

To:

Andrew Griffiths MP
Economic Secretary to the Treasury
1 Horse Guards Road
London
SW1A 2HQ

April 2023**Consultation and call for evidence on the future financial services regulatory regime for cryptoassets**

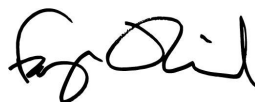
Coinbase Global, Inc. and its UK subsidiary CB Payments Ltd. (together, Coinbase) welcome the opportunity to respond to the UK Government's consultation and call for evidence on the future financial services regulatory regime for cryptoassets (Consultation).

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 US and provide a trusted and easy-to-use platform relied on by millions of verified users in over 100 countries around the world to access the broader crypto economy.

Coinbase is committed to the UK, where we have a significant presence reflecting its importance as our largest international market outside of the US. The Government has taken a leadership role globally in its approach to cryptoassets and sent a powerful message to the market that it is open to cryptoasset businesses, giving firms like Coinbase the confidence to invest, grow, and innovate further, here in the UK.

We are excited to follow the progress the UK is making towards its mission to become a center of web3 excellence and global cryptoasset hub, and we appreciate the Government's openness to dialogue and the thoughtful and strategic approach it is taking to regulating the sector. We stand ready to support the Government as it develops a regulatory framework that delivers on its ambitions and puts the UK on a strong competitive footing in the journey towards web3.

Yours sincerely,



Faryar Shirzad
Chief Policy Officer

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.

The depth and strength of the UK's capital markets, globally respected regulators, and deep talent pools all combine to present a unique opportunity for global tech and financial leadership. Now, a well-designed and implemented cryptoasset regulatory framework will put the UK at the forefront of the digital finance revolution. While the UK has already shown impressive leadership to date, other jurisdictions are making significant headway in delivering legal and regulatory certainty to the market. It is time for the UK to seize the opportunity and move quickly to bring its regulatory framework to reality.

Key principles for a regulatory framework

In order to achieve its objectives, the UK should build a regulatory framework that:

1. Focuses on regulatory outcomes

We commend the UK for adopting the design principle of "same risk, same regulatory outcome." This formulation recognizes the importance of outcomes, and that the same outcomes may be achieved through the use of different or adapted rules, because blockchain technology differs in meaningful ways from the technological infrastructure underlying the traditional financial system. **The UK should make sure that it puts this principle into practice, adapting existing rules where the risks associated with cryptoassets meaningfully differ from the risks in traditional financial services.**

2. Delivers proportionate and focused regulation to support innovation

We share the UK Government's objectives of promoting responsible innovation while safeguarding consumers. These objectives are not mutually exclusive and can be delivered through a proportionate and focused regulatory framework. In particular, we note the following areas where it will be particularly important to take a proportionate approach to regulation and which the UK Government should enshrine in legislation:

- **Custody requirements.** There are many appropriate parallels between centralized crypto custodians and traditional securities custodians in respect to their safekeeping of customers' assets. We therefore call on the UK to establish similar standards for both. This means cryptoasset custodians should be permitted to:
 - Arrange custody and appoint a sub-custodian without requiring an ultimate custodian to be UK-based, the same as with traditional finance rules
 - Hold customer assets in omnibus customer accounts
 - Maintain some limited firm assets in the same customer account to support the operation of the market
 - Rehypothecate customer funds with their clients' express permission

The UK should confirm it will permit cryptoasset custodians to engage in these activities. Regulatory clarity on these issues would positively differentiate the UK from other regulatory regimes where the approach remains unclear.

The UK should also recognize crucial differences between the provision of custody as a financial service and the use of self-hosted wallets. A self-hosted wallet is not like a bank or brokerage account, it is the digital equivalent of a physical wallet that a person may use to hold paper currency in their pocket. **A self-hosted wallet application is a software product, not a financial service. The development and use of self-hosted wallets should not be regulated as financial services.**

- **Vertical integration and conflicts of interest.** Cryptoasset markets should not be bound by historical path dependence. It is important to re-evaluate traditional market structures and the different combinations of activities in light of the particular benefits, as well as risk-mitigation tools used widely in traditional finance. The regulatory framework should not force blockchain technology to unnecessarily replicate traditional financial market structures. **The UK should promote the benefits of blockchain technology – for example, real-time transaction settlement – while mitigating risks through proportionate measures such as information walls and appropriate governance structures.**
- **Asset listing and disclosure.** In line with the approach taken by other jurisdictions, we do not believe that trading venues should be responsible for drafting disclosure documents for assets where there is no identifiable issuer. Where a trading venue is required to make disclosures (e.g., the issuer is based outside the UK, and the trading venue lists the asset on its own initiative), the Consultation rightly recognizes the need to strike the balance between “the interests of the investor” and “avoiding a disproportionate burden on the issuer or the trading venue.” We support the UK approach of a principles-based regime for disclosure, allowing trading venues to decide how best to meet these principles. **Trading venues should only be subject to disclosure requirements on a best efforts basis, and with respect to publicly available information.**

There are two specific areas where the approach set out in the Consultation may not be in line with the Government's objectives of supporting innovation and providing regulatory clarity to the market:

