and receive Bitcoin easily and securely. Today, we are publicly listed in the United States and provide a trusted and easy-to-use platform that millions of verified users in over 100 countries rely on to access the crypto economy.

Digitally native money, in all its forms, has the potential to revolutionize payments. In its Discussion Paper, the FCA rightly recognises the opportunities afforded by stablecoins, and has set out its objective to promote innovation and competition in the payments space, driven by new technologies. While the approach and objectives of the FCA are admirable, the detailed regulatory requirements applied to stablecoines will be critical to achieving these outcomes.

A mixed payments ecosystem that includes a flourishing stablecoin market will deliver many benefits to UK consumers. Key to this is promoting a level playing field for stablecoins to compete with other forms of digital money. Coinbase stands ready to support the FCA as it designs its regulatory framework for stablecoins used in payments in a way that harnesses the innovative potential of this new technology.

Yours sincerely,

Tom Duff Gordon
Vice President, International Policy
Coinbase

Introduction

Blockchain technology is the backbone of a new financial architecture. While nascent, it is already bringing efficiency, transparency, and resiliency to the existing financial system.

Blockchain applications enable people to transfer value quickly and at lower cost, particularly for cross-border transfers. Stablecoins that put fiat currencies on digital rails will drive competition in the payments space. Decentralized finance, smart contracts, and related new technologies will drive further innovation and exponentially expand opportunities for the financial system. Yet, cryptoassets are more than a financial innovation; they have the potential to transform every sector of the economy. Today's internet is dominated by a handful of companies that profit from monetizing their users' personal data. The next phase of the internet's development, web3, will be owned by builders and users and will be driven by tokens, creating a more decentralized and community-governed version of the internet.

Digitally Native Money

Digitally native money that can travel peer-to-peer has the potential to revolutionize payments. The underlying blockchain technology enables the interoperability of payments systems, removes layers of costly intermediaries, and creates an entirely new competitive landscape, one which can strengthen and limit dependencies on existing banking infrastructure. Critically, within this new payment architecture, the atomistic nature of settlement can materially de-risk the global financial system, removing complicated netting processes, as well as unnecessary financing and credit risk.

As current stablecoin payment adoption grows, commercial banks are also exploring ways to tokenize their deposits and central banks are evaluating and governments are piloting central bank digital currencies (**CBDC**). Each has the potential to improve and modernize today's payments infrastructure, and none are perfect substitutes. Coinbase supports the UK's goal of delivering a "mixed payments ecosystem", with CBDC, stablecoins, and tokenized deposits co-existing and delivering more competition and choice, with market forces – through implementation of regulations that foster a level payfield – determining which model best serves consumers.

Stablecoin Opportunity

We welcome the FCA's commitment to "promoting innovation involving... the use of Digital Ledger Technology or innovative products, in line with [a] commitment to shape digital markets to achieve good outcomes". We are grateful to the FCA for its attention to ensuring that any stablecoin regulatory framework balances the benefits and risks and Coinbase stands ready to assist the FCA in designing a regulatory framework for stablecoins that achieves this objective.

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We agree with the FCA's analysis that stablecoin payments are faster, cheaper, and can operate with greater efficiency with 24/7 availability. Programmability of digitally native money creates scope to automate not only regulatory requirements (e.g. compliance checks) but also how and when transactions are made and settled (e.g. micropayments, salaries, subscriptions, trading, insurance, prediction markets, lending etc). This will give commercial enterprises – particularly small and medium size businesses – important alternatives to existing payment networks. More broadly, with the accelerating digitalisation of commerce globally, a mechanism to transact and exchange value peer-to-peer on the internet is needed; stablecoins could make it possible to send money to anyone, anywhere in the world as easily as sending a text message.

Stablecoins give users alternatives to incumbent payment systems that can be slow and more costly, particularly for cross border transfers. For example, current payment and remittance platforms require multiple intermediaries to execute a transaction, often resulting in longer transaction and settlement times and additional fees, such as foreign transaction fees. Stablecoin transfers settle as fast as the underlying blockchain, which is typically measured in minutes, whereas international transfers can take multiple business days. As the Bank of England itself notes, "in some instances, a cross-border payment can take several days and can cost up to ten times more than a domestic payment,"[1] a lag that can significantly stress cash flow and cause downstream effects.

Lack of interoperability among payment rails in traditional markets is an additional constraint to both individuals and commercial enterprises. Separate from high fees and lengthy delays, restricted and exclusive access to payment rails represent a significant disadvantage to consumers making payments and transfers. In contrast, stablecoins are not exclusive to a single blockchain, giving users competitive options on making and receiving payments and transfers. For example, credit card processing fees typically range from 1.5% to 3.5% of the value of each transaction, with the vast majority of transactions processed on one of only four large networks, each with a walled-garden of users. Of course, these networks offer tremendous value to consumers today, which is why high fees are possible, but increasing adoption and permissibility of stablecoins as an alternative will create competitive pressures that could lead to lower the costs for merchants to receive payment for goods and services using incumbent services. The same is true for wire transfers and other traditional payment systems.

Stablecoin Adoption

According to a report by Brevan Howard, stablecoins settled over $11 trillion onchain in 2022. While these numbers are crypto-centric and hard to verify from an economic relevance perspective, the reported magnitudes are remarkable, dwarf the volumes processed by PayPal at $1.4 trillion, and almost surpass the payment volume of Visa

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[1] https://www.bankofengland.co.uk/payment-and-settlement/cross-border-payments

($11.6tn). Adapting to this innovation, Visa, the largest payments provider, recently enabled settlement with Circle's USDC stablecoin allowing the network to send settlement payouts in USDC and routing these payments in USDC to merchant clients. Moreover, PayPal has launched its own US dollar denominated stablecoin (PYUSD). The movement of traditional payments operators into this market segment is strong evidence that its potential is significant.

More generally, the current trajectory of stablecoins being broadly used for retail payments and transfers should be the guiding consideration of regulation. Stablecoins originated as a fiat onramp to the crypto-ecosystem, e.g. to purchase virtual currencies like Bitcoin, but this is best viewed as the proof of concept for wide scale adoption as a settlement instrument for any payment application. For example, Coinbase Commerce currently has 48,000+ merchants accepting digital assets including USDC and DAI from their customers globally. Moreover, the fees charged are 1%, well below the rate that merchants are typically charged by major credit cards.

Regulatory Approach

We strongly agree with the FCA's objective of promoting innovation in the payments space, while protecting consumers and financial stability, but there are elements of the proposals that undermine this. One of our overarching comments is that the practicality of applying substantially different regulatory regimes as set out by the FCA and Bank of England is not clear, and the regulatory design is such that a stablecoin issuer could never design a product that navigates both regimes. And yet, the stablecoin use cases for both regimes are the same. As we explain in more detail below, we believe that this will unnecessarily distort more efficient market outcomes, and potentially limit the ability of this payment innovation to flourish in the UK.

We also note throughout our response examples of where the direction of travel on stablecoin regulation unnecessarily diverges from the e-money regime. In HMT's consultation response of April 2022 ("*UK regulatory approach to crypto assets, stablecoins, and distributed ledger technology in financial markets*") HMT confirmed that, following consultation, the intention from UK legislators was to make:

> "*[...] changes to the e-money and payment services regimes to provide the FCA with appropriate powers over stablecoin issuers and other entities, including wallet providers. The approach will ensure convertibility into fiat currency, at par and on demand. FCA guidance and rules will set out in detail the requirements that apply to specific activities*"

While we recognize that different technologies will necessarily result in different applications of specific rules, the objectives and regulatory outcomes should be the same. We do not believe that the FCA's proposed approach in the Discussion Paper – to regulate stablecoin issuers, and stablecoin custodians, in a similar way to investment

firms in the UK – achieves this goal. Moreover, it is a step-change from the approach confirmed in HMT's consultation response. **Notably, we do not believe that a properly regulated stablecoin project provides any additional risk over and above an e-money issuance, that cannot be appropriately mitigated by targeted amendments to the e-money and payment services regimes, as proposed by HMT.**

Therefore, our overarching view is that, in order to deliver on the FCA's stated objective of "*same risk, same regulatory outcome*", it would be appropriate for the FCA to move away from the broad approach suggested in the Discussion Paper and follow HMT's proposed position in its consultation response to regulate stablecoin issuance in a manner consistent with the treatment to e-money, appropriately amended to reflect the differences in technology and risks between the two solutions.

Path Forward

Policy choices about stablecoins will fundamentally shape the future financial system. We urge the FCA to introduce a regulatory framework that fosters innovation in the payments space, and harnesses the innovative potential of blockchain technology. In doing so, we believe that:

- **Stablecoins should be allowed to compete on a level playing field with e-money and bank deposits.** We welcome the UK vision for a mixed payments ecosystem. This is an important objective, and one to which the regulatory approach should align, as the future financial system transitions to digitally native environments and distributed ledger technologies. However, Coinbase has concerns that the approach, as proposed, would make it challenging for stablecoins to compete with other forms of digital money. The proposed regime is far more onerous for stablecoins than for e-money (e.g. higher capital requirements, applying requirements such as senior managers regime) and with none of the benefits of tokenized deposits (e.g. offering of interest). As a result, the proposals are not tech neutral. A true mixed payments ecosystem should drive real competition in the payments space and better outcomes for consumers. It is important that the regulatory approach delivers on these objectives.

- **Custody requirements should draw on established practices in traditional finance, with adaptations to reflect the nuances of how crypto asset markets operate.** With respect to the FCA's separate custody entity proposal, concerns with potential conflicts of interest and bankruptcy remoteness can be addressed through means other than requiring legal separation. As we explain in more detail in Chapter 5, Coinbase has adopted an organization structure that includes a separate legal entity for custodial activities. But the Coinbase exchanges also separately engage in custodial activities. Specific practices depend on client preferences and use cases, and these can not be satisfied with a one-size-fits-all

4

approach. Mandating legal separation will increase costs to clients, introduce potential frictions and vulnerabilities during trading activity, and result in operational inefficiencies, all while in our view not delivering additional benefits. Whilst it should be an option to operate a separate exchange and custody arrangement, it should not be mandatory; clients benefit most from flexibility and choice in custody models.

- **The capital regime for stablecoins should better reflect the risks associated with this payment instrument.** As currently conceived, the proposal imports requirements from the investment firm regime, which is designed for firms with much more complex business models and risk profiles, whereas the risks posed by stablecoins are otherwise no greater than e-money. We do not believe the proposed capital requirements are commensurate with the risks posed. In particular, we do not believe a capital charge should be associated with the custody of instruments such as stablecoins for which the issuer is already subject to a capital charge. This will lead to unnecessary challenges for exchange services involving stablecoins. Instead, we encourage the FCA to consider the appropriate overall capital requirements for custodians of crypto assets when it considers the broader regulatory framework for crypto assets, because these requirements have ramifications beyond just stablecoins.

- **The FCA and Bank of England regimes should be more aligned in their approach in order to support the growth of the stablecoin market.** We do not believe the proposed bifurcation of stablecoin regimes will yield a well functioning digital payment ecosystem. The proposed regime for systemic stablecoins would create a huge cliff edge effect, providing disincentives for stablecoins issuers to grow past the systemic threshold because doing so would require a different operational model. No stablecoin under FCA supervision will ever attain wide scale adoption without being required to switch regulatory regimes, and fundamentally overhaul their business and product offering in order to fulfill different regulatory requirements under the Bank of England's regime. This is, in effect, a cap on innovation and a cap on the growth of stablecoins as a payment mechanism.

To deal with the potential cliff-edge issue between FCA and systemic regimes, we would propose that the FCA further explores a middle ground approach that avoids the step from stablecoin project, into systemic payment system. That middle ground could be structured around a higher level of oversight, reporting and governance for larger stablecoin projects which have become so large as to be systemically important, but have not themselves morphed into a systemic payment system themselves (and thereby required to change their business model and fall under the remit of the Bank of England).

Phased Approach and Application of Custody Requirements

We agree with a phased approach that begins with regulating stablecoins used as a means of payment. However, Phase 1 requirements should cover stablecoin issuers only. Many of the requirements under consideration by the FCA for stablecoins (e.g. separate custody entity within the group, no de minimis house assets in customer wallet) should be considered more holistically, alongside a a full array of crypto assets beyond just stablecoins, to help ensure a broadly workable regulatory framework for the entire ecosystem.

There is potential for significant unintended and adverse outcomes if rules designed for payment use cases are adopted for other crypto use cases, which are not currently being considered. We believe it is important that any non-stablecoin issuer related rules be considered and ultimately applied to stablecoins in conjunction with rules that apply to crypto assets more broadly, otherwise the differences in timing will introduce significant operational and compliance challenges.

Our view is that custody requirements for stablecoins should only apply when the broader regulatory framework for crypto assets comes into effect, and Phase 1 rules should apply to stablecoin issuers only. Otherwise, crypto asset custodians face a difficult choice – either to implement the requirements applicable only to stablecoins across their entire business at a time when the rules that would apply to other crypto assets are still to be determined, or alternatively to de-list stablecoins from their platforms. These are both sub-optimal policy outcomes, and for this reason we urge the FCA to ensure that the implementation timelines are aligned for custody rules for both stablecoins and crypto assets generally.

Chapter 2: A New Stablecoin Regime

Q1: Should the proposed regime differentiate between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes? If so, please explain how.

Stablecoin regulation should be designed in a way that allows broad scalability, without being tethered to specific use cases, and in a way that allows for there to be a smooth transition from the FCA non-systemic regime to the Bank of England regime for systemic stablecoins. As currently contemplated, the requirements are overly punitive for stablecoins used for both wholesale purposes and in a retail context. Before the FCA considers whether certain requirements should apply in a wholesale context, we would suggest that the FCA recalibrates the regime more broadly, in a way that allows stablecoins to compete as a means of payment with other forms of digital money.

Q2: Do you agree with our assessment of the type of costs (both direct and indirect) which may materialize as a result of our proposed regime? Are there other types of costs we should consider?

Policy choices for fiat-backed stablecoins will fundamentally shape the course of their development, adoption, and use cases, and these choices should be carefully considered in light of global trends on the future of payments. Fundamentally, regulation should foster innovation and competition in the market for payment services and ensure that rules are proportionate to the potential risks that a product or service could introduce.

Competitiveness of Stablecoins vs Other Forms of Digital Money

The UK has set out its vision for creating a mixed payments ecosystem. However, the proposed approach would create an unlevel playing field, on which the benefits of stablecoins cannot be fully realized because of disadvantages relative to other forms of digital money, such as tokenized bank deposits. The proposed regime for stablecoins appears to be more onerous than for e-money (e.g., higher capital requirements, applying requirements such as senior managers regime), even though the stablecoin risk profile is designed to be similar or better than e-money.