- **Staking.** At present there exists significant uncertainty regarding the UK's views on the regulatory nature of staking services, as a result of the FCA apparently preventing some registered UK cryptoasset firms from providing staking services to clients. We also believe there are a wide variety of models of staking services that do not have the features of a Collective Investment Scheme (CIS). **To provide regulatory clarity to the market, the UK should introduce a new regulated activity of providing a staking service, which covers custodial platforms providing services that enable customers to participate in proof-of-stake consensus mechanisms, where these services fall outside the CIS framework.**
- **Third country activities.** The proposed territorial scope of the regime appears to depart from the UK's traditional approach, in a manner inconsistent with the principle of "same risk, same regulatory outcome." Adopting a Reverse Solicitation regime would create unintended consequences and risks damaging the UK market in terms of harming competition and innovation, and reducing access to third country liquidity pools. Among other things, it could prevent UK customers from gaining access to third country liquidity venues via UK arrangers, which is a common operating model for cryptoasset businesses serving UK customers. **The UK should adopt the Overseas Persons Exclusion (OPE) to define the regulatory perimeter for cryptoasset services. This is consistent with the well-established approach to traditional financial services, which plays an important role in promoting cross-border financial activity and investment in the UK.**

We discuss each of these issues below in response to specific questions from the Consultation, and we look forward to engaging with HM Treasury on how best to achieve good regulatory outcomes in each of these areas.

3. Focuses on and promote trusted intermediaries

The ability to interact directly with blockchains – without intermediaries – is an important aspect of the potential benefit of this technology. However, we recognize that most people lack technical knowledge of blockchains and how they work, and we therefore believe broad-based market participation will be facilitated through centralized platforms, especially in the early stages of development of blockchain technology. **Regulation should focus on centralized platforms to provide consumer protection, while preserving the freedom for developers and engineers to advance the cutting edge innovations that provide direct access to the base layer of the blockchain.**

The decentralized finance (DeFi) ecosystem is still evolving and maturing and will likely require the creation of a bespoke approach in the future, which accommodates the important differences between direct access to software protocols and offerings by

centralized intermediaries. DeFi is at a relatively early stage in its development, with low levels of interconnection with the real economy. As the ecosystem develops, policymakers will be able to see where the risks and benefits may emerge and how best to mitigate the former and promote the latter. **The UK should proceed carefully to understand and preserve the unique features and benefits of the developing DeFi ecosystem.**

4. Encourages cross-border cooperation

Regulatory frameworks should incentivize cryptoasset firms to establish themselves onshore and provide their services from jurisdictions with well-developed regulatory regimes. Moreover, given the global nature of the cryptoasset industry, consistency and cross-border cooperation are critical. **The UK should prioritize the development of an equivalence regime for cryptoassets, which will encourage more consistent regulation across international markets and promote cross-border regulatory cooperation.**

Chapter 2 Definition of cryptoassets and legislative approach

1. Do you agree with HM Treasury's proposal to expand the list of “specified investments” to include crypto assets? If not, then please specify why.

We support expanding the list of specified investments to include cryptoassets. We also support an activity-based approach to regulation. The UK should establish clear rules for what activities involving cryptoassets are deemed specified activities. This is particularly important in light of the extremely broad definition of cryptoasset in the Financial Services and Markets Bill.

As part of this move, we encourage a wider review of the use of “specified investments” and “investments,” as part of the UK regulatory framework, to ensure this change does not have any unintended consequences. For example, this change would potentially prevent exchange traded programs referencing cryptoassets from taking advantage of an exemption to the Collective Investment Scheme rules, without amendments to that exemption. While we support the change, we would advocate for it to be done with wider consequential amendments as necessary to avoid unintended consequences.

In relation to how cryptoassets are defined, we would strongly advocate for assets used for infrastructure purposes (for example, cryptoassets used in blockchain infrastructure solutions) to be out of scope of this regime to avoid any unintended coverage of software solutions that are not used in a financial activities context.

2. Do you agree with HM Treasury's proposal to leave crypto assets outside of the definition of a "financial instrument"? If not, then please specify why.

We support leaving cryptoassets (other than cryptoassets that already fall within the definition of a financial instrument by virtue of their characteristics, e.g., tokenized securities) outside of the definition of “financial instrument.” Otherwise cryptoassets would be shoehorned into existing rules that may be incompatible with the unique features of cryptoassets. We also support providing the FCA with the power to develop fit-for-purpose regulation that is tailored to the meaningful ways in which cryptoassets differ from assets in traditional finance.

3. Do you see any potential challenges or issues with HM Treasury's intention to use the DAR to legislate for certain crypto asset activities?

We caution that the DAR provides HM Treasury with very broad powers; it will be important to signal well in advance and seek public input before using the DAR to legislate for certain cryptoasset activities. In particular, HM Treasury should recognize that the cryptoasset sector is developing rapidly and thus should be very careful before “prohibiting [any] activity in its entirety.”

We welcome more clarity as to what is intended by the term “financial investments” and how it may differ from “financial instruments” and “financial products.” The proposed legislation also provides for the FCA to make requirements that extend to activities which are not designated activities (s. 71O). We would like to see more information as to when such powers can be exercised and would caution against providing for powers that can be used not on a properly consulted, objective basis.

Chapter 3 **Overview of regulatory landscape for cryptoassets**

4. How can the administrative burdens of FSMA authorization be mitigated for firms which are already MLR-registered and seeking to undertake regulated activities? Where is further clarity required, and what support should be available from UK authorities?

The FCA should be provided with and allocate greater resources so that it can process cryptoasset service provider authorization requests in a timely manner. The UK should set out an indicative timeline for completion of the application process, as is helpfully the case under the EU's Markets in Crypto Assets (MiCA) regime. We welcome the recent FCA feedback statement on good and bad quality applications under the MLR and believe a similar initiative for authorizations would be helpful for market participants. To the extent possible, the FCA should rely on existing information provided by applicants during the AML registration process in order to streamline crypto license application processes.