We note three specific areas where we think the approach will unnecessarily bias against stablecoin adoption in the UK:

- **Ban on Interest**: There is no inherent reason why holders of stablecoins should not be able to participate in the returns conferred by the reserves. This would be an unambiguously good outcome for consumers. We understand that prudential regulators have historically taken the view that payment of interest to e-money holders should be prohibited to help consumers distinguish between e-money and

bank deposits. However, the FCA and Bank of England should revisit this view in light of bank efforts to tokenize deposits, which would be a competing payment instrument. Creating different standards for like instruments will impair competition and create a distorted playing field that, e.g., could unnecessarily favour tokenized deposits over e-money and stablecoins. Allowing one form of digital money to pay interest but not another is akin to picking winners and losers within a product market (in this case an implicit subsidy for the banking system).

- **Capital Requirements**: As proposed, the capital regime is overly complicated and inappropriately conflates stablecoin issuance with ancillary activities such as custody of stablecoins. The regulatory treatment of these activities should be considered separately. For the purpose of the current proposal, we encourage the FCA to focus exclusively on the capital treatment of stablecoin reserves, and consider requirements related to the custody of stablecoins, and all other digitally native assets, in a separate consultation.

  We agree that the issuance of stablecoins and their reserve backing should be subject to capital requirements, but it is not clear why issuers should be subject to a regime designed for investment firms, where there are significantly more complicated financial arrangements and greater risks. Stablecoins are backed 1:1 with safe, highly liquid reserve assets and, as is the case for e-money, reserves are held in an account at a regulated financial institution. Capital requirements should be directly related to operational risks of the issuer and with an additional allowance for a small amount of duration risk related to government debt securities.

  Activities at the stablecoin issuer level more closely resemble that of an e-money firm than an investment firm, making e-money capital requirements a better starting point for stablecoins issuers than investment firms. For e-money issuers, capital requirements are 2% of the average outstanding e-money, and can include reserves that carry greater risk than those contemplated for stablecoin issuers. By our estimates, and as further discussed in our response to Chapter 8 below, a well-structured stablecoin issuer would carry operational and financial risk that could be covered by a capital buffer of well below 2% of the total amount of stablecoins outstanding.

  Given that reserves are simple, capital requirements need not be complicated:

  - **Stablecoin Issuers:** With respect to capital requirements, we encourage the FCA to apply the principle of "same risk, same regulatory outcome". This includes capital treatment that is no more severe than e-money, which applies a flat rate of 2% in most cases, and permits a broader range of reserve assets than what the FCA is currently contemplating for

stablecoins. Capital requirements should not follow those used by investment firms. The activities of stablecoin issuers are far simpler and need not be subject to a more complex k factor regime, which could ultimately misprice risks that are otherwise readily quantifiable through standard methods.

- ○ **Custodian of Regulated Stablecoins:** The FCA is proposing an additional capital requirement calculated with a k factor for regulated crypto asset activities e.g. safeguarding crypto assets. This is unnecessary and inappropriate; it is unclear why the custody of stablecoins (as opposed to the reserves) should have a capital regime more akin to banks, which take on credit and lending risk in the course of their business. Given that stablecoins themselves would be subject to capital requirements, the FCA should instead focus attention on the safeguarding requirements currently in place for traditional custodians. We explore this in considerable detail in our responses to Chapter 5.

Systemic Stablecoin Arrangements

We have prepared a separate response to the Bank of England Discussion Paper on systemic stablecoins but note here that the proposals put forward for systemic payment arrangements envision a business model that does not yet exist. Moreover, the proposals provide no realistic path for current stablecoin issuers, or those envisioned to operate under the FCA's contemplated regime, to ever transition to a systemic supervisor regime.

This regulatory design fundamentally misunderstands how the existing stablecoin market is developing, and if applied, would severely impair its continued development. It assumes that there are two market use cases for stablecoins – crypto within payments, and an entire end-to-end retail payment solution – and that the first should be overseen by the FCA, and second by the Bank of England. But the stablecoin market makes no such distinction. Stablecoins are designed to equally serve all potential use cases – retail payment, wholesale settlement, remittances, and gateway to any digital asset, whether virtual currency, digital asset security, tokenized real world asset, utility tokens, brand rewards tokens, or any host of services that can be executed through digitally native payment means.

With this in mind, it is hard to imagine how a stablecoin could successfully operate under the FCA's proposed regime because if it becomes a systemic retail payment instrument, this requires an issuer to operate under the Bank of England regime. All stablecoin issuers will seek to achieve wide scale adoption, and if success in doing so means they must switch regulators and adopt an entirely new business model, there will be tremendous disincentive to even try. It is not reasonable to expect that any business would ever

design a product that would one day not be permitted in its original form. This is, in effect, a cap on innovation and a cap on the growth of stablecoins as a payment mechanism.

This proposed bifurcation in regulation creates (1) one regulatory regime that does not work for existing stablecoin models, and (2) another regime that proposes a business model that does not yet exist. We also worry that the envisioned systemic stablecoin regime may not work. Our initial thoughts:

- **Requiring Assets to be Held at the Central Bank.** The Bank of England proposal requires reserves for systemic stablecoin arrangers to be held at the central bank. While we agree that this is a safer model, because it removes private bank credit risk, it is a different model than what exists today, and appears to simply be a synthetic CBDC issued by the private sector, where the private sector takes on the operational risk of issuance.

- **Ban on Interest on Reserves:** The Bank of England proposal will not permit the payment of interest on the reserves for systemic stablecoin arrangers held at the central bank. The result is that an issuer would need to rely solely on a fee-based business model, which fundamentally shifts the economics towards the traditional model of charging fees for payment processing. While we have no principled objection to such a model, we fail to see why it should be the only model. Allowing issuers to subsidize transactions through earned interest on reserves would benefit consumers and promote competition. We believe a more prudent path is to let the market decide which models should succeed, which could include a blend of the two.

- **Cap on Individuals' Holdings:** We believe the FCA approach of no cap on holding is correct. Besides being impractical as an enforcement matter, it is difficult to understand the merit of the Bank's proposed holding limit of £10,000 to £20,000 on individual holders. The limit is intended to mitigate risks to financial stability associated with large-scale outflows from bank deposits into stablecoins. But holding limits at the proposed level would constrain the use of stablecoins by commercial enterprises, particularly SMEs who would benefit most from a lower cost payment system. The ban would, therefore, exclude a key population of users and limit its appeal. To that end, this requirement could very well achieve its intended goal of financial stability, but for the wrong reason (i.e. lack of adoption). A holding limit is a far inferior regulatory tool relative to capital requirements when it comes to mitigating financial stability concerns.

Overall, we believe the combination of (1) limiting the scalability of a stablecoin under the FCA regime and (2) banning interest on reserves in the BoE regime will have the effect of picking winners and losers in the UK at the outset, potentially leading to unbalanced support for tokenized deposits. This undermines the objectives of greater competition in

the payments space and the emergence of a "mixed payments ecosystem." We believe that the FCA and Bank of England regimes should be more aligned in their approach in order to support the growth of the market.

Q3: Do you agree with our assessment above, and throughout this DP, that benefits, including cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, increased competition, could materialize from regulating fiat-backed stablecoins as a means of payment? Are there other benefits which we have not identified?

Benefits of Stablecoins

Compared to traditional payment systems, stablecoins are faster, cheaper and operate 24/7. Programmability of payments using stablecoins creates scope to automate not only regulatory requirements (e.g., compliance checks) but also how and when transactions are made and settled (e.g., micropayments, salaries, subscriptions, trading, insurance, prediction markets, lending etc). With accelerating digitalisation, a mechanism to transact and exchange value on the internet is needed; stablecoins could make it possible to send money to anyone, anywhere in the world as easily as sending a text message.

Stablecoins give users alternatives to incumbent payment systems that can be slow and more costly, particularly for cross border transfers. Current payment and remittance platforms require multiple intermediaries to execute a transaction, often resulting in longer transaction and settlement times and additional fees, such as foreign transaction fees. Stablecoin transfers can be settled in under 30 minutes whereas international transfers can take multiple business days. High costs and lengthy delays represent a significant disadvantage for conducting payments transfers in traditional markets today.

The flexibility and low cost associated with stablecoin payment methods will benefit consumers and businesses by increasing competitive pressure on incumbent systems.

Pursuing Regulation That Fosters The Benefits Associated With Stablecoins

Coinbase has long called for a workable regulatory framework for crypto assets, to deliver regulatory certainty to the market and to raise standards and level the playing field across the ecosystem. We welcome the UK moving ahead with an appropriately tailored regime for regulating fiat backed stablecoins given their huge potential as a means of payment.

However, we have concerns that the regulatory regime, as proposed, will not harness the benefits of stablecoin. To the contrary, as we explain throughout our response, the proposed approach would create an unlevel playing field (due to ban on interest paid to consumers and excessive capital requirements); the benefits of stablecoins cannot be fully realized because of the regulatory regime proposed relative to other forms of digital money, such as e-money or tokenised deposits.

Chapter 3: Backing Assets and Redemption

Q4: Do you agree with our proposed approach to regulating stablecoin backing assets? In particular, do you agree with limiting acceptable backing assets to government treasury debt instruments (with maturities of one year or less) and short-term cash deposits? If not, why not? Do you envision significant costs from the proposal? If so, please explain.

We agree that a proper stablecoin reserve structure should include high quality, liquid assets, and that it is appropriate for reserves to include short-dated government debt instruments denominated in the fiat currency to which the stablecoin is referenced. Relying on safe assets with minimal financial risk will help ensure that a stablecoin maintains a stable value.

If limits to acceptable backing assets follow what is proposed, then the capital requirements should reflect only minimal exposure to financial risk, which would be primarily duration risk related to the maturity of government debt. By way of comparison, we do not believe there should be materially different standards of treatment between e-money safeguarded funds, and regulated stablecoin safeguarded funds. The current e-money regime requires ongoing capital of 2% and allows a broader range of assets for backing than what is proposed for stablecoins, so there should be a commensurately lower expected capital charge for stablecoin reserves. In this respect there should be alignment between the two regimes.

We recognize that stablecoins are different from e-money by way of having a continuous market value through trading activity. When the market value drops below the par value there can be redemption pressures as holders may seek to arbitrage the difference. Redemption pressure can be exacerbated when the underlying assets are under stress – as we previously noted, bank deposits carry credit risk due to the fractional reserve nature of banking, and that risk can be transmitted to stablecoin issuers. As the consultation correctly notes, the USDC stablecoin temporarily lost its peg with the collapse of Silicon Valley Bank, where it held substantial deposits. However, it is also important to note that the peg was restored once US regulators guaranteed the underlying deposits.

For the purpose of stablecoin capital requirements, we think the UK should think carefully about whether stablecoin issuers should bear an additional charge for reserves held at UK banks. A well-structured stablecoin need not heavily rely on bank deposits as part of the reserves structure; the primary benefit of such deposits to the stablecoin arrangement is liquidity management – accommodating mints and burns (creates and redeems) as part of the on/off ramp between the stablecoin and fiat currency. But secondary markets can also absorb supply and demand pressures. Like with other exchange traded financial

products, it is natural for there to be small temporary deviations between market and book values to accommodate buy, sell, create, and redeem activity.

To the extent that there are safety and soundness concerns with UK bank deposits, those issues should be primarily addressed at the bank capital level as opposed to stablecoin capital requirements. A stablecoin arrangement can withstand a bank failure and temporary loss of liquidity for those assets if it is known that the stablecoin will be made whole. For example, additional capital for credit risk would not be necessary if stablecoin deposits participated in the FSCS program. If no such guarantee is provided, then a capital charge may be appropriate to cover the credit risk exposure associated with bank deposits.

Finally, while stablecoin issuers need not heavily rely on bank deposits to manage financial risk as part of the overall composition of their reserve assets, issuers are nonetheless reliant on banking services as a critical component of the stablecoin arrangement's operational infrastructure. Banking services are necessary for a stablecoin issuer to enable the conversion of fiat currency into the stablecoin, and vice versa. Loss of access to banking services could impair the issuer's ability to conduct timely redemption, which in turn could cause the stablecoin's market value to trade at a discount to par and ultimately damage the stablecoin's utility as a medium of exchange. As such, securely maintaining access to banking services is critical to the issuer. Today, in some jurisdictions there is a perception that banks are under pressure to avoid onboarding (i.e., debanking) clients that are engaged in stablecoin issuance and other crypto-related activities. Implementing a regulatory regime that explicitly removes this friction would mitigate a potential source of both financial and operational risk.

Q5: Do you consider that a regulated issuer's backing assets should only be held in the same currency as the denomination of the underlying regulated stablecoin, or are there benefits to allowing partial backing in another currency? What risks may be presented in both business-as-usual or firm failure scenarios if multiple currencies are used?

We believe it most economically efficient for the backing assets to be held in the same currency as the stablecoin itself as this removes any FX or basis risk associated using other currencies. However, we do not believe there should not be a prohibition on holding assets in another currency. It is a common practice at funds and other investment vehicles to create synthetic exposures to lower cost or enhance liquidity compared to holding an underlying, and we do not want to rule out that possibility here. This may be particularly true for fiat currencies where the derivatives/FX market is more liquid than the underlying government debt instrument.

We also think it is important for stablecoin issuers to be able to place reserve assets in non-UK banks where such banks meet certain criteria; the e-money regime allows for

13

custody across different countries in the same way and we would consider this regime to be appropriate to map across to safeguarding of backing assets for a regulated stablecoin. Moreover, there is international precedent, for example the Monetary Authority of Singapore (MAS) allows for reserve assets to be placed in overseas banks with a minimum credit rating of A-, and which have a branch in Singapore regulated by MAS. This would reduce concentration risk, if issuers can spread backing assets across a number of different banks, including non-UK banks.

Q6: Do you agree that regulated stablecoin issuers should be able to retain, for their benefit, the revenue derived from interest and returns from the backing assets? If not, why not?

Revenue Derived from Interest/Returns from Backing Assets

Today, the business model of the most widely used fiat-backed stablecoins is for issuers to earn revenue derived from the interest and returns from the reserve assets. If stablecoin issuers were unable to retain revenue derived from the interest on backing assets, this would require a fundamental change to the current business model of stablecoin issuers, and as a result, potentially impact the long term viability of their stablecoin arrangements.

Absent interest and returns on reserves, issuers would be required to charge transaction fees. But unlike e-money or traditional payment systems, stablecoin issuers do not maintain control over ongoing transactions or the blockchain infrastructure that their stablecoins operate on. Given existing token standards and stablecoin arrangements, issuers would only be able charge fees for minting/burning (creating/redeeming) the tokens and not for any payment transactions for which the tokens are used. Changes to token standards or the development of other commercial arrangements would have to be implemented for a fee-based model to appropriately compensate the issuer for their services.

Regulators should take care in not prescribing business models that do not yet exist. It is of course possible that fee-based stablecoin arrangements may yet emerge based on their economic merit. In particular, charging fees could ultimately complement current arrangements by mitigating the cyclicality in expected revenues based on the interest rate environment. Today, issuers are subject to periods of depressed revenues during periods of low interest rates, and competition from alternative stores of value during periods of high interest rates. But the tradeoff between a fee-based and interest-based revenue model will be more efficiently decided by the market through practice and evidence, which is something that a regulator cannot foresee.

Moreover, consumers will benefit from stablecoins to the extent that interest on the reserve assets and other revenues can be passed on by the issuer and thus stave off the need to charge fees. Today, stablecoin transactions can operate outside of traditional payment systems, including on-platform (i.e., offchain) transfers between clients on the same platform for both person-to-person transfers or retail-to-commercial payments. Enabling stablecoin issuers to provide a lower cost structure based on revenue from the interest on reserve assets would introduce healthy competition into a system where consumers and merchants might otherwise bear higher rates because of a lack of alternatives.

Forcing stablecoin issuers to adopt a transaction fee-only model by regulatory decree would benefit the incumbency of existing practices, and would be contrary to supporting innovation and a mixed payments ecosystem. Although difficult to predict how the proposed systemic issuer model would develop in practice, it is possible that it could engender a 'winner-takes-all' outcome, because fee income will be driven primarily by the velocity of the stablecoin. Larger issuers with a higher velocity will have the ability to charge lower fees to further drive adoption and thus create a material barrier to entry that ultimately creates an uncompetitive market.

For these reasons, we strongly advocate for an issuer being entitled to retain the interest on backing assets. Market regulators should not put themselves in a position of picking winners and losers. Instead, regulators should focus on taking appropriate risk mitigations for the various potential models, allowing markets to decide through consumer use and preference which of the models works best.

Paying Interest to Customers

As also explained above, we do not see a principled reason that stablecoin issuers should not have the option to pay interest to stablecoins holders. This would unambiguously benefit consumers. We understand the public policy reasons for a prohibition on a ban of interest – so as not to confuse e-money or stablecoins with deposits – but technology is changing such that deposits can similarly be tokenised, and therefore be more readily used as a means of payment. To the extent that stablecoin issuers will be subject to prudential requirements, and capital charges on their reserves, then there is a strong economic and commercial case to permit the payment of interest. This would also put competitive pressure on depository institutions to pay interest to their clients, which, particularly for retail clients, is often not done, or at rates well below market rates.

Allowing issuers to pass through some portion of the interest and returns enhances the viability of stablecoin arrangements, particularly in higher rate environments like markets are experiencing today. Permitting interest payments to holders allows them to further participate in the economic benefits of the arrangements, and lessen the need for them to redeem tokens for alternative stores of value during idle periods of use. This therefore has

the added benefit of contributing to enhanced stability of the stablecoin arrangement itself.

Ultimately, the decision of whether interest can be paid on digitally native forms of money should be guided by the need to foster technology neutral and level playing field – one that fosters a mixed payment ecosystem. There should be consistency with the treatment of stablecoins, e-money, and tokenized bank deposits. We recognize the FCA's concern regarding potential consumer confusion on the payment of interest reflecting the same protections as interest bearing bank deposits that are subject to the Financial Services Compensation Scheme (FSCS). As set out above, this also relates to whether a stablecoin issuer could or should be able to participate in the FSCS program for the portion of its reserves held at banks. We believe these concerns can be addressed with clear disclosures.

Overall, we believe that permitting interest payments on regulated stablecoins will promote innovation within the payments sector, and facilitate a mixed payment ecosystem. Should this not be permitted, then we strongly encourage regulators to ensure that there is parity within the payments ecosystem that is technology neutral and that does not unduly favour one form of payment over another, or favour incumbents and their legacy practices over the innovations in payments that we are experiencing today.

Q7: Do you agree with how the CASS regime could be applied and adapted for safeguarding regulated stablecoin backing assets? If not, why not? In particular:

- **i. Are there any practical, technological, or legal obstacles to this approach?**

Overall we agree with the principles of the proposals around application of the CASS regime for safeguarding of regulated stablecoin backing assets broadly in the same way that it applies to existing firms today, subject to the following comments:

Firstly, we agree that issuers should not be allowed to distribute unbacked assets, but we believe it should be possible for issuers to hold regulated stablecoins that are not backed as part of the initial minting process prior to distribution.

Having an inventory of preminted coins is operationally efficient and leads to better service level agreements (SLAs) with respect to software integrations and ultimately to a better customer response times and experience. We believe the risk of unbacked assets being issued is low and can be managed via internal processes including reconciliations against blockchain records (for example mandating that unbacked stablecoins must be held in a firm segregated wallet designated for that purpose, which can be disregarded for the purposes of reconciling issued stablecoins vs backing assets), as this will allow

more flexibility from a technical perspective and allow an issuer to issue coins more quickly on customer request.

Secondly, we strongly support the concept of including blockchain analysis as part of reconciliation methods and would encourage the FCA to ensure that it allows flexibility in how reconciliations are provided for in CASS in order to allow for further innovation in this regard.

- **ii. Are there any additional controls that need to be considered?**

No additional comments.

- **iii. Do you agree that once a regulated stablecoin issuer is authorized under our regime, they should back any regulated stablecoins that they mint and own? If not, why not? Are there operational or legal challenges with this approach?**

We agree that under this regime issuers should not be allowed to distribute stablecoins that are not 1:1 backed; however, as described above, we believe it should be possible for issuers to hold regulated stablecoins that are not backed as part of the initial minting process prior to distribution. This enables a higher velocity of 'money' onchain without compromising the integrity of the backing assets.

Q8: We have outlined two models that we are aware of for how the backing assets of a regulated stablecoin are safeguarded. Please could you explain your thoughts on the following:

- **i. Should regulated stablecoin issuers be required to appoint an independent custodian to safeguard backing assets?**

While stablecoin issuers may choose to appoint an independent custodian to safeguard backing assets, it should not be required if the issuer is appropriately authorised to conduct such activity. Issuers should be given optionality, with a requirement to disclose to customers which model has been pursued.

We disagree with the premise that the independent custodian model "would help to ensure consumers are not exposed to any insolvency risk of the issuer and minimize disruption if the issuer fails." The FCA proposal sets out that, at a minimum, there should be a ring-fenced, insolvency remote safeguarded account. An additional requirement for an independent custodian would introduce operational lags in the management of reserves and additional inefficiencies in the mint/burn/redeem processes as a result of adding an additional third party. These changes compromise many of the potential benefits of stablecoin technology without commensurate benefits from the perspective of safety.

- **ii. What are the benefits and risks of this model?**

If the UK were to mandate a model of independent custodians, we are concerned that there would be few custodians willing to offer these services, with issuers unable to find a custodian that is willing to be consumer facing. By way of analogy, crypto asset firms already face challenges with provision of banking services (including access to bank accounts), with many banks in the UK unwilling to offer services to businesses involved in digital assets.

- **iii. Are there alternative ways outside of the two models that could create the same, or increased, levels of consumer protection?**

Nothing further to add.

Q9: Do you agree with our proposed approach towards the redemption of regulated stablecoins? In particular:

- **i. Do you foresee any operational challenges to providing redemption to any and all holders of regulated stablecoins by the end of the next UK business day? Can you give any examples of situations where this might be difficult to deliver?**

Holders should have the right to redeem at par at any time but the conditions for redemption, including timelines, thresholds and periods should be at the issuer's discretion with clearly disclosed user agreements to holders.

The 24hr redemption requirement may not be practically possible in all cases given the operational limitations of a banking system that does not currently operate 24/7. There could, therefore, be periods where reserve assets, notably bank deposits, are not available for distribution to redeeming holders. To a certain extent this can be managed through the relationships stablecoin issuers have with distributors who are able to absorb redemption requests during these down periods out of their own inventory (i.e., using their balance sheet). However, there are natural limits to what distributors would be willing or able to absorb, particularly during periods of stress, when many holders seek to redeem at the same time.

Issuers should have clear policies and procedures in case of events of this nature. For example, USDC broke its peg when Silicon Valley Bank failed, and it was unclear whether or if reserve assets would be recovered. As we discussed above, it is critical that stablecoin holders have confidence that reserve backing is 1:1 at all times, which includes accounting for fragilities in the banking system.

Banks may also, eventually help alleviate these issues by facilitating extended hours or 24/7 to access funds, for example, through inter-client transfers, where the issuer and

distributors are both clients of the bank holding reserves. These types of services have been made available to crypto firms in the US by certain banks.

Finally, in some instances there may be challenges associated with financial crime checks and other risks that could slow the redemption process. This friction is commonly observed at banks, which set daily limits on the amount of cash that can be withdrawn from deposit accounts. When a deposit account holder intends to withdraw a large amount of cash, this can entail a 24 hour notice so that banks can apply appropriate financial crime checks, as well as to ensure that the funds are available for the account holder. For these reasons it makes sense for the issuer to clearly disclose to holders the mechanisms and timeframes for redemption as opposed to having a time limit prescribed by regulation.

- **ii. Should a regulated issuer be able to outsource, or involve a third party in delivering, any aspect of redemption? If so, please elaborate.**

Yes. While the FCA's proposed redemption model rightly puts the regulatory and legal obligation to redeem on the issuer, the issuer should be free to engage in commercial solutions that outsource parts of the redemption process to exchanges or other entities that may have great access to the stablecoin user base. This is a practical response given many issuers design their process in a way that restricts redemption to wholesale users e.g. exchanges. Even where issuers and exchanges partner to facilitate redemption, legal liability must always remain on the issuer to redeem.

- **iii. Are there any restrictions to redemption, beyond cost-reflective fees, that we should consider allowing? If so, please explain.**

We agree that there should be no undue restrictions or conditions that would prevent holders from redeeming their stablecoins. However, frictions should be permitted to ensure that financial crime controls are applied and therefore it is not always appropriate for redemption to be immediate. We do not consider such a control to conflict with the ability of holders to redeem their stablecoins at par value, on demand.

- **iv. What costs associated with our proposed redemption policy do you anticipate?**

We agree that redemption fees should be cost reflective. Costs will include the cost of KYC (approx £7-8 per person), cost of transferring assets including gas fees and charges applied by the safeguarding bank (e.g., card transaction, bank transfer, FX fees).

Q10: What proof of identity and ownership requirements should a regulated stablecoin issuer be gathering before executing a redemption request?

In general, standard KYC checks (photographic ID, proof of address) should be applied, as set out in the UK MLRs. However, we suggest that the approach adopted by the FCA around customer risk assessments be commensurate with the nature of regulated stablecoins; for example the FCA is clear that simplified due diligence is not generally appropriate for UK registered crypto asset firms to adopt in any circumstances. However, for regulated stablecoins, given their intended highly regulated nature, and that the intention is for them to be used in mainstream payments, the option to use simplified due diligence with a risk based approach (e.g. for smaller redemptions), in line with e-money requirements, should be considered.

Chapter 4: Other key expectations of stablecoin issuers

Q11: Do you agree with our approach to the Consumer Duty applying to regulated stablecoin issuers and custodians. Please explain why.

Yes, we agree.

Q12: Do you consider that regulated stablecoins should remain as part of the category of 'restricted mass marketed investments' or should they be captured in a tailored category specifically for the purpose of crypto asset financial promotions? Please explain why.

Stablecoins should not fall under the Financial Promotion regime. Today, crypto assets are categorized as "restricted mass-marketed investments" for the purposes of communicating financial promotions to consumers, and all stablecoins currently fall within this category. However, e-money is not a specified investment and therefore not in scope of Financial Promotions. Given that stablecoins can be designed to be no more risky than e-money, and following the "same risk, same regulatory outcome" principle, we believe that stablecoins used in payments should also be out of scope of the Financial Promotions regime. Regulated stablecoins are not in our view likely to be used for investment purposes and therefore, in the same way as e-money, should not be captured by the Financial Promotions regime.

Moreover, under the FCA's proposals, entities issuing fiat backed stablecoins used in payments will be subject to robust regulation, and once this regulation applies, fiat backed stablecoins should be carved out of the Financial Promotions regime. We would however support regulated stablecoins falling with the more general requirements around communications that are imposed on e-money issuers in BCOBS 2.

Chapter 5: Custody requirements

Q13: Should individual client wallet structures be mandated for certain situations or activities (compared to omnibus wallet structures)? Please explain why.

There Are Many Benefits of Omnibus Wallets

No. Individual client wallet structures should not be mandated. Omnibus wallets deliver many benefits to both service providers and their clients. Like with traditional financial services, omnibus wallets facilitate rapid settlement of trades within internal books and records (i.e., offchain ledgers) and they deliver significant transactional efficiencies by eliminating the gas fees required for onchain recording. Using omnibus wallets also helps to preserve confidentiality for institutional clients whose holdings might otherwise be traced back to them if segregated onchain. Institutions in traditional markets go to great lengths to protect information about their holdings and trading behaviors to lessen potential adverse price impact of their actions and thereby satisfy their client fiduciary requirements. Finally, omnibus wallets reduce operational and security risk by reducing the total amount of activity, in terms of onchain movements necessary to effect a transaction.

Omnibus Wallets Are Used In Traditional Securities Markets

The use of omnibus wallets in crypto markets is similar to traditional finance, whereby a securities custodian or collateral manager is instructed to transfer assets from one of its client's accounts to another. As both these clients' assets are held in the same omnibus client account at a Central Securities Depository (CSD), there is no need to make a transfer at the level of the CSD. Instead the custodian updates its books and records for instant settlement finality. The custodian reconciles its books and records against the aggregate holdings in the CSD client account, and internal controls surrounding the ledgering and reconciliation are in place to identify and resolve discrepancies. The business models of large collateral managers such as BNY Mellon and JP Morgan utilize these efficiencies.

The same principle applies to omnibus crypto wallets when the crypto custodian is instructed to transfer assets from one of its client's accounts to another, for example, as a result of a trade settlement. Where both of these clients' assets are held in the same omnibus wallet, there is no need to incur recordation (gas) fees through an onchain ownership transfer. Instead the crypto custodian updates its books and records for instant settlement finality. The crypto custodian reconciles its books and records with respect to the onchain record of the aggregate assets held in the relevant omnibus wallet.

Onchain Segregation is an Important Client Choice

For institutional customers, many crypto custodians offer a premium service that includes the provision of individually segregated wallets, with the private keys maintained in cold storage. This individually segregated wallet service caters to clients with a buy-and-hold investment approach, prioritizing maximum security at the expense of trade and transfer execution speed, as retrieving assets from cold storage can take several hours. The option of having segregated wallets can also provide an additional layer of transparency for clients wishing to have onchain visibility of their holdings. Though, as discussed above, this choice could also reveal information about their positions to the public. Some institutions may view this positively, as proof of holding, while others may be concerned about signaling to markets about investment and trade decisions (e.g. the potential to front run a block trade). Nevertheless, onchain segregation is an important client choice, which offers a higher degree of separation and autonomy than what is typically available to institutional clients in the traditional securities markets.