5. Is the delineation and interaction between the regime for fiat-backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2) clear? If not, then please explain why.

We believe there are several open questions and issues related to the phased approach that could benefit from clarification:

- Sometimes the Consultation refers to “fiat-backed stablecoins” and sometimes it refers to “fiat-backed stablecoins used for payments”, which generates some confusion. We believe Phase 1 should apply to all fiat-backed stablecoins, because stablecoins in all relevant contexts are designed to be payment instruments. Imposing a “used for payment” requirement thus requires an assessment of a stablecoins user’s intent, which would be very difficult to measure or apply as a rule (e.g., it is unclear what threshold of use in payments is necessary).
- There is an open question as to how the licenses required for Phase 1 interact or dovetail with the licenses required for Phase 2. For example, for an exchange offering access to both stablecoins and other cryptoassets, it is unclear whether the exchange would be required to hold two separate authorizations (one for the stablecoin activities under the new stablecoin legislation, and another for the other cryptoasset activities that are the subject of this Consultation). It may be administratively sensible to offer powers for appropriately authorized exchanges and brokers to be able to offer stablecoin support under a single authorization, given that offering stablecoins and wider cryptoasset support is prevalent in the industry.
- The Consultation states that Phase 1 focuses on “issuers, custodians and PSPs for fiat-backed stablecoins” and “does not capture exchange or trading activities of

stablecoins.” But this delineation does not provide clarity for centralized exchanges (CEXs), whose “exchange” activities also involve custody. For example, when a customer buys a stablecoin on a CEX, it is then custodied at the CEX. However, the customer may then send the stablecoin from their account at the CEX to custody at another centralized intermediary or an external wallet shortly – or even immediately – thereafter. Assets move in the same manner across centralized entities in the traditional financial system, each of which may offer its own custodial solution – indeed, a brokerage firm may hold securities as well as cash balances on behalf of its clients, and both activities are generally treated as related aspects of a single, integrated business. We believe it would similarly be more workable to regard an exchange’s custodial activities as ancillary to its exchange activities and thus part of Phase 2 rather than Phase 1.

If the UK maintains the exchange versus custody distinction for stablecoins, it should provide more guidance on how this will be delineated for CEXs that provide both services.

6. Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.

As described in response to question 5, the proposed phased approach would present significant challenges for CEXs in their provision of exchange and custody activities for stablecoins.

To mitigate broader challenges related to the phased approach, the UK authorities should provide indicative timelines for the completion of secondary legislation for each phase. The UK should also seek to complete this legislation on an accelerated basis, so as to align with the timetable of the EU’s MiCA regime. Implementation on differing timetables would impose significant burdens on market participants, as they would have to separately design their operational and compliance systems for each set of requirements.

Chapter 4 Cryptoasset activities

7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.

We support the overall objective of the UK, which is to incentivize cryptoasset firms to come onshore. However, the proposed territorial scope of the regime for cryptoassets appears to differ from the territorial scope of rules for traditional financial activities under the RAO and thus marks a departure from the UK's stated approach of "same risk, same regulatory outcome."

The UK already has a well-established framework for defining the scope of the territorial perimeter via the Overseas Persons Exclusion (OPE), intra-group services exemptions, and the Financial Promotions Regime. The OPE plays an important role in promoting cross-border financial activity and investment in the UK by reducing regulatory barriers and encouraging international firms to do business in the country, utilizing offshore platforms that gain access to the UK market via onshore authorized firms.¹ These benefits encourage healthy competition, increased liquidity, and innovation. We believe that OPE supports the Government's objective to onshore firms within the UK for retail customers, in a way that structurally works with the proposed regime, and does not overly restrict certain business-to-business activity on a cross-border basis.

The key difference between the OPE and Reverse Solicitation regimes is that the former regime would permit third country firms to solicit and have access to UK "Qualified Investors" (provided they complied with the Financial Promotions rules) without triggering UK authorization requirements, whereas the latter regime would prohibit this and would require the third country platform to come onshore and become UK authorized in order to do this. In our view, any incremental "benefit" in terms of possible enhanced investor protections for these categories of UK sophisticated investors is far outweighed by the

¹ More specifically, the OPE permits firms based outside of the UK to engage in certain regulated activities (e.g., dealing as principal and agent, advising on investments) with UK-based clients provided the transaction or advice is the result of a legitimate approach; that is, an approach that was not solicited by the overseas person or was solicited by or on behalf of the overseas person in a way which does not breach the financial promotion restriction in section 21 of the FSMA. In practice, due to the nature of the exemptions in the Financial Promotion Order, that means an overseas person can generally approach UK institutional clients, such as investment professionals under Article 19 and high net-worth entities under Article 49 of the Financial Promotion Order, without contravening the financial promotion restriction (noting that these exemptions are planned to be narrowed for crypto activity). Conversely, the ability of an overseas person to communicate with UK-based retail customers in a manner that does not breach the financial promotion restriction is significantly constrained by the limited availability of applicable exemptions in the Financial Promotion Order. We believe a similar approach, based on the existing distinction in the OPE between activities with institutional versus retail customers, should apply in relation to the ability of third country firms to engage in cryptoasset-related activities with UK customers without the need for FCA authorization.

damage it would do to the UK market in terms of harming competition, reducing access to third country liquidity pools, and harming innovation. It also appears to be somewhat inconsistent with the approach being taken under the forthcoming Financial Promotions regime for cryptoassets, which permits third country firms to market to UK customers, provided such marketing complies with s21 of FSMA, and the Financial Promotions Order more widely.

Moreover, the existing securities regime is built around OPE, and a separate move to Reverse Solicitation for crypto would create unintended consequences. For example, Reverse Solicitation would prevent “arranging” activity within the UK on behalf of third country liquidity venues as those third country venues would likely have to be authorized in the UK under Reverse Solicitation (even when deals with them are arranged with or through a UK-authorized firm, since the UK-authorized firm may be seen as soliciting customers on behalf of the third country venue). Under OPE, by contrast, a third country venue can access the UK market via a regulated arranger, provided that the third country venue complies with the Financial Promotions Regime (with the UK arranger doing or approving the promotions). This operating model (i.e., where a UK arranger facilitates access to a third country liquidity venue) is a common operating model for cryptoasset businesses servicing UK customers. As a result, the limited benefits of moving to a Reverse Solicitation regime would be significantly outweighed by other unintended consequences. We therefore strongly recommend maintaining the existing position from the securities regime so that the crypto regime may be structured in the same way.

There are two further points that we believe the UK should bear in mind for purposes of defining the territorial scope of the licensing and authorizations regime. First, we believe it should be revised to conform with the characteristic performance test, which has traditionally been used to determine where a particular regulated activity takes place. Second, we also believe it would be helpful for the UK authorities to provide additional information on what criteria will be used to determine the availability of equivalence-type arrangements with other countries, and the UK should prioritize bringing an equivalence regime to fruition, in order to promote cross-border consistency and cooperation.

8. Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?

We agree with the list of economic activities, but, as discussed in our response to question 5, we suggest that UK authorities clarify the interaction between custody and exchange activities for stablecoins in the context of CEXs. We also note our point under the response to question 45 around staking and it potentially being classed as a new regulated activity.

9. Do you agree with the prioritization of cryptoasset activities for regulation in phase 2 and future phases?

Broadly we agree that the regulation of cryptoasset activities needs to be introduced in a phased manner. However, there are two areas that we feel may need further consideration with respect to phasing to reflect how cryptoasset markets and activities operate in practice. These are in relation to (1) the interaction between exchange activities and stablecoins and (2) DeFi.

As also discussed in our response to question 5, we are concerned that the differing approaches to regulating the issuance of stablecoins, custody of stablecoins, and exchange services involving stablecoins will lead to difficulties in practice. Currently, all cryptoasset exchanges list and custody stablecoins as a core part of their operations, and in some cases, they also issue and redeem stablecoins as a part of their business. Stablecoin activities are integral to exchange activities and should be regulated accordingly because it is highly unlikely that there will be an exchange seeking UK licensing that does not wish to list or custody stablecoins. In practice, we suggest that an exchange authorization should come with the necessary permissions to be able to deal in, and custody, stablecoins – without an exchange needing to seek additional separate licenses. It would therefore be a separate stand-alone permission but also an ancillary activity within the exchange authorization.

As the Consultation acknowledges, the regulation of DeFi raises a number of novel and complex policy issues. Regulators have historically overseen financial markets by imposing and enforcing rules on market intermediaries. Equivalent intermediaries do not exist in the DeFi ecosystem. Governments and regulators should carefully examine the specific features and benefits of open, decentralized networks, as well as the potential impact, and unintended consequences, of any regulatory measures affecting DeFi protocols.

10. Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?

The adoption of blockchain technology has led to the combination of market functions that had previously been confined within separate institutions or intermediaries. For example, Coinbase provides both exchange and custodial services. Blockchain-based recordkeeping has both enabled this combination and made it more efficient than in the traditional financial system by removing the need for centralized settlement and clearance of market trading activity.

Cryptoasset markets should not be bound by historical path dependence. Instead, traditional market structures should be re-evaluated in light of the particular benefits and

risk-mitigants of blockchain technology to determine the best path forward for consumers and the market.

Blockchain innovations can promote safer and more efficient markets. For example, blockchain recordkeeping enables real-time settlement because it eliminates the need for a centralized counterparty to clear transactions or determine net exposures. A market that operates on real-time settlement effectively eliminates the counterparty credit exposure that would otherwise exist because of the delay between the moment when a trade is confirmed and the moment when ownership of the asset is transferred. Removing this credit risk makes markets safer and more capital-efficient because a market participant no longer needs to pledge collateral during the settlement period to protect its counterparty from the risk that it may fail before settlement completes.

The potential benefits of combining blockchain-based functions extend well beyond just real-time settlement. Combining functions into a single technology stack offers economies of scope, reducing the number of intermediaries that can charge a fee for a transaction. This combination can also improve the overall user experience, enabling users to access a wide range of services from a single platform with one overarching set of rights and risks to understand. Finally, and critically, combining functions makes it easier for regulators to obtain a holistic view of the market, by making data more readily available in interoperable formats and reducing the need to piece together activity from a large number of layered intermediaries.

Combining functions could also give rise to conflicts of interest, which require internal controls and supervisory oversight to protect customers. These controls and oversight are absent in many jurisdictions, as illustrated by the failure of FTX, which took custody of customer funds without the most basic level of governance, controls, and procedures that market participants customarily rely upon.