Given the trade-offs institutions face between privacy and settlement speed in omnibus wallets, and additional security with potential price slippage for segregated wallets, and the custodial standard of care institutions owe their clients, we believe that crypto custodial rules should allow institutions to balance these factors and make their own decisions about client wallet structure.

Q14: Are there additional protections, such as client disclosures, which should be put in place for firms that use omnibus wallet structures? Are different models of wallet structure more or less cost efficient in business-as-usual and firm failure scenarios? Please give details about the cost efficiency in each scenario.

As set out in the answer to Question 13, omnibus wallets present operational benefits for custodians as well as benefits to customers, and are normal practice in both crypto markets and traditional securities markets. Any disclosure requirements should be aligned to achieve the same regulatory outcome for both crypto and traditional financial markets.

Omnibus wallets for crypto are particularly important for speed and cost. As described above, they minimize the amount of onchain fund movement and thereby lower transactions fees for users. Omnibus wallets also lower operational complexities for service providers. Less onchain movement of funds (from one wallet to another) simplifies transactions and enhances the speed of execution. Requiring the sweeping of funds to dedicated user wallets introduces friction that simply makes it not practical to apply segregated wallets at scale for businesses with a large number of customers.

Omnibus wallets also improve the security profile of custodial activities by allowing the custodian to move a large portion of customer assets into cold storage without losing the

ability to provide real time services. This is possible because most customer assets tend to be at rest for the vast majority of time, and only a small fraction of aggregate funds need to be in a hot wallet at any given time to meet a real time redemption, transfer, or trade request. Because assets in an omnibus wallet are not tied to a particular customer, they can facilitate the real time settlement of any customer, which would not be the case for any segregated wallet requirement.

Hence, omnibus custody allows a custodian to properly balance funds across both hot and cold storage in an efficient manner for all its customers. The custodian can securely store the vast majority of customer assets in cold wallets, only moving funds to hot wallets when necessary to support customer onchain withdrawals and transfers. This ensures the highest security, operational efficiency, and gas fees savings. From a customer perspective, omnibus wallets not only enable on-demand withdrawals, and fast and efficient trade settlement, but they also save on transaction fees through minimizing gas costs (that would otherwise need to be passed onto customers). In short, omnibus wallets maximize safety while making the overall product-offering more economical for consumers.

Facilitating this model for crypto should be regulatorily equivalent to what is currently done in traditional finance. Here, internal books and records (i.e. internal ledgers) play a crucial role in identifying individual client's entitlements and therefore their beneficial ownership of their assets. Appropriate regulatory oversight can help ensure accurate books and records as well as the treatment of custodial assets in events like insolvency, where clear delineation of beneficial ownership is essential.

Finally, the use of omnibus or individual wallets does not impact bankruptcy remoteness in the event of insolvency provided there is appropriate ledgering at the custodian and the assets are held on trust. We disagree with any suggestion that client holdings could be more difficult (using practices currently employed today at traditional custodian) to identify with omnibus wallets, if assets are held 1:1 pursuant to a trust or similar arrangement, with accurate books and records; for example, regardless of whether assets are held in omnibus or segregated wallets, it is still necessary to reconcile the wallet address with that of the client, relying on books and records for both custody models. In fact, in a firm failure scenario, omnibus wallets would likely make it easier (lower operational cost and risk, and lower gas fees) to return and redistribute client assets, as there would be a smaller set of private keys to manage.

Put succinctly, custodial protections should include (a) a requirement to hold client / customer assets 1:1 pursuant to a trust or similar arrangement, (b) a prohibition on the custodian making use of customer assets without consent, (c) a requirement to obtain reasonable insurance to protect against asset loss, and (d) recordkeeping requirements to ensure customer assets are bankruptcy remote from the custodian.

Q15: Do you foresee clients' cryptoassets held under custody being used for other purposes? Do you consider that we should permit such uses? If so, please give examples of under what circumstances, and on what terms they should be permitted. For example, should we distinguish between entities, activities, or client types in permitting the use of clients' cryptoassets?

Rehypothecation of Client Assets

If the CASS framework is applied, the custodian should be allowed to use assets in certain, limited circumstances. With express client consent, we believe there are some appropriate use cases where client assets (including retail client assets) may be rehypothecated safely and for the benefit of the client, for example crypto lending activity to the extent the firm is authorized under the UK's future crypto asset regulatory framework to do so.

More generally, with respect to rehypothecation of client assets in a retail context, we would recommend changes to CASS 6.4.1A to widen the circumstances in which retail client assets can be rehypothecated. At present only securities financing transactions are permitted for retail client assets, and we believe this is likely too restrictive in the context of crypto asset markets, particularly when considering the possible new authorisation around crypto asset lending that may be incoming, which could allow a properly regulated form of rehypothecation in the context of retail assets.

Staking

One key element of the framework relates to staking. When a token owner participates in the proof-of-stake consensus mechanism, the staked assets are, for the duration of the process, delegated to a validator node. However, during this period, the ownership rights of staked assets remains unchanged. This process is unparalleled in traditional securities markets, and its regulatory treatment would benefit from an express carve-out from the provisions of CASS 6.4. Staking is critical to the operational infrastructure of the underlying blockchain and it should be made clear that staking can be appropriately performed by custodians without having to follow the requirements of CASS 6.4 (which are not appropriate in the context of staking).

Today, many crypto service providers offer staking as a service in exchange for a fee. This service can be structured such that customers instruct their custodian to stake their assets for the purpose of validating transactions, but throughout the process the customer retains full ownership over their staked assets. During this period the client agrees to lockup assets and temporarily give up potential alternative uses (an opportunity cost). In exchange, the proof of stake protocol pays an award for the validation service, and from this award a fee is paid to the service provider.

Staking is a low risk activity. Network penalties, known as slashing, are possible if the validator behaves maliciously or otherwise violates protocol rules, but in current practice these are extremely rare. By way of context, Coinbase has offered staking services since 2019 and has never been slashed. For the largest staking network, Ethereum, less than .001% of all staked ETH has been lost to slashing since its inception. This figure includes "solo" stakers (i.e. asset holders who do not stake through a service provider).

In terms of regulatory treatment, staking services entail custody plus some ministerial "administration". In this context, the custody rules should make clear that a custodian may receive an ancillary instruction to stake custodied assets, while holding customer keys. Carrying out this instruction may require the custodian to perform ancillary technical functions beyond merely custodying the asset.

Accordingly, we believe that the service of staking should not be considered as rehypothecation activity or other "right of use" for a custodian, and the regulations should make that clear.

Q16: Do you agree with our proposals on minimizing the risk of loss or diminution of clients' crypto assets? If not, please explain why not? What additional controls would you propose? Do you agree with our proposals on accurate books and records? If not, please explain why not.

Custodial Liability

The regulatory standard of care applicable to crypto asset custodians should be consistent with the existing CASS framework applicable to traditional financial instrument custodians. It should be fault-based (rather than strict liability), holding firms to account for their gross negligence and failures to maintain adequate systems and processes.

Coinbase has a contractual obligation to exercise reasonable skill and care under our terms and conditions, and where we do not fulfill this requirement or fall short of this standard, Coinbase is liable to reimburse customers. For example, if there is an issue at protocol level, this is outside of the custodian's control, as opposed to mis-management of private keys, for which Coinbase would be liable. Custodial liability should be aligned with the standards set out in traditional financial services rules, and disclosed to customers.

Accurate Books and Records

We agree that accurate books and records are essential for ensuring a custodian holds the correct amount of assets in custody for a client at all times, reducing opportunities for fraud and loss of assets, as well as facilitating a prompt return of assets if a firm fails. The existing CASS framework for traditional finance provides detailed requirements for firms

to keep accurate books and records, including for omnibus wallets (e.g. requirement for regular reconciliations). Based on the "same risk, same regulatory outcome" principle, these requirements should and can be applied to crypto asset firms.

We support the FCA's proposal to permit firms to rely upon onchain records to help meet its record keeping requirements (see our response to Question 17 for further information). However, this new technology should not result in additional record keeping requirements for crypto firms compared with traditional financial services firms. Therefore, onchain records should provide an additional layer of useful information to comply with the existing record keeping requirements under CASS.

De Minimis Amount of House Assets in Customer Omnibus Wallet

We agree that segregation of client versus firm assets should form a core element of any custody regime for crypto assets, to ensure only appropriate use (and avoidance of misuse) of client assets, and to ensure bankruptcy remoteness.

However, firms should have the ability to hold a de minimis amount (in our view, less than 3% of the total omnibus wallet balances) of house originated assets within client omnibus wallets for operational purposes to (1) support customer business, (2) cover costs incurred from the omnibus wallets, and (3) receive fees denominated in the form of the crypto for which it was earned before sweeping these house assets ("in flight house assets") out of the client omnibus wallet. However, this number can vary significantly based on the type of services provided. The amounts needed for typical retail activity are quite low, and significantly higher for activity that entails services provided to institutional clients such asset managers and market makers, whose trade flows are more complicated. For example, at Coinbase, we offer Prime Financing products that enable trade execution with delayed settlement for assets held in cold storage.

CASS 6.2.6 contemplates the use of firm funds in customer accounts in limited circumstances, for example where this is necessary for operational or compliance purposes and arises incidentally to investment business carried out for a client. We believe that an analogous provision should similarly be included for crypto assets, given how the crypto asset market operates and how crypto assets are transacted.

The need for house originated assets to be held in the omnibus wallet primarily arises from two situations:

1) **To pay onchain gas fees for both firm & customer-initiated onchain movements (payables).**

   Platforms incur gas fees when moving assets between wallets, including between hot and cold wallets. Some of the movements are not customer initiated; they are firm generated movements (e.g. for security reasons moving assets from hot to

cold wallets), so it is incumbent on the firm to pay these fees. For this to happen, firm funds must be in the same wallet as the asset that the firm is moving.

Firm funds are also required to covergas fees incurred as a result of customer-initiated transactions. Charging fees in advance of transfer is often impractical because the expected gas fee is typically different from the incurred fee. These deviations occur because it is impossible to know exactly what the fee will be in advance of a block being recorded. To provide certainty to customers, and to ensure the transaction is completed as intended, current market practice is for platforms to pay gas fees on behalf of customers, and then be compensated in the form of a fee, although many platforms also offer to subsidize these fees in whole or part.

If firms do not have the option to keep house assets in omnibus wallets, it is not clear how platforms would balance between cold and hot wallets, potentially delaying settlement or action upon customer instructions. Moreover, because customers would be required to pay upfront the full gas fees, and because gas fees cannot be predicted in advance, it would be challenging for a customer to attain a zero balance without risking a transaction failure. These options would, at a minimum, increase costs for customers and provide an inferior customer experience (such as by delaying settlement or access to customer assets).

2) **When firms earn Commission paid in crypto e.g. for staking services / crypto to crypto trades (receivables / in flight house assets).**

For crypto-to-crypto trades, platforms earn fees on transactions, which accrue in the omnibus wallet. Similarly, when providing staking services, the rewards accrue in the omnibus wallet from which the assets are staked, and fees owed to the custodian providing those services are earned as a percentage of those rewards. There is no technical solution to prevent these new house assets from originating in an omnibus wallet. The most that could be done is to immediately sweep any firm receivables into a separate onchain wallet the moment they are earned. However, realtime asset sweeps would involve an enormous number of onchain movements, substantially increasing operational costs, which would ultimately be borne by customers.

These house originated assets are "in flight" and should be allowed to sit within firm omnibus wallets until they are swept out at a regular cadence, in a batch process, and at a rate determined by permissible thresholds of omnibus house assets.

Having considered all options, we strongly believe that the best way for firms to manage their business is by permitting a de minimis amount of firm originated assets in the customer omnibus wallets, as the "cleaner" and safer approach. We believe that: (1) with

appropriate safeguards around these de minimis balances (e.g. clear segregation of client and firm assets preserved at all times through the internal ledger system), and (2) using a "waterfall" arrangement for the statutory trust, similar to that adopted by exchange-traded product issuers for distribution of assets (i.e. where client monies are paid out in full prior to any assets being remitted back to the firm) - would additionally reduce client risk by ensuring that firm assets would be used to make clients whole.

Q17: Do you agree with our proposals on reconciliation? If not, please explain why not? What technology, systems and controls are needed to ensure compliance with our proposed requirements?

Custodians of digital assets should be required to regularly perform internal reconciliations – covering in particular offchain transactions – to ensure accuracy of the internal ledger and to identify and resolve any discrepancies that arise. The standards applied to digital assets custodians should track those required of traditional financial firms – the internal ledger should keep track of internal customer holdings (i.e. what is ledgered to the individual customer accounts) and transaction history, and the reconciliation process should ensure that the sum of the internal ledger equals the sum of funds reflected for the omnibus addresses on the blockchain.

However, we do not agree with the FCA's proposed approach of requiring custodians to conduct reconciliations of each client's crypto assets "on a real-time basis" to identify and resolve discrepancies. In our view, real time reconciliation is neither necessary nor practically possible. Onchain data, while updated on a near real-time basis and limited only by the speed of block formations, must be reconciled against offchain ledgers that rely on software systems and methods designed for use by traditional custodians. Real time reconciliation should be an ambition that the crypto asset industry works to over time, but the FCA should not impose requirements that industry as a whole is not yet able to incorporate. This issue will be particularly acute for custodians that aim to serve both digitally native and traditional securities. To start, reconciliation requirements should be at least daily, consistent with existing standards, or as soon as practically possible, recognizing that even without the imposition of real time reconciliation, onchain data provides additional and publicly verifiable information that delivers enhanced disclosure relative to traditional custodial practice.

More generally, we see no reason why the FCA should impose higher standards on FCA-supervised crypto asset firms than traditional financial services firms with respect to reconciling omnibus accounts against CSD records. Such a requirement would otherwise be anticompetitive, particularly for traditional financial services firms seeking to engage in digital asset activity, and who may not be able to reconcile with the same degree of frequency (as cypto-native custodians) given their legacy systems. In this respect, to

ensure a level playing field and the principle of "same risk, same regulatory outcome" principle, there should be parity in requirements.

Where CASS 6 reconciliation arrangements are adopted, as noted in the answer to question 16 above, we agree that it is important for the FCA to consider the benefits of onchain data. One fundamental benefit of DLT is the near real-time view that it gives of balances in custody. With appropriate rules that allow for the authorized firm's direct reliance on this data to help fulfill its recordkeeping obligations, reconciliations will be easier to carry out and will also enable some visibility for the FCA on a near real-time basis. This may then allow some elements of the burdensome reconciliation requirements in CASS to be reconsidered, for example the external custody reconciliation requirements which are currently required at least monthly under CASS 6, given the access to near real-time data.