A regulatory framework tailored to permitting combined activity can mitigate these risks. In tailoring rules, regulators should focus on outcomes and recognize that not all combinations should be regulated in the same way. For example, consider the following three types of combinations:

- **Exchange services and custody of trading assets.** As noted above, combining exchange services with custody of trading assets allows for real-time settlement. This benefit comes with no meaningful risk of misalignment between the incentives of the custodian and the exchange. The custodian holds the assets, and the exchange matches orders to buy and sell those assets.
- **Exchange and broker services.** Combining exchange and broker services allows for economies of scope and reduces operational complexity by permitting straight-through processing of customer orders within the same technology stack. This type of combination can present a conflict of interest because a broker may be incentivized to route customer orders through its affiliated exchange even if a

third-party exchange would provide better execution. But participants in traditional financial markets have long been aware of these conflicts and developed effective mitigants to manage the corresponding risks while retaining the benefits. These mitigants include the separation of management and focus on duties to customers, as described below.²

- **Exchange and market making.** Exchanges that operate order matching engines depend on the participation of market makers, which provide liquidity to customers through a willingness to take either side of a transaction and earn a spread. But affiliation between an exchange and a market maker – like FTX and Alameda – can create an acute conflict of interest, particularly if the market maker has unfair advantages when transacting on the trading platform, such as privileged access, lower latency, or other preferred terms. This conflict is exacerbated if the market maker has access to confidential information, such as counterparty positions and orders, which may inappropriately inform trading and lead to the front-running of exchange customers. The risks of combining these activities are high and any market making arrangement tied to exchange order matching should be clearly disclosed and subject to a commensurate level of controls and oversight. In addition to implementing information barriers and independent governance, as noted below, exchanges should be required to treat all market makers on the same terms irrespective of affiliation.

Mitigating potential conflicts of interest from combined functions begins with separate governance and management to help ensure that decisions are made independently. Well-constructed and understood information barriers can minimize opportunities for improper use of information. Clear articulation of the duties that employees have to customers can clarify whose interests need to be considered. Disclosure and the transparency of the blockchain can keep the market and regulators apprised of inter-company relationships. Simple to understand, written disclosures should help customers understand any potential conflicts of interest.

11. Are there any commodity-linked tokens which you consider would not be in scope of existing regulatory frameworks?

We agree with the proposed approach. That is, a bespoke regulatory regime for commodity-linked tokens is not required. Activities relating to commodity-linked tokens that do not meet the definition of a specified investment or financial instrument but do meet the definition of a cryptoasset will be adequately catered for through the broader cryptoasset regime described in the Consultation.

² Other combinations might also fall into this category of risk. For example, an exchange affiliated with a venture capital firm may face pressure to list cryptoassets that are tied to the venture capital firm's investments. This type of conflict can also be addressed by the measures noted in the text.

12. Do you agree that so-called algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets?

We agree that crypto-backed tokens should be regulated in a similar way to unbacked cryptoassets. While cryptoassets should generally be subject to similar regulations, certain requirements, such as disclosure rules, may differ somewhat so as to be tailored to the unique features of each type of token.

Crypto-backed tokens are relatively similar to fiat-backed stablecoins in that they sustain their pegs based on a pool of reserve assets of at least equal value to the total amount of the tokens outstanding, and rely on cryptoassets (such as Bitcoin and Ether) whose primary purpose is not to support the crypto-backed token. DAI is an example of a crypto-backed token and has established a long track record of maintaining price stability, even through periods of market dislocation. These types of cryptoassets might therefore be properly viewed as “stablecoins.”

So-called algorithmic stablecoins, in contrast, attempt to use another cryptoasset within the same stablecoin arrangement to maintain their peg. In other words, the strength of the peg in such an arrangement rests on a tautology.³ While we do not believe an outright prohibition on algorithmic “stablecoins” is appropriate because such action would likely have unintended consequences and market experimentation should be permitted to continue, it might not be appropriate to view this category of cryptoassets as “stablecoins.”

13. Is the proposed treatment of NFTs and utility tokens clear? If not please explain where further guidance would be helpful.

We do not believe the proposed treatment of NFTs and utility tokens is clear, and we believe it does not strike the right balance to enable innovation in the UK. NFTs can be used for an extremely broad range of activities, many of which are not financial activities (for example, art, event ticketing, or back-office solutions), and therefore the proposed rules must appropriately delineate between these different use-cases.

The Consultation notes that NFTs and utility tokens “would have the potential to be included in the future regulatory perimeter if they were used in one of the activities in Table 4A.” Otherwise, they “would not fall into scope of financial services regulation” unless they constitute a specified investment or are involved in activities that already fall within the existing regulatory perimeter. But, critically, Table 4A includes activities that are *not* necessarily financial activities. For example, Table 4A includes safekeeping activities. The safekeeping of an event-ticketing NFT should not be considered a financial activity, just as a ticket seller’s safekeeping of physical event tickets is not considered a financial

³ See Coinbase’s [Stablecoins White Paper](#) (July 2022) for additional information on stablecoins and stablecoin arrangements, in particular regarding the important differences between crypto-backed stablecoins and so-called algorithmic stablecoins.

activity. Rather, the regulatory regime should clearly distinguish between NFTs and utility tokens that are used for financial activities from those that are not. For example, other than fractionalized NFTs, most NFTs have consumptive and artistic uses rather than financial uses. If an NFT or utility token does not serve a financial purpose, it should be outside of the financial regulatory perimeter, even if it is used in one of the activities listed in table 4A.