Q18: Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.

Sub-Custody and Appointment of Third Parties

Yes. Sub-custody is a common practice in traditional finance and firms should be permitted to use third parties to provide custody services that are subject to rigorous due diligence and third-party risk management standards. The same approach should be taken for crypto asset custody.

Permitting the appointment of a sub-custodian that is not UK-based can strengthen the regulatory objectives of preventing misuse of client assets and making sure that client funds remain protected at all times, including in the event of insolvency. This is important to UK clients; they should have access to a network of reputable custodial platforms, including those outside the UK. It is also critical that UK custodians are able to utilize technology and infrastructure from third parties under appropriate outsourcing arrangements (which should not be considered sub-custody), to ensure they are able to provide best-in-class custody services. Offshore sub-custodians are widely used in traditional financial markets, and this practice is expressly permissible under the existing financial services framework for financial product custody arrangements.

Sub-custody vs Technical Service Provision

It is important to recognize the difference between a genuine sub-custody arrangement and the outsourcing of technical and operational arrangements to allow for custody of crypto assets. Both are important. We believe that crypto-asset custodians should be

able to utilize technology and infrastructure from third parties through suitable outsourcing arrangements, without involving the transfer of assets into the custody of a third party. This will improve custodians' operations, systems and controls, providing greater protection to clients' crypto assets.

We recommend that the concepts around sub-custody used in CASS 6 are reviewed and updated to reflect this difference so that there is clarity around what arrangements are genuinely sub-custody and therefore are required to be operated in accordance with CASS 6 requirements, and what is a technical service that should be considered an outsourcing arrangement. The latter should not be considered sub-custody arrangements.

Changes to CASS Framework

CASS 6.3 places obligations on custodians to ensure that sub-custodians in third countries are authorized to perform custody activities, except in limited circumstances (i.e. where law compels holding of assets in the third country, or a professional client explicitly requires holding with that third country custodian). In the context of the crypto assets industry, we recommend updating this provision to allow for a wider range of potential regulatory arrangements under which a sub-custodian may operate . This is merited given the significant differences in permitted custody arrangements globally (for example the US authorisation requirements which are limited except in certain states, and EU member states that primarily operate under MLR registration regimes at present, which are not considered "authorisations"), and also the potential for uncertainty between genuine sub-custody and technical service provision.

Location Requirements

We have observed that some jurisdictions, under the banner of customer protection (e.g. Japan) have imposed operationally prohibitive localisation requirements on custodians. This can include requiring storage of digital assets (keys) and/or custodial personnel to reside within a jurisdiction. While we recognize the customer protection concerns, we believe the better approach is for jurisdictions to accommodate global models that focus on protections designed for digital rather than physical custody. With appropriate guardrails, an enhanced security outcome can be achieved at a lower cost. What remains is to ensure that customers have appropriate legal protections, and in particular, priority over all other creditors in the event of insolvency of the relevant intermediary or platform.

Distinct to crypto asset custody is the specialized management of private key material needed to access and control the digital assets. Current security best practices involve separating, storing, and operating wallet key materials across different locations and time zones. Geographic separation of human capital, wallet operations infrastructure, and cryptographically enforcing consensus eliminates the ability to compromise the safeguarding of assets through a single point of failure and minimizes the potential

damage of an isolated security breach within any single jurisdiction. Any requirement for specific human or technical resources to be exclusively located in a single jurisdiction could materially undermine the availability and resiliency of secure wallet operations.

Requiring a custodian to localize operations in each jurisdiction it operates would undermine efficiency and customer protection. Notably, it would significantly lower economies of scale – by requiring custodians to build redundant infrastructure and split resources across jurisdictions – and thereby open additional attack vectors. More generally, any requirement or incentive to limit the ability of a custodian to realize economies of scale (e.g. by additionally pursuing an unbalanced objective of limiting concentration risk) could result in the underinvestment in security technology and practices. Requiring firms with global operations to stand-up fully localized operations for a nascent field such as crypto may, for certain players, undermine the business justification for operating within the jurisdiction.

Japanese Experience

Sub custody arrangements work. For example, in 2023, Coinbase wound down its Japan exchange, with tokens for all of the customer liquidations returned directly from the wallets in sub-custody of Coinbase Inc. Coinbase Japan was able to make all Japan clients whole while operating from Coinbase Inc's globally distributed custody solution. This successful liquidation demonstrates that including robust protections in intercompany agreements are sufficient and effective for protecting and returning customer assets.

However, certain localization requirements were unnecessarily inefficient. In particular, Coinbase Japan Exchange was required for all wallet operations to have localized approval, which unnecessarily created a delayed access experience for Coinbase Japan Exchange clients. Notably, crypto markets are 24/7/365. But having only Japan domiciled employees available to perform hot wallet liquidity approvals during local business hours created service level agreement ("SLA") delays for wallet operations. Due to labor laws, we were only able to perform transactions on a "best effort" basis and rely on voluntary availability of authorized approvers outside of normal business hours.

This localization requirement also lowered our ability to ensure Coinbase Japan Exchange business continuity. The requirement for Coinbase Japan approvers created a business continuity risk for the Coinbase Japan exchange where, in the case of a critical business disruption in Japan (e.g. due to technical and/or natural disasters), liquidity would necessarily freeze for the Coinbase Japan exchange until authorized approvers were back on-line.

Best practices for secure processing centers and storage locations for custody solutions are designed, from first principles, to be geographically distributed across multiple time zones and continents. An exchange's ability to configure secure storage locations for

32

primary and disaster recovery key material storage powers the ability to maintain operations through localized and global disasters such as the COVID pandemic.

Q19: Do you agree with our proposals on adequate governance and control? If not, please explain why not? What (if any) additional controls are needed to achieve our desired outcomes? What challenges arise and what mitigants would you propose?

Yes, we agree with the FCA's points on adequate governance and controls.

Proof of Reserves

The FCA is right to consider whether novel disclosure requirements such as Proof of Reserves (PoR) should be used by a custodian. Publicly verifiable holdings on the blockchain can provide enhanced disclosure relative to traditional practices. But there are both pros and cons to proving reserves through crypto native methods. Today, it is best viewed as something that could augment traditional verification practices, but not replace them. In that light, the techniques underlying should be permitted for use by custodians, but should not be required nor considered a sufficient verification practice.

Any application of PoR should be in conjunction with a certified, independent third party, and relied on only in connection to a number of other considerations beyond just onchain proof of assets. This includes encumbrances, offchain liabilities, and shared ownership that may impact the availability of client assets. Only a point in time audit of all assets and liabilities, and broader conditions of the custodial arrangement, can provide a complete and accurate picture of the health and viability of a custodial platform. Unless these other measures are taken, any PoR disclosure would be incomplete and potentially misleading.

Any application of PoR should also consider potential privacy and security issues with PoR, because even with anonymized account identifiers, the public could potentially still glean information about customer activity trends including trading and transfer patterns. For example, Coinbase has measures in place to maintain customers' financial privacy and prevent third parties from being able to track customers' activity based on onchain data every time they send crypto to and from their Coinbase accounts. Coinbase does not support any requirement that would require revealing, especially en masse, wallet addresses to any third parties. We view this as akin to revealing customer private information. Moreover, doing so has the potential of making Coinbase a clearer target to hackers – necessarily narrowing the search space that bad actors would need to consider.

While we recognize that technology like zero knowledge proofs may ultimately mitigate some of these privacy concerns, the technology is not sufficiently mature and operationally robust to mandate such a requirement today. Until such a time as there are

33

formally accepted rules and procedures that define an acceptable PoR audit, it would be inappropriate for PoR to be a requirement.

Even with an established set of rules, it is important to recognize that proof of reserve schemes have only limited value when they are not subject to the same level of audit and assurance required, for example, of a public company registration. With respect to Coinbase, our financials are subject to quarterly external auditor review, and they are filed annually with a federal market regulator, the Securities and Exchange Commission.

Our overarching view is that Proof of Reserves can play an important role in the reporting and disclosure requirements of digital asset custodians, but requiring or relying on such disclosures could be misleading if not properly represented in the context of additional information and verifications – gaps still remain relative to traditional financial audits. While we are optimistic about the possibilities that Proof of Reserves could provide, more work is needed before any requirements are introduced.

Q20: Should crypto asset custodians undertaking multiple services (e.g., brokers, intermediaries) be required to separate custody and other functions into separate legal entities?

Meaningful benefits are derived from combining custody and exchange/broker activities

Due to the seamless peer-to-peer transferability and instant settlement benefits enabled by blockchain technology, the crypto asset ecosystem has naturally evolved to combine custody with other services such as trading and staking. These and other activities can be safely performed by a single intermediary and in a manner that aligns with the regulatory objectives of consumer protection and market integrity. Of course, like with traditional financial market intermediaries, conflicts of interest can emerge, and where they do, they should be mitigated through regulation designed to preserve the efficiencies and risk mitigating benefits of instant settlement, while providing robust consumer protection.

The FCA is proposing to require that crypto asset exchanges establish separate legal entities for all custody-like activities to address potential conflicts of interest. We agree that separation in some circumstances can provide benefits. In fact, as explained in more detail below, Coinbase has already adopted such an organisational structure to accommodate certain bespoke scenarios. However, we do not believe that separate legal entities established for exchange and custody activities should be a universal requirement as doing so could materially damage the ecosystem.

Unlike with securities markets, which require a separate and centralised custodial entity for the purpose of post trade netting and settlement, it is technologically feasible to

combine exchange/brokerage services with custody for digital assets. Doing so allows for real-time (atomic) settlement, in which interconnected legs of a transaction, such as the transfer of a digital asset from one party in exchange for the transfer of funds from its counterparty, are both completed in the same instant or not at all. Importantly, this eliminates counterparty credit exposure, because there is no delay while having to wait for the assets to be moved from the custodian. This benefit comes with no meaningful risk of misalignment between the incentives of the custodian and the exchange. The custodian holds the assets on behalf of users, and the exchange matches orders to buy and sell those assets on behalf of users.

Permitting an exchange to custody assets in proximity to an order matching engine is both economically and technologically prudent. Such arrangements allow a customer to onboard assets, exchange them, and off-board all within a few minutes. This immediacy is fundamental for the broader adoption and utilisation of digital assets because they have consumptive use. They are often required to operate a protocol or application and are purchased in the same manner a consumer would make a purchase at an online storefront. They may also be used as a means of payment, requiring immediate change of ownership and custody. This requires the asset to be delivered onchain to the client. Relying on a single, centralised custodian to manage digital assets in a manner commensurate with traditional custodians, e.g. for securities, which can require multiple days to physically settle for custodial purposes, is impractical.

More generally, and consistent with practices at traditional financial institutions, combining business activities can improve operational efficiencies, create better customer experiences, improve regulatory oversight, and lower overall costs to consumers. Combining functions into a single technology stack offers economies of scope, reducing the number of intermediaries that can charge a fee. An integrated tech stack also results in more streamlined operational processes and smoother interfaces. And all activities at a single entity makes it easier for a regulator to obtain a holistic view of the market by avoiding the need to piece together transactions across multiple intermediaries.

Blockchain provides an opportunity to re-examine traditional market structures

This historical separation of intermediaries – like with brokerage, exchange, and custody in securities markets – is a reflection of the technology available when prior legal regimes were adopted and well before electronic trading let alone atomic settlement technology existed. Quite the opposite – these requirements reflect an era of customer protection that had to navigate paper systems and physical settlement, which spanned days and required trusted intermediaries to facilitate the appropriate checks and balances. FCA requirements should allow firms to take advantage of the efficiency gains from blockchain technology rather than require crypto firms to adapt blockchain technology to legacy infrastructure.

Whether an exchange creates a separate legal entity for custodial activities should depend on the nature, scale, and scope of a firm's customer base and activities. For example, institutional clients may prefer that an exchange maintain their at-rest assets in a separate legal entity for reasons related to commercial preference and/or their own regulatory requirements. And correspondent clearing activities among different regulated financial entities might be better facilitated by a stand alone custodian. But such a requirement should not be mandated for all custodians, particularly those that are operating a digital asset storefront for a variety of clients, the bulk of which may not have a commercial need for separate custody.

Combining custody & brokerage is a common model in traditional finance

Vertical integration is not unique to crypto asset markets. The model of combining different activities within the same group has long been common practice in the traditional financial services industry; we see this model in the prime brokerage services provided by the largest investment banks, CFD brokers, spread betting and a number of other financial services firms. Under these business models, traditional financial services firms may be the broker, the market maker and the custodian, and may provide services to both retail and institutional customers. Custody services are provided alongside other services, all within the same legal entity.

Other conflicts of interest merit more attention than exchange/brokerage plus custody

It is unclear to us what risks the FCA is trying to mitigate by separating custody from other services in the crypto asset industry, and why the CASS framework as currently applied is sufficient for traditional financial services firms (where the volumes and complexity are much greater), but not for crypto asset firms.

Attention would be better focused on conflicts that may arise from:

- **Exchange and broker services,** whereby a broker may be incentivised to route customer orders through an affiliated exchange, irrespective of the customer's best interest.

- **Exchange and market making services,** which can create unfair advantages if the market maker has privileged access to information such as counterparty positions and orders.

- **An exchange issued token that is linked to its own future trading volumes or revenues,** which can create significant conflicts of interest if the issuance is not properly regulated.

The prevalence of the first conflict is predominantly a traditional financial market risk as most digital asset trading platforms provide direct customer access, i.e. a storefront

model, without a fee-generating intermediary brokering the service. With this design, there is by definition no conflict.

The second and third conflicts are reminiscent of the FTX failure, and not an issue of combining custody and broker/exchange services, but an issue related to the misuse of client assets and fraudulent criminal activity that can arise from any financial services activity. Neither of these potential conflicts implicate the combination of custody and exchange/brokerage. Where an exchange/broker is not seeking to make markets or provide liquidity, these two functions do not raise conflicting obligations or incentives.

Therefore, we would respectfully ask the FCA to articulate in more detail what conflict of interest it is trying to solve for in proposing separation of custody and brokerage/exchange activities.

Pre-funding does not give rise to conflicts of interest or confusion over ownership rights

The vast majority of spot trading in digital assets takes place on a pre-funded basis. There is no net settling of transactions. As explained above, this facilitates real time (atomic) settlement – i.e., client assets are available for settlement at the time of trade execution. Because clients, particularly retail clients, frequently move assets on and off platform, from one venue to another, and to self hosted wallets for consumptive use, the exchange generally custodies some portion of assets in onchain hot wallets. As also previously explained, not all assets need to be made available to trade at all times, and through omnibus custody treatment, some of these assets can be more securely placed in cold storage. The precise mix depends on the particular velocity of assets, as determined by the firm based on predicted customer activity.

Many institutional clients, particularly asset managers, often have a lower velocity of transactions, particularly to the extent that assets are held for investment purposes. These assets are often held in cold storage, in a segregated wallet, and custodied at a separate legal entity. These assets, when custodied at a separate legal entity, can still be traded in real time, ahead of moving assets to the exchange, through the provision of trade financing. However, these arrangements are bespoke and generally only economically feasible for large, institutional clients.

Importantly, neither the pre-funded nature of spot trading, nor the decision of where to custody assets, whether at the exchange or at a separate legal entity, gives rise to conflicts of interest. An order matching engine is agnostic to any proprietary information about client assets; it operates according to a rules engine and well-defined and pre-specified order types. There is little scope for conflicts to emerge provided that a platform does not also engage in proprietary trading, by taking the other side of client orders. In those situations, conflicts could emerge if decision-makers were given access to information about counterparty positions and activity by way of the custodial relationship. Similar conflicts of interest exist in traditional financial services (e.g. when a

broker is also a market maker), and these conflicts are managed with information barriers between different activities. But pre-funding of crypto asset trades does not introduce any of these conflicts.

If the FCA moves forward with the requirement to hold custody activities in a separate entity, this could materially impair access to consumer and investment services by precluding firms from placing client funds at the exchange ahead of a transaction. While trade financing can accommodate some clients, particularly large institutional clients focused on investment use cases, this would not be suitable for all clients, particularly retail clients focused on consumptive use cases. More generally, forcing such a separation of activities defeats the purpose of the technology and unnecessarily drives up the costs of execution.

Finally, as set out in previous answers, accurate books and records are critical to preserving ownership rights, which are not affected by prefunding; statutory trusts, and proper record keeping can ensure that ownership rights are preserved notwithstanding any prefunding that might occur. For insolvency, protection of client assets comes from requirements to hold assets 1:1, proper record keeping and reconciliation and restrictions on rehypothecation of client assets. As in traditional financial services, client assets are held on trust and are bankruptcy remote. The more crucial factor for bankruptcy remoteness is that the exchange conducts adequate legal and operational diligence around its holding patterns, contracts and structures to achieve bankruptcy remoteness.

Firms Have Different Trading And Custody Entity Structures For Different Reasons

We note that in section 5.51 of the Discussion Paper, the FCA identified examples where separate custody entities are provided for institutional clients. However, as we explained above, Coinbase offers dedicated cold storage custody as an optional additional premium service, rather than a replacement for exchange custody. Coinbase takes a flexible approach to custody, offering a menu of services optimized for each client's unique needs and priorities. In contrast to a one-size-fits-all model, our solutions include:

- Exchange custody: To trade on the Coinbase exchange, all clients require a custody relationship with the exchange entity where wallets are optimized for trading efficiency; and

- Dedicated custody: Our separate dedicated custody entity provides an additional location for enhanced cybersecurity and safeguarding for assets clients wish to store long-term in segregated cold storage.

While exchange custody focuses on trading optimization, dedicated custody prioritizes security and asset protection. This additional protection is achieved by segregated wallets and cold storage and is not derived from the separation of the legal entities. As we explain above, we caution against rigid legal entity segregation mandates. Instead,

clients benefit most from flexibility and choice in custody models, as well as competition driving innovation and value. Prescriptive legal entity rules risk limiting client convenience and choice without clear advantages in terms of bankruptcy remoteness or conflicts management.

Separation Requirements Depart From 'Same Risk, Same Regulatory Outcome' Principle

Regulation of traditional financial intermediaries permits the combination of custody and exchange/brokerage activities in one entity. Applying separation requirements to crypto asset firms would be a departure from the "same risk, same regulatory outcome" principle. If the existing and globally recognised CASS rules are deemed sufficient for traditional finance markets, they should also be deemed suitable for crypto markets. Separation should be required only in instances where the FCA determines that an authorized firm is unable to comply with the CASS requirements for client assets.

We were concerned to hear from the FCA, at a recent industry roundtable, that the proposal for separation requirements is to ensure "the strongest level of protection" because crypto is a new, global industry, with different maturity and sophistication to traditional financial services.

We strongly believe that any customer protection concern be dealt with through uniform supervision and not by prescribing different standards of regulatory compliance – between crypto and traditional finance. We do not believe it is appropriate for the FCA to impose different rules to a specific community of firms because of supervisory and authorisation gateway concerns. When the FCA applies its proposed requirements, it will be doing so on firms that it has assessed and approved for authorisation to a high standard, including applying investment firm requirements such as SM&CR and others, which should give the FCA sufficient comfort that these firms will be operating to the highest standard of compliance and integrity, negating the need for any disproportionate separation requirements.

Moreover, applying two different rule sets will not be appropriate where traditional financial services firms move into the crypto space. If there is no equivalent separation requirement applied to their crypto activities, this will result in significant regulation-driven level playing field and competition concerns. We also believe that it undercuts other decisions the FCA may have taken in an attempt to remain technology agnostic.

Finally, we do not perceive there to be any need to differentiate between retail and wholesale solutions here. In both cases, it is our view that any conflicts that might exist can be managed in line with existing rules and do not need to be gold plated for crypto assets in either context.

Path forward and other measures

We strongly believe that the FCA should not move forward with its proposal to require a separation of custody and exchange activities. There are bespoke benefits associated with combining these activities, but no meaningful advantages from introducing the requirement; it does not address core conflicts of interest concerns and delivers no meaningful benefits for protection of client assets over and above standard measures that can be taken. Instead, it will introduce significant and unnecessary additional costs for the industry, and would be a clear departure from the "same risk, same regulatory outcome" principle, resulting in clear disadvantages for one industry over another. Separation should only be required as a last resort, where the FCA decides an authorized firm is unable to comply with the CASS requirements for client assets.

There are more proportionate measures that can be taken as an alternative to a separation requirement, including:

- Dedicated resources applied to identify, prevent and manage of conflicts;

- Policies to manage general and specific conflicts;

- Conflicts avoided where possible; and

- Full disclosure given on potential conflicts and the role of the platform when providing services to clients.

In addition, the FCA could require the appointment of senior managers for the different activities, to ensure individual responsibility for best outcomes for clients in relation to those particular activities i.e. to ensure there is no opportunity for the firm to prioritize its own interests over that of its customers, for either exchange or custody activity.

Finally, we do not think that the benefits of mandating separate legal entities outweigh the costs. Instead, the crucial factors for bankruptcy remoteness should be that the exchange conducts adequate legal and operational diligence (e.g. legal opinions) around its holding patterns, contracts and structures to achieve bankruptcy remoteness, that the assets are held 1:1 on trust, and there is proper record keeping and reconciliation.

Q21: Are there any practical issues posed by requiring cryptoasset exchanges to operate a separate legal entity for custody-like activities? Specifically, please could you explain your thoughts on the following:

- **i. Would these issues differ between institutional and retail clients?**

Retail and institutional clients share the high level objectives of operational efficiency, cost effectiveness and making sure their assets remain protected at all times, including in an event of insolvency.

Retail clients are typically comfortable holding their assets either (1) in custody with a trusted exchange or (2) in a self-hosted software wallet or a hardware wallet (such as a Ledger). Typically, retail customers are looking for a cost effective solution depending on whether they value convenience or prefer to have direct control over their private keys. In our experience retail clients usually are not inclined to pay for segregated cold storage or the additional costs associated with having a separate custodial entity.

Institutional clients will typically rely on a trusted intermediary to act as a custodian of their assets. The custodian could be an exchange, a broker, or a monoline custodian. These clients tend to be more willing to pay a premium for a segregated cold storage custody facility, given the correspondingly higher value of greater security over a larger pool of assets and potential duties they owe to their underlying clients. An institutional client will choose a solution based on whether the relevant holdings are intended to be readily available for trading or intended to be held securely for a longer period of time.

Institutional participants in crypto markets tend to have larger holdings, and as such may be more sophisticated and more attuned to risk, and they perform rigorous due diligence on their service providers. In particular they are typically focused on:

- Bankruptcy remoteness (verifying the assets are held on trust and will not be available to satisfy claims of any other creditors of an insolvent custodian);

- Transparency and making sure that they have access to sufficient information to remain assured of the custodian's financial soundness and operational resilience;

- Cyber-security; and

- Operational systems and controls (e.g. SOC reports).

Crucially, all of the above objectives can be satisfied within a single legal entity that offers trading and execution services, custody, and even other services such as collateral management or financing. This is similar to traditional finance where investment firms can provide prime brokerage and other packages of services that include elements of trading,

custody, collateral management and financing, all from the same legal entity. Asset safeguarding can be achieved through the use of trusts and sensible client asset rules (similar to CASS). Furthermore the type of conflicts that are of greatest concern to clients are those that relate to proprietary trading and misuse of their position or transaction information (e.g. to front-run their orders). Their concerns do not relate to providers offering a package of exchange/brokerage services that includes agency/riskless principal trading and custody.

- **ii. What would be the operational and cost impact?**

We recently evaluated the impact for our MiCA entity structure and considered whether to create separate legal entities for trading and custody even though MiCA does not require such a separation. We estimated the impact of significant duplicated costs and compliance burdens:

- Multiple entities needing to apply for authorisation;

- Legal entity establishment costs;

- Legal, finance and accounting fees for multiple entities;

- Prudential requirements such as minimum capital buffers;

- Separate business plans; and

- Separate personnel including executive directors, non-executive and senior managers.

The majority of the costs are associated with doubling the substance requirements for an additional regulated entity. We also think that the main concerns that give rise to calls for separation of trading and custody functions can be adequately managed within a single legal entity:

- **Conflicts of interest:** whilst we are unclear what conflicts of interest the FCA is referring to, similar to MiFID investment firms (and our discussion above), conflicts of interest across multiple activities can be managed within the same legal entity pursuant to Principle 8 of the FCA's Principles for Businesses as supplemented by the rules and guidance in SYSC 10.

- **Bankruptcy remoteness:** can be achieved by the custodian holding the assets on trust for the benefit of its clients and ensuring that each client's entitlements are accurately recorded on its books and records. Having a separate legal entity does not change this characterisation.

We note that in traditional finance MiFID investment firms frequently provide a combination of trading, custody and financing services from within the same legal entity.

42

Some clients prefer the operational convenience and cost efficiency of obtaining the package of services from a single counterparty such as a prime broker. For clients that prefer to have a monoline custodian they can select such service providers, however this should not prevent the existence of other business models.

- **iii. What are the benefits to clients of cryptoasset exchanges pre-funding trades? Can these be achieved if there is legal separation of entities?**

As set out in more detail in our answer to Question 20, crypto exchanges generally require that clients pre-fund their transactions by transferring the necessary assets to the exchange's trading wallets ahead of time. This has a number of benefits. Primarily it ensures that the client cannot enter into a transaction for which it does not have the necessary assets available to settle. This prevents settlement failures and keeps a venue from needing to assume credit or settlement risk on the client's trade.

If the FCA moves forward with the requirement to hold custody activities in a separate entity, this could materially impair access to consumer and investment services by precluding firms from placing client funds at the exchange ahead of a transaction. While trade financing can accommodate some clients, particularly large institutional clients focused on investment use cases, this would not be suitable for all clients, particularly retail clients focused on consumptive use cases. More generally, forcing such a separation of activities defeats the purpose of the technology and unnecessarily drives up the costs of execution.

We do not think that the benefits of mandating separate legal entities outweighs the costs. The more crucial factor for bankruptcy remoteness is that the exchange conducts adequate legal and operational diligence around its holding patterns, contracts and structures to achieve bankruptcy remoteness. This includes precise ledgering and account agreements designed to provide bankruptcy remoteness.

- **iv. Would separating custody and exchange functions impact the way clients' accounts are managed and structured (in omnibus and individual client wallets)?**

No, separating custody and exchange functions would not impact the way clients' accounts are managed or structured. The benefits of omnibus wallets in a retail and trading context stands, and segregated clients assets would continue to be used by institutional customers with a buy-and-hold investment approach, prioritizing transparency at the blockchain level, at the expense of immediate trade execution.

- **v. Do you agree that the conflicts of interest we have identified exist? Are there other conflicts of interest we should consider?**

The Discussion Paper notes that potential conflicts of interest may arise because of the multiple services that cryptoasset exchanges provide. However, there are different combinations of activities in crypto asset markets, which carry different degrees of risk with regards to conflicts of interest, including: (1) exchange and broker services, whereby a broker may be incentivised to route customer orders through an affiliated exchange, irrespective of the customer's best interest; and (2) exchange and market making services, which creates unfair advantages if the market maker has privileged access to information such as counterparty positions and orders. An exchange's issuance of a token that is linked to its own future trading volumes or revenues may also raise concerns.

In contrast, for exchange services and custody of assets, blockchain-based recordkeeping has both enabled this combination and made it more efficient than in the traditional financial system. An exchange business matches supply and demand. Where an exchange is not seeking to make markets or provide liquidity, these two functions do not raise conflicting obligations or incentives. It is therefore unclear to us what conflicts of interest the FCA is trying to solve for in proposing separation of custody and exchange/broker activity, into different entities.

We disagree with the statement in the Discussion paper that providing multiple services within one entity can mean that the distinction between what is a client asset versus what is the custodian's asset can be unclear to clients; at no point should a custodian take ownership of client assets. Critical to safeguarding customer assets are requirements to hold assets 1:1 with appropriate internal ledgers, to ensure client assets are segregated, record keeping and reconciliation, and preventing client assets being rehypothecated unless that is what customer expressly directs.

In general, we consider that conflicts of interest can be managed through other means, without needing legal separation. Legal separation will increase costs to clients, could introduce potential frictions and vulnerabilities during trading activity, and cause operational inefficiencies. Whilst it should be an option to operate a separate exchange and custody arrangement, it should not be mandatory.

- **vi. Are there alternative ways to ensure the same level of consumer protection?**

As set out in our answer to Question 20, mitigating conflicts of interest does not necessarily mean forcing platforms into the same market structure as traditional finance, or disaggregating functions. There are a number of lessons we can learn from traditional finance for managing conflicts and there may be more proportionate measures that can be taken including:

- Dedicated resources to identify, prevent and manage of conflicts;

44

- Policies to manage general and specific conflicts;

- Conflicts should be avoided where possible; and

- Full disclosure on potential conflicts and the role of the platform when providing services to clients.

We believe that conflicts can be appropriately managed via the processes set out above, and perhaps made more specific to capture particular areas of concern for the FCA around exchange versus custody conflicts, rather than mandating legal separation.

Q22: What role do you consider that custodians should have in safeguarding client money and redemption? What specific safeguards should be considered?