We agree that some NFTs and utility tokens may be used for speculative investment purposes and this type of activity should be covered by regulation, but to regulate NFTs and utility tokens as a whole on the basis that they are effectively financial instruments would chill socially beneficial and responsible innovation in relation to two types of cryptoassets that have potential to be used in pure social and utility-based contexts. We would therefore welcome further guidance and thought in relation to what types of NFTs and utility tokens should be covered under these rules and urge the UK authorities to consider broad exclusions of NFTs and utility tokens that have social or utility-based uses that go beyond the possibility of speculative trading.

Chapter 5 Regulatory outcomes for issuance and disclosures

14. Do you agree with the proposed regulatory trigger points – admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue or making a public offer of cryptoassets?

We agree with the first regulatory trigger point: admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue. The second trigger point is framed broadly, but we assume that the intention is for this to only encompass offers with a UK nexus consistent with the existing public offer regime under the Prospectus Regulation. Cryptoassets are digitally native and can be publicly offered to anyone in the world over the internet. Making a public offer of cryptoassets should only trigger regulation if the cryptoasset is offered by a UK firm or directly targeted at UK persons. General offers by non-UK firms over the internet (which may be available to UK persons but not directed at them specifically) should not trigger UK regulation.

15. Do you agree with the proposal for trading venues to be responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset? If not, then what alternative would you suggest?

We support a proportionate approach to asset listing that focuses on supervision of trading venues' processes and procedures for assessing and reviewing cryptoassets. We agree that trading venues should be responsible for setting robust standards for admission. We also agree that trading venues should establish internal listing processes that consider a range of factors, including a cryptoasset's use cases, the factors affecting its supply and demand, the governance of updates to its underlying protocol, and its susceptibility to hacking or manipulation. We disagree, however, that detailed due diligence on the entity seeking to admit a cryptoasset should be a significant factor in this process. With respect to traditional securities, information about the issuer – for example, its balance sheet, income statement and corporate policies – are critical to an assessment of a security's quality. For cryptoassets, however, their most important characteristics relate to their use in a particular smart contract or protocol. We accordingly believe the focus of a listing review should remain on the cryptoasset itself, not its issuer.

We commend the UK for observing that disclosure documents should not take the same shape and form as a traditional prospectus given the specific characteristics and investor profiles of cryptoassets. From experience with our customer base, and as highlighted by the FCA in DP23/2⁴ relating to fund prospectuses, we have found that disclosures are best comprehended and internalized when there are fewer of them. It is also helpful for them to be highlighted in the logged-in experience just before a product or service is

⁴ <https://www.fca.org.uk/publication/discussion/dp23-2.pdf>

accessed for the first time. A lengthy disclosure statement shown to a user during onboarding has a risk of not being properly read and understood (or accurately remembered at the appropriate time).

The Consultation states that, “where there is no issuer (e.g. Bitcoin), the trading venue would be required to take on the responsibilities of the issuer if they wish to admit the asset to trading.” However, we note the approach set out in MiCA is that disclosure requirements do not apply to assets with no identifiable issuer because of the transparency already afforded by assets like Bitcoin. We recommend the UK take the same approach.

As discussed in our response to the next question, we strongly oppose subjecting trading venues to liability for the accuracy or completeness of information which is not in the public domain or cannot be reliably verified.

16. Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?

We agree that cryptoasset issuers should be liable for the accuracy of disclosure documents that they prepare. However, in instances where the trading venue is required to make disclosures (e.g., where the issuer is based outside the UK and the trading venue lists the asset on its own initiative), the Consultation rightly recognizes the need to strike the right balance between “the interests of the investor” and “avoiding a disproportionate burden on the issuer or the trading venue.” Trading venues should not be subject to liability or disclosure requirements for information that is not in the public domain or cannot be reliably verified.

Provided that a trading venue performs a good faith investigation into a cryptoasset, it should not be unfairly held liable for information that cannot be verified with absolute certainty. Such liability would unduly chill responsible innovation by making regulated trading venues reluctant to provide consumers with access to new cryptoassets, which could lead customers to use unregulated, offshore platforms instead. Any requirement for trading platforms to issue disclosures should be performed on a “best efforts” basis.

One issue to consider further is in relation to assets that are listed before the regulatory framework comes into effect. We recommend that such assets, which are already widely circulating and well known by market participants, are subject to a grandfathering period of three years after the regime comes into force, in line with the EU approach.

17. Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?

We support the UK approach of a principles based regime for disclosure, allowing trading venues to decide how best to meet these principles. We believe the necessary information test is appropriate but may need to be refined to take into account cases

when there is no identifiable issuer behind a cryptoasset and where the disclosures are produced by a trading venue to reflect the knowledge of the trading venue. Further clarification will be required to ensure that the expectations are clear in terms of what venues should be requiring issuers to produce and provide (which we believe will be provided by the FCA, based on the Consultation), and we would request that these are not designed in a way to indirectly slow the market. As noted above, subjecting trading venues to overly burdensome requirements and liability standards may unduly hinder responsible innovation by making regulated trading venues reluctant to provide consumers with access to new cryptoassets, which could lead customers to use unregulated, offshore platforms (that would list assets which don't comply with disclosure requirements) instead.

To provide clarity to the market, we agree that the UK should set out the principles that govern disclosure documents. These principles should distinguish between information required for disclosures made by issuers as opposed to trading venues, recognizing the crucial differences in their respective access to information. For example, a trading venue will not have access to information about the financial condition or business plans of the issuer. As discussed above, requirements applicable to trading venues in respect of such information should be limited solely to what is publicly available on a "best efforts" basis.