Client money

With respect to client money requirements, generally we agree with the FCA's approach, although we would raise the question around clarity in relation to client money versus payment services. Generally to date crypto asset firms have operated on the basis of requiring payment services permissions given that this has generally fitted better with the nature of the services being performed - given that CASS client money requirements can currently only be used in connection with investment services.

We would therefore advocate for further views from the FCA on how the application of client money rules to crypto assets would interact with existing payment services permissions, and the extent to which crypto firms with payments permissions would be required to obtain client money permissions.

To the extent that client money rules are mandated for crypto asset firms, we would advocate for a review of CASS 7 to ensure that it appropriately reflects the nature of the way in which fiat to crypto trades are carried out, and pre-funding processes (particularly in the context of smart order-routing).

Redemption

While the FCA's proposed redemption model rightly puts the regulatory and legal obligation to redeem on the issuer, the issuer should be free to engage in commercial solutions that outsource parts of the redemption process to exchanges or other entities that may have great access to the stablecoin user base. This is a practical response given many issuers design their process in a way that restricts redemption to wholesale users e.g. exchanges. Even where issuers and exchanges partner to facilitate redemption, legal liability must always remain on the issuer to redeem.

Chapter 6: Organizational Requirements

Q23: Do you agree that our existing high-level systems and controls requirements (in SYSC) should apply to the stablecoin sector? Are there any areas where more specific rules or guidance would be appropriate?

The requirements in SYSC are a clear example of how the e-money regime would be a more appropriate basis upon which to regulate stablecoin issuance:

- As a "modified e-money firm" (if HMT's proposed way forward was adopted), a stablecoin issuer would be subject to a broad range of requirements in SYSC as they apply to an EMI, including outsourcing requirements and operational resilience. We agree that anything in SYSC that applies to e-money firms, should apply to stablecoin issuers;

- But SM&CR, which does not apply to e-money and payments firms in the UK, should not apply to stablecoin issuers as it was created in the wake of the financial crisis, to cover firms that provide ongoing investment and other financial services to customers, to improve standards and accountability. Stablecoin issuance ultimately involves the issuance of an asset, redemption of that, and safeguarding in between, in a very similar way to how an e-money firm operates - therefore if SM&CR is not applicable to e-money firms, it is our view that it should not apply to stablecoin issuers.

With respect to custody of stablecoins, we agree with the intention to make this activity akin to the regulated activity of safeguarding and administration of securities, as further described below and as proposed by HMT in its consultation response in October 2023 in respect of wider crypto assets. As we put forward in our response to Question 21, we would suggest harmonising both stablecoin and wider crypto asset custody under one regime simultaneously and thereby applying the FCA's proposed regime for stablecoin custody, and the wider intentions behind crypto asset custody more generally, into one phase.

Q24: Do you agree with our proposal to apply our operational resilience requirements (SYSC 15A) to regulated stablecoin issuers and custodians? In particular:

> **i. Can you see how you might apply the operational resilience framework described to your existing business (e.g, considering your important business services and managing continuity)? Please set out difficulties with doing this.**

Yes, we agree the operational resilience requirements should apply to stablecoin issuers (as per the requirements on e-money firms) and custodians (as per the requirements on securities custodians).

- **ii. What approach do you take when assessing third-party providers for your own internal risk management (such as responding to, testing, and managing potential disruption)?**

As an e-money firm in the UK, Coinbase complies with the SYSC 15A operational resilience requirements as they apply to e-money firms, when assessing third party providers. Our view is that this position should be adopted equally for stablecoin issuers and custodians, in the same way.

- **iii. Are there any minimum standards for cybersecurity that firms should be encouraged to adopt? Please explain why.**

Fiat-backed stablecoin arrangements, because they custody reserve assets at a centralised financial institution, face many of the same operational risks as with traditional payments systems. For example, to process issuance and redemption transactions, information from the blockchain must be sent off-chain to a custodian; these communications between the issuer and the custodian should be protected by high standards of information security. The issuer should follow best practices in vetting the custodian and any other entities performing important functions within the stablecoin arrangement. And, as for any process controlled by human beings on a day-to-day basis, certain types of operational risk – physical security risk, the risk of fraud or malfeasance, and basic fat-finger error risk – cannot be eliminated but can be managed effectively.

The blockchains themselves also present novel forms of operational risk, where minimum standards will need to be developed in terms of risk management. While blockchains have no single point of failure and can be more resilient than centralized payment systems in some respects, they introduce new risks related to programming errors and software bugs. Moreover, blockchains vary widely in terms of their security guarantees, resilience against malicious attacks, and extent of decentralization – on some blockchains, a centralized developer team maintains a high level of control, whereas others rely on agreement among a disparate set of validators. Other potential risks could arise from the security arrangements associated with any super-users of a stablecoin smart contract – for example, if a small number of core developers are empowered to push through updates to the smart contract code in an emergency, strong safeguards must be in place to prevent malicious use of these special powers.

Best practices for development should apply not only to the blockchain itself but at the level of stablecoin smart contracts too. A stablecoin is only as good as the blockchain on which it runs, or if a stablecoin runs on many blockchains, as good as the weakest one. Operational problems could disrupt stablecoin holders' access or even cause them to lose their money. Before a stablecoin is deployed, a blockchain should reach a sufficient level of maturity in accordance with best practices for development, including testing, detecting bugs, and deploying fixes. The importance of these technical issues will grow

as the total amount of stablecoins increases over time. To reach sound, well-informed decisions on stablecoins, regulators will need to develop greater fluency in these areas of technical expertise and integrate them into policymaking processes.

Fiat-backed stablecoin issuers should be subject to high standards that cover a wide range of areas that could affect stablecoin holders. These would include cybersecurity including establishing an Information Security Management Program with policies, procedures, and standards to manage information security risks and drive the administrative, technical, and physical protections for digital assets.

Additionally, privacy safeguards to prevent hacks and protect stablecoins holders' personal information, operational risk and business continuity measures to sustain uptime, and a compliance program to prevent financial crimes.   In most cases, these standards can be developed based on the existing standards that apply to banks today, tailored in an appropriate manner to reflect the differences in stablecoin issuers' business model and risk profile.

Q25: Do you agree with our proposal to use our existing financial crime framework for regulated stablecoin issuers and custodians? Do you think we should consider any additional requirements? If so, please explain why.

Yes, we agree that the fincrime framework as it stands today is sufficiently flexible to deal with different business models.

However, in crypto markets, we would note that the FCA's general approach is that there is no such thing as a low risk customer, so there is no opportunity to do simplified due diligence. In certain circumstances, for example the redemption of regulated stablecoins, we believe it should be justifiable to use simplified due diligence where risk is low - regulated stablecoins will, by their nature of being heavily regulated, be low risk assets. In short, there should be a payments-focused approach to KYC, rather than a crypto asset approach, to ensure a "same risk, same regulatory outcome" with payments.

Q26: Do you agree with our proposal to apply our existing Senior Managers and Certification Regime to regulated stablecoin issuers and custodians? In particular:

- **i. Should we apply the current SMR and requirements to issuers and custodians of regulated stablecoins? Are there additional SMFs or requirements needed to capture the nature of regulated stablecoin business services?**

It is appropriate to apply the Senior Managers Regime to custodians. However, as noted in our response to question 23 above, we are concerned that the FCA is applying an

investment firm regime to stablecoin issuers, that is a departure from the requirements applied to other payments firms e.g. e-money, and a departure from the regime proposed by HMT in its consultation response of April 2022.

Application of the senior manager regime to stablecoin issuers is another example where the FCA is proposing a more onerous regime than that applied to e-money, and we ask for greater consistency in approach. Issuers of stablecoins do not present additional risk vis-a-vis e-money issuers that cannot be dealt with via proportionate amendments to the existing e-money regime.

- **ii. Should we create additional criteria to determine when the 'enhanced category' of the regime should apply to regulated stablecoin issuers and custodians?**

No.

- **iii. Should we apply the current certification functions and requirements to regulated stablecoin issuers and custodians? Are there any additional functions needed to capture the nature of regulated stablecoin issuers and custodians business services?**

It is appropriate to apply the Certification Regime to custodians. Again, however, we are concerned that the FCA is applying an investment firm regime to stablecoin issuers, that is a departure from the requirements applied to other payments firms e.g. e-money. Issuers of stablecoins do not present additional risk vis-a-vis e-money issuers.

- **iv. Do you agree that we should apply the existing Conduct Rules to regulated stablecoin issuers and custodians?**

It is appropriate to apply the Conduct Regime to custodians. Again, however, we are concerned that the FCA is applying an investment firm regime to stablecoin issuers, that is a departure from the requirements applied to other payments firms e.g. e-money. Issuers of stablecoins do not present additional risk vis-a-vis e-money issuers.

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Chapter 7: Conduct of business and consumer redress

Q27: Do you agree with our consideration to apply our Principles for Businesses and other high-level standards to regulated stablecoin issuers and custodians? Are there any particular areas you think we should apply detailed rules regarding information to (other than those for backing assets set out in Chapter 3)?

Yes, we agree with the application of the FCA's Principles for Business and other high level standards to regulated stablecoin issuers and custodians.

Q28: Do you consider that we should design more specific conduct of business rules to regulated stablecoins issuers and custodians? In particular, what approach should we take to applying rules on inducements and conflicts of interest management to regulated stablecoin issuers and custodians?

It is appropriate to apply the Conduct of Business rules to custodians. The Conduct of Business rules should be aligned with the conduct of business sourcebook (COBS), albeit there may be parts of COBS that are not appropriate due to the way in which crypto asset markets operate.

With respect to the statement in paragraph 7.13, stating that stablecoin use cases may expand to be used for investments as well as payments in the future, we strongly disagree and do not believe that this premise should be used to broaden the requirements of COBS that apply to stablecoin issuance. The regulatory regime being discussed here is designed to create safe, stabilised crypto assets that do not fluctuate in value, in the same way that fiat currency does not. Therefore, stablecoins cannot, and indeed should not, be used for investment purposes in the same way that consumers do not "invest" in fiat currency. This is particularly true to the extent that the stablecoin issuers are not permitted to pay interest to holders. Consumers can invest fiat currency into other products (for example ISAs) and receive a return, but in that case the regulated product is the ISA, not the fiat.

COBS should apply to stablecoin issuance only to the extent that COBS applies to e-money firms (with appropriate amendments to reflect the nature of the asset), and not apply wider investment firm requirements such as:

- Any requirements relating to client classifications (COBS 3), which are only appropriate for investment firm activity in order to ensure appropriate protections for retail customers from higher-risk investment products, which regulated stablecoins are not

- Suitability and appropriateness requirements (COBS 9 and 10), which again are designed to appropriately categorise investment products

- Certain transparency requirements such as COBS 13 and 14, which in part may be suitable for stablecoins to provide basic transparency but in general are highly focused on investment products which have risk and volatility associated with them (for example, production of key features documents which are required to outline the "*material benefits and risks of buying or investing*", which in our view is clearly inappropriate for a product designed to have a stable fiat value)

- Generally not applying any of COBS to the extent that it is predicated on the activity being "designated investment business" (for example COBS 8), as stablecoins are not investment products

Requiring issuers of regulated stablecoins to apply sections of COBS designed for investment products – e.g., to provide disclosures, transparency, reporting, Key Information Documents, and the like – is unnecessary and not expected of a payment instrument. It is also impractical. Unlike an investment scheme, whose conditions change over time, the ubiquity of a stablecoin relies on the constancy of its design and use. Confirming this constancy through disclosures and any other reporting obligations is more appropriately and efficiently done by a single regulator than chasing millions of users.

Q29: Do you agree that the dispute resolution mechanisms provided in traditional financial services (ie the application of the DISP sourcebook and access to the Ombudsman Service) should be applied to the business of regulated stablecoin issuers and custodians? Have you identified any gaps or issues in relation to dispute resolution? Please explain.

Yes.

Q30: Do you agree that the FCA should not be proposing to extend FSCS cover to the regulated activities of issuing and custody of fiat-backed stablecoins? If you do not agree, please explain the circumstances in which you believe FSCS protection should be available.

Yes. We agree that FSCS coverage should be available for the regulated activities of issuing and custody of fiat-backed stablecoins. Moreover, we do not believe that this activity poses high risk. A well designed, appropriately capitalized, and properly regulated stablecoin poses little risk to its users. Unlike with banks or investment companies, issuers do not engage in lending or other risky activities commensurate with the typical need for an insurance scheme.

Chapter 8: Prudential requirements

Q31: Do you agree with our proposed prudential requirements for regulated stablecoin issuers and custodians? In particular, do you agree with our proposals on any of the following areas:

- **i. Capital requirements and quality of capital**

Approach

We broadly agree with the FCA's identified goals for prudential requirements: to enable a firm to remain financially viable through economic cycles, to be able to afford to put right any harm that it causes, and to enable an orderly wind-down. Nonetheless, we believe the requirements proposed by the FCA are very likely to exceed the levels necessary to achieve these goals.

First, the FCA's proposed capital regime would impose requirements at multiple points in a stablecoin arrangement – to both issuers and custodians of regulated stablecoins, in addition to the separate capital requirements that would already apply to the custodian of a stablecoin's reserve assets.

Second, the requirements include a k-factor for both the custodian and issuer of stablecoins. While the Discussion Paper does not specify how the FCA intends to calculate k-factors (K-CUC and K-CII, for custodians and issuers respectively), these specifics will be of critical importance to whether a healthy GBP-denominated ecosystem can develop in the UK. Given that the concept of k-factors is drawn from the investment firm regime, we are concerned that it may lead to requirements that are unnecessarily complex – and ultimately too high – as applied to firms with much simpler business models and risk profiles than traditional investment firms.

- **Custodians***: Custodians of traditional financial assets are subject to investment firm capital requirements that include a k-factor. In principle, as stated above, we agree with the FCA's goals for prudential regulation, and we also broadly agree with the importance of maintaining alignment to the extent appropriate across traditional finance and crypto assets. However, the business of an investment firm is not an apposite comparison to the specific, narrow activity of holding stablecoins in custody. A custodian of stablecoins would be holding on behalf of its customers only a single type of asset, regulated stablecoins, which itself is subject to capital and liquidity requirements as well as redemption rights from the issuer. The primary burden of maintaining high standards of consumer protection will already have been largely upheld by the issuer of the stablecoin and the custodian of its reserve assets by the time the stablecoin custodian interacts with a customer. Should the need arise, the process for transferring stablecoins (e.g. to another digital wallet controlled by a customer, including in the event of an

insolvency) can be executed much more quickly and simply than in a similar case involving securities held by an investment firm. Of course, additional complexity may arise to the extent that the custodian is holding other types of assets, beyond only regulated stablecoins, and we agree that custodians of crypto assets more generally should be subject to prudential requirements. However, this should be considered as part of the regulatory framework for crypto assets more generally; in our view, it would not be appropriate for the FCA to take such risks into consideration in a Discussion Paper that, by its terms, addresses only stablecoins.

- **Issuers**: With regards to issuers, we see no material differences in the risk between stablecoin issuance and e-money issuance, and it is unclear to us why the FCA has decided to introduce capital requirements that are more akin to the investment firm prudential regime, which goes over and above the e-money regime. While we agree that capital should be set aside to cover operational and financial risk, an overly complicated k factor application could ultimately misprice risks that are otherwise readily quantifiable through standard methods.

Capital Analysis for Issuers of Stablecoins

Although Coinbase is not a stablecoin issuer, stablecoins are a critical component to the digital economy, and as such, we have undertaken a rigorous quantitative analysis to assess what levels of financial resources, including a capital buffer, the issuer of a fiat-backed stablecoin should maintain. The purpose of the exercise was to better understand and quantify the risks associated with stablecoins as it relates to our activities.

The initial results of this analysis indicated that, if the stablecoin's reserves are composed entirely of highly safe, liquid assets – such as highly rated sovereign debt securities maturing in less than 90 days, and deposits at regulated financial institutions – then the stablecoin's exposure to financial risks can be minimal. Our initial estimates depended significantly on assumptions regarding the accounting treatment of reserve assets – i.e., approximately 20 basis points under held to maturity (HTM) assumptions, and 36 basis points under available for sale (AFS) assumptions. Given this composition of assets, a minimal capital buffer would be sufficient to fully protect stablecoin holders against all categories of financial risk, including credit risk and market risk.

The stablecoin's remaining risk exposures are operational in nature. In our exercise of estimating operational risks we considered a bottom-up, scenario-based methodology that proceeded as follows. First, we identified all of the potential categories of operational risk events. This included, for example, activities related to minting, reserve reconciliation, illicit financial transactions, theft, loss, misuse of assets, cyber incursions, and data breaches.

Then, for each category, we estimated the probability of an operational risk event occurring and the magnitude of financial losses that would be realized if it does. In the final phase of the analysis we calibrated and extrapolated the probability/loss distribution curves to ascertain the amount of capital necessary for sufficient certainty that all reasonably foreseeable losses are adequately addressed, with an additional margin for error.

As with any analysis of this nature, the results are sensitive to a wide range of factors, including expert judgments and assumptions regarding such matters as the likelihood of events that may range from 'vanishingly improbable' to 'not in a million years.' While the crypto asset industry does not have a long history with which to calibrate results, many aspects of operational risk can be extrapolated from the traditional financial system. Based on these assumptions, our estimates supported an operational risk capital buffer of between 39 and 76 basis points.

Hence our initial findings indicate that a capital buffer of a well-structured and properly regulated stablecoin on the order of one percent of the total amount of stablecoins outstanding should be sufficient to protect against financial and operational risks for an issuer that maintains a reasonably effective risk management program. We would welcome the opportunity to discuss these analyses with the FCA.

- **ii. Liquidity requirements and eligible liquid assets**

Although we disagree with the FCA's overall proposed approach on prudential requirements, as set out in our answer to Q31(i), we are not opposed to the specific points raised in this section, including the types of assets that a firm may use to satisfy these requirements. We do not believe that the additional liquidity upon which a regulated stablecoin issuer may draw to "top up" the backing assets in the event of a shortfall should be restricted to a narrower range than is provided in paragraph 8.46.

- **iii. Group risk**

We certainly agree with the FCA that the regulatory tool of traditional prudential consolidation is not appropriate for crypto asset firms, and we appreciate the importance of reducing the risk that being part of a group may lead to potential sources of harm to a stablecoin issuer or custodian. However, it is not clear to us that the creation of even a simplified regime, such as the FCA is currently minded to suggest, is necessary or beneficial.

In particular, we caution the FCA against an approach that would purport to bring the parent or affiliates of a stablecoin issuer or custodian within scope of the FCA's regulatory remit, particularly where, for example, the regulated issuer or custodian is able to demonstrate sufficient financial and operational resilience of its own and is not otherwise reliant on the creditworthiness of its parent for funding.

Further, it should be noted here that, from the perspective of consumer protection and the need to have capital to manage firms' solvency, the key risk element of a stablecoin solution is the safeguarding of the backing assets, and the entity that holds those. In the present proposal, the FCA intends to adopt a safeguarding regime for backing assets which is very similar to e-money (or in some cases more restrictive). The safeguarding bank that holds the backing assets will be subject to prudential consolidation and will hold appropriate capital to manage its capital requirements in relation to the backing assets. It therefore would appear to be unnecessary to do the same at the issuer or custodian level – given that e-money capital requirements are not subject to group consolidation in part due to the reliance on an external safeguarding bank, we would therefore advocate for the same position with respect to regulated stablecoins.

- **iv. Concentration risk**

We are generally neutral on the FCA's proposed approach in respect of concentration risk. We appreciate the FCA's recognition that concentration risk is one element of good risk management, and that smaller regulated stablecoin issuers may require greater proportionality given the smaller absolute size of their exposures. We anticipate that regulated stablecoin issuers and custodians will be relatively quick to coalesce around best practices, and in the meanwhile the FCA should take care that any applicable requirements are drawn up so as not to impede the development of the industry.

- **v. Internal risk management**

We are generally neutral on the FCA's proposed approach in respect of internal risk management. Coinbase has on many occasions expressed support for the importance of effective risk management in the crypto industry, as we do here as well. At the same time, however, we remind the FCA that any stablecoin issuers in scope of this regime are, by definition, not systemically important, and caution against application of individual capital adequacy and risk assessment requirements developed in a different context for investment firms with very different business models and risk profiles from the stablecoin issuers and custodians considered in this Discussion Paper.

Chapter 9: Managing stablecoin firm failure

Q32: Do you agree with applying the existing CASS rules on post-failure treatment of custody assets to regulated stablecoin issuers and other firms holding backing assets for regulated stablecoins, as well as CASS pooling events? If not, why not? Are there any alternative approaches that should be considered? If so, please explain.

We broadly agree with application of the existing CASS rules as described in the Discussion Paper.

Q33: Do you agree with our thinking on how the CASS rules can be adapted for returning regulated stablecoin backing assets in the event of a firm failure or solvent wind-down? If not, why not? Do you foresee the need for additional protections to ensure prompt return of backing assets to consumers or otherwise reduce harm in firm failure (e.g., strengthening wind-down arrangements, a bespoke resolution regime)? If so, please explain.

We broadly agree with the FCA's thinking and proposed distribution process in the event of a firm's failure or solvent wind-down. In this context, we note that there may be tension between the competing objectives of returning backing assets as quickly as possible, and maximizing the ultimate recovery. In other words, it may be the case that liquidating assets quickly could lead to a lower return than if the same assets had been held and liquidated over a longer period of time. This is not likely to be a major concern for regulated stablecoins, as the reserves are expected to be highly safe and liquid. Nonetheless, it may help make the distribution process more efficient and further reduce the risk of market dislocation for the FCA to expressly provide that a firm (or an insolvency practitioner appointed over the firm) to have access to a secured financing, using the regulated stablecoin reserves as collateral. This mechanism would enable the firm (or insolvency practitioner) to have both access to liquidity to satisfy claims quickly as well as time to maximize recovery.

Q34: Do you agree with the proposed overall approach for post-failure trading? If not, is there anything else that should be considered to make the approach more effective? If so, please explain. Are there any arrangements that could avoid the distribution of backing assets in the event an issuer fails and enters insolvency proceedings?

We agree with the proposed approach for post-failure trading, in particular the FCA's view that secondary trading of a regulated stablecoin should continue notwithstanding the failure of a stablecoin issuer. In such circumstances, many stablecoin holders may prefer to receive assets onchain in exchange for their claims, rather than to receive backing

assets, such as fiat currency or securities, that cannot be held in a digital wallet. So long as secondary trading continues, holders would be able to trade their stablecoins, and corresponding claims, in exchange for onchain assets from other parties who may prefer to participate directly in the administration of claims and distribution of backing assets.

Q35: What challenges arise when stablecoins are returned to consumers, particularly with respect to their entitlements? Do you foresee the need for additional protections to facilitate the prompt return of regulated stablecoins to consumers or otherwise reduce harm in firm failure (e.g., introducing distribution rules within CASS for cryptoassets, strengthening wind-down arrangements, or a bespoke resolution regime)? If so, please explain.

The creation of a bespoke resolution regime is a potentially promising regulatory innovation, and Coinbase is generally supportive of giving it further consideration. However, we believe this issue is best considered in relation to custody of crypto assets of all kinds, not only of regulated stablecoins in isolation. We would welcome the opportunity to continue discussing these issues with the FCA as the approach for crypto asset custody further develops.

Chapter 10: Regulating payments using stablecoins

Q36: Do you agree that this approach to integrating PSR safeguarding requirements and custody requirements will secure an adequate degree of protection for users of stablecoin payment services?

Yes, we agree.

Q37: Do you agree that the custody requirements set out in Chapter 5 should apply to custody services that may be provided by payment arrangers as part of pure stablecoin payment services?

Yes, we agree, with one core comment around PSPs that custody stablecoins within a payment flow. We consider that it will be unattractive to PSPs for them to be responsible for taking on custody obligations in respect of stablecoins, given that these are proposed to be significantly different from what the PSP is subject to under the PSRs. This will potentially put a block on PSPs seeking to adopt new models given the high burden of regulation involved.

Accordingly we would suggest that the FCA considers expressly allowing a model whereby a PSP can appoint a third party custodian that would have regulatory and operational responsibility for custody of the stablecoins as they pass through the PSP's payment flows; the idea being to allow the PSP to integrate stablecoins into their models easily, and integrate with existing regulated stablecoin custodians that can enable PSP activity using their existing frameworks.

Q38: Are there additional risks or opportunities, not considered above, of different stablecoin payment models that our regulation of payment arrangers should seek to tackle or harness?

No further comment.

Chapter 11: Overseas stablecoins used for payment in the UK

Q39: What are the potential risks and benefits of the Treasury's proposal to allow overseas stablecoins to be used for payments in the UK? What are the costs for payment arrangers, and is the business model viable?

The Case for Overseas Stablecoins

We support the FCA's proposal to allow non GBP denominated stablecoins to be used in UK payments. We believe this will bring significant benefits to UK customers by introducing greater competition and consumer choice in the market. Stablecoins are the entry point for DeFi and Web3, and a flourishing stablecoin market will put the UK on the map as a global crypto asset hub.

While the UK should promote a flourishing GBP stablecoin market - i.e. by allowing stablecoins to compete on a level playing field with other forms of digital money - this will take some time to develop, and the UK should allow robust - fiat backed 1:1 in highly liquid assets - overseas stablecoin arrangements (such as USDC) to operate as a means of payment in the UK.

Global Coordination and Equivalence Frameworks

A significant challenge for global stablecoin issuers is regulatory fragmentation: how to comply with different regulatory regimes across multiple jurisdictions. Stablecoin arrangements are global by nature, and the application of different and conflicting regulatory regimes will fragment liquidity pools. Global collaboration and coordination is necessary for global stablecoins.

We agree with the FCA proposal that overseas stablecoins should meet equivalent standards to the UK regime. This will ensure that consumers will continue to have an appropriate degree of protection. However, we also believe that overseas stablecoins should not be required to adhere to UK specific rules, i.e. a line by line assessment of equivalence, and instead any assessment of equivalence should be outcomes based. We believe that there is a role for the FCA in determining if there are certain jurisdictions whose rule sets are deemed UK equivalent. It may be that some stablecoins, regulated in other jurisdictions deemed equivalent, could be used in the UK without a payment arranger.

With equivalence in mind, it is also important the UK does not introduce a significantly more stringent regime than other regimes around the world, otherwise equivalence will not be possible and no overseas stablecoin will be able to operate in the UK; for example, we note that the proposed UK stablecoin regimes goes further than the EU with regards to capital requirements, separate entity for custody, and further still more significant

requirements when the stablecoin becomes systemic (e.g. ban on interest on reserves, cap on individuals holdings).

Payment Arrangers Acting As Approvers

In principle, payment arrangers acting as approvers is an interesting model. However, it is unclear how this model would apply to overseas stablecoins being held by UK users, but that are not being used in UK payments. Whilst the proposed framework applies to all fiat backed stablecoins, it would not make sense for a payment arranger to approve overseas stablecoin arrangements that are not being used for payments in the UK. For example, we feel it should be possible for overseas stablecoins to be used as a store of value or as a trading pair against other crypto assets without needing to be "on-shored" by a payment arranger, as in those cases the stablecoin is not being used for payments and therefore should fall outside of this regime. To not allow this will amount to a de facto ban on the holding of overseas stablecoins by UK residents unless they have been on-shored by a payment arranger. We would therefore believe that the payment arranger model should only apply in cases where an overseas stablecoin is to be used for payments, and not for simple store of value or trading pair against other crypto assets.

The other point we would make is around the liability attaching to payment arrangers and how potentially punitive that could be, as further described in the response to question 40 below.

Q40: What are the barriers to assessing overseas stablecoins to equivalent standards as regulated stablecoins? Under what circumstances should payment arrangers be liable for overseas stablecoins that fail to meet the FCA standards after approval, or in the case where the approval was based on false or incomplete information provided by the issuer or a third party?

Whilst the idea of using payment arrangers as approvers for overseas stablecoins is interesting, we are concerned that the liability on the approver may limit the number of arrangers in the market willing to take on this role. The FCA suggests some carve outs e.g. not hold payment arrangers responsible for the approved stablecoin failing to maintain its peg. However, a better approach in our view - so that arrangers could become more comfortable with the risks - would be for the rules to set out everything the approver would be liable for (instead of saying the approver is liable for everything with a few exceptions). For example, an arranger should make reasonable efforts to confirm that a stablecoin issuer meets certain requirements such as reserves, governance and bankruptcy remoteness, and the redemption model should be public and have parity with UK regime requirements.

This will provide greater clarity and limitations on the responsibility and liability placed on the arranger. Throughout the process of creating these rules it should be borne in mind that the payment arranger is not the issuer of the stablecoin, nor the custodian, and cannot influence how the issuer or custodian makes decisions on a day-to-day basis. Nor indeed will they be able to control how the stablecoin is used within the UK either, unless they are granted some form of exclusive distribution arrangement - even then given the open-loop nature of stablecoins, they will not be able to control all uses of the asset that they have approved.

The liability regime should be designed around that premise to ensure that payment arrangers do not become responsible for things they simply cannot control, and instead focus on what they can control, which in broad terms is the requirement to have done appropriate due diligence, and keep that due diligence up to date. Beyond that, it is difficult at this stage to see what else a payment arranger should be actively responsible for, based on what they are likely to have control over.