Overall we welcome the proposal to be principles-based in terms of required information and allowing venues to set the specific standards for disclosures and admission. This is a more progressive, flexible, and proportionate approach than the EU is taking under MiCA (which has a strict set of requirements on disclosures) and will allow significantly more in the way of responsible innovation within the UK market, if the points around trading venue disclosure and liability requirements are appropriately reflected.

18. Do you consider that the intended reform of the prospectus regime in the Public Offers and Admission to Trading Regime would be sufficient and capable of accommodating public offers of cryptoassets?

We have no objection to this approach, provided the concerns related to disclosure obligations and liability standards for trading venues are appropriately addressed. We do not, however, agree that the DAR should prohibit public offerings of cryptoassets that are not security tokens unless such public offerings are conducted via a security platform.

We would also ask that more consideration is given to the situation around trading platforms listing assets from offshore issuers of their own initiative. We have made the point above about differing requirements and standards for disclosure and liability but would also ask for clarity that this is allowable. This is a core part of the cryptoasset market and one that needs to be maintained to ensure that UK-regulated platforms can be competitive in the global ecosystem and that UK customers can access the global ecosystem via regulated UK platforms, as opposed to being driven to use unregulated offshore platforms.

Chapter 6 Regulatory outcomes for operating a trading venue

19. Do you agree with the proposal to use existing RAO activities covering the operation of trading venues (including the operation of an MTF) as a basis for the cryptoasset trading venue regime?

We agree with this approach, provided that the proposed regime recognizes that the technologies underlying cryptoasset activities differ in meaningful ways from those that power traditional financial activities. This means that necessary changes must be made to address the differences between cryptoasset and traditional market structures.

One other element that should be reflected is that not all crypto exchanges operate on the basis of multilateral matching of trades. In many cases exchanges operate on a matched principal basis, with participants on the exchange not directly concluding trades between them. The Consultation currently indicates that the “exchange” concept will be based around an MTF-style defined activity, which may not capture the majority of cryptoasset exchanges. Therefore, building this concept into the wider framework to clearly capture how a matched principal venue will be regulated, will be important.

We would also note the points we raise in other responses to questions which are particularly pertinent for this Chapter, in particular around:

- jurisdiction and subsidiarization issues (see response to question 7);
- vertical integration (see response to question 10);
- phasing of stablecoin and exchange regulation, in particular potentially allowing for exchanges to have an ancillary permission for stablecoin trading and custody (see response to question 8); and
- the potential addition of staking as an ancillary activity to an exchange permission (see response to question 45).

20. Do you have views on the key elements of the proposed cryptoassets trading regime including prudential, conduct, operational resilience and reporting requirements?

The proposed regime must recognize that the technologies underlying cryptoasset activities differ in meaningful ways from those that power traditional financial activities.

One point we would raise specifically is in relation to subsidiarization and how this works in practice. We generally agree that firms seeking authorization should be UK entities (subject to any equivalence regime that may be adopted). That said, in relation to exchange and intermediation activities, we suggest making clear that a UK-authorized intermediary may engage with and source liquidity from exchanges that are not UK-based or authorized, provided appropriate controls and due diligence standards are satisfied.

Chapter 7 **Regulatory outcomes for intermediation activities**

21. Do you agree with HM Treasury's proposed approach to use the MiFID derived rules applying to existing regulated activities as the basis of a regime for cryptoasset intermediation activities?

Similar to our response to question 19, we agree with this approach, provided that the proposed regime recognizes that the technologies underlying cryptoasset activities differ in meaningful ways from those that power traditional financial activities.

Further, as set out in our response to question 20, we would recommend that these intermediation activities are designed to enable a UK-authorized intermediary to be the conduit for UK customers to engage with liquidity based offshore. This is a very common structure for cryptoasset exchange platforms and, with appropriate controls over the third country venue (for example placing due diligence requirements on the UK-authorized intermediary), we think this structure should be permitted, with an appropriately regulated arranging or execution platform in the UK that is the contracting entity for UK customers. The alternative would be to require liquidity pools to be UK-based which, given the global nature of the cryptoasset market, is not likely to be practical or desirable.

22. Do you have views on the key elements of the proposed cryptoassets market intermediation regime, including prudential, conduct, operational resilience and reporting requirements?

Our views on the regulation of cryptoasset trading venues also apply to the regulation of cryptoasset intermediation activities. See our response to question 20.

Chapter 8 Regulatory outcomes for custody

23. Do you agree with HM Treasury’s proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

We broadly agree with the proposal to apply and adapt existing frameworks for traditional finance custodians. There are many parallels between centralized crypto custodians and traditional dematerialized securities custodians in respect of their practices for the safekeeping of customers’ assets. The foundations of trust law, accurate books and records, and proportionate segregation requirements are similarly important safeguards that can effectively mitigate the risks that would arise in the event that a custodian were to face insolvency⁵.

We consider it to be important to ensure that crypto custodians have similar flexibility in their business practices as traditional securities custodians. For example, crypto custodians should be permitted to:

- **Arrange custody and appoint sub-custodians.** We agree that authorization to arrange for the safeguarding and administration of cryptoassets should be available in the UK, as mentioned on page 51 of the Consultation. This would enable cryptoasset custodians to have the freedom to arrange for the ultimate custodial services to be provided by a non-UK third party or to appoint a non-UK entity as a sub-custodian. With respect to sub-custody, the requirements for arranging or appointing sub-custodians should be similar to the requirements applicable to traditional custodians under CASS 6.3, including obligations to exercise all due care, skill, and diligence in their selection and appointment. This freedom would enable UK consumers to benefit from direct or indirect access to a broader range of services, while retaining the protection of due diligence conducted by an entity subject to authorization and oversight in the UK.
- **Hold customer assets in omnibus customer accounts.** Custodians should be able to hold their clients’ cryptoassets in omnibus accounts similar to omnibus accounts in traditional finance. This structure confers certain benefits on the crypto custodian and its clients. The ability to settle transactions directly on the custodian’s books and records rather than on-chain:
 - reduces the risk of erroneous on-chain transfers (e.g., sending assets to an incorrect wallet address resulting in a transfer that cannot be reversed);

⁵ We draw attention to the important work of the Law Commission’s [Digital Assets consultation](#) and the responses provided by [International Digital Assets Counsel Association and CryptoUK](#).

- reduces transaction fees, as on-chain transfers of ownership may require payment of gas fees or other costs, compared to a books and records transfer;
 - enables near-instantaneous settlement without the risk of delayed on-chain movements due to congestion on the blockchain (e.g., settlement finality achieved on custodian’s books and records); and
 - makes it easier to access liquidity quickly and efficiently, especially for retail customers with small orders.
- **Maintain some limited firm assets in an omnibus customer wallet to help facilitate customer transactions.** In traditional securities markets, custodians may hold some firm assets in the same account as the custodian's clients' assets under certain circumstances, such as to address fractional entitlements or shortfalls, provided the operational and compliance requirements under CASS 6.2.5R and 6.2.6G are satisfied. We believe that a similar rationale should apply to cryptoasset custody arrangements. Limited placement of firm assets in an omnibus customer wallet should be permitted specifically to facilitate customer transactions, so long as customers at all times remain protected through accurate recordkeeping of their entitlements on the custodian’s books and records.

Cryptoasset intermediaries facilitate customer transactions by efficiently moving assets where they are needed for trade execution. In some cases, this may mean moving assets out of cold storage and into hot wallets for trading. In others, this may require an intermediary to prefund positions at multiple exchanges, in order to have the ability to route customer orders to the exchange with the best price. In each case, holding a buffer of additional firm assets in the omnibus customer account ensures better outcomes for customers while maintaining compliance with segregation requirements.

- For example, moving assets out of cold storage to a hot wallet for trading carries some delay. For customers who want to trade immediately, an intermediary can allow the customer to trade out of the hot wallet using an asset prepositioned there by the intermediary for such purpose. This means that the customer would not be impacted by the operational delay of moving assets out of cold storage. Instead, this operational delay is borne by the intermediary, as the asset in cold storage would be moved to the intermediary's own wallet in repayment for the asset used for trading in the hot wallet. Because the intermediary has control over both the cold and hot wallets, the intermediary would not bear any risk of loss during this process.
- Order routing has similar mechanics. Exchanges require assets to be prefunded in order to trade – that is, a customer must place either fiat or cryptoassets at the exchange before they are able to enter into transactions

– and this prefunding requires on-chain movements that carry some limited delay. This creates a chicken-and-egg problem because it is not possible to predict where the best price will be at a given time in order for a customer to prefund a position at the right exchange. But a lack of prefunding means the customer may not be able to trade at the best price, as prices will certainly move during the time it takes to send assets to the exchange. To ensure that customers can get the best price across multiple trading venues, an intermediary prefunds its own assets in omnibus wallets across multiple venues. When a customer order is routed to a given venue, that order is filled using those prefunded assets and, on the back end, the intermediary updates its ledger accordingly.

In both of these examples, if the intermediary did not hold a buffer of its own funds in the omnibus wallet, it would be unable to provide these services to customers without violating the principle that a customer's assets should only be used for that customer's trading activity. The additional buffer ensures that the intermediary always holds customer assets on a one-to-one basis and does not use one customer's assets to facilitate the trading activity of another. Importantly this is not about custodians using customer funds for their own purposes (which of course should be prohibited) but the other way around: firms using their own funds to support the operation of the market for the benefit of customers. Regulatory clarity on this point would enable the UK to differentiate itself from other regulatory regimes where this issue remains unclear.⁶

- **Rehypothecate customer funds with their express permission.** Coinbase does not lend or take any action with customer assets and will never repurpose client funds unless specifically instructed to by the client. We agree that cryptoasset custodians should not be able to use customer assets without their permission. We believe it is consistent with this principle for cryptoasset custodians to be permitted to enter into collateral arrangements with their clients such as title transfer collateral arrangements or security financial collateral arrangements with rights of use (i.e., rehypothecation). Consistent with traditional financial instruments, these arrangements should be subject to consent and proportionate disclosure requirements but should remain outside the scope of the client asset regime applicable to cryptoassets, similar to CASS 3 (Collateral).

Finally, the regulatory standard of care applicable to cryptoasset 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 negligence and failures to maintain adequate systems and processes.

⁶ For example, Art 67(7) of MiCA requires on-chain separation of client and firm assets without any clear exemptions for operational or customer-facilitation purposes.

While we agree with the proposal to apply and adapt the existing framework for traditional finance custodians, we note two key distinctions where the activities differ in meaningful ways from traditional financial activities.

- **Market structure.** As we note in the answer to question 10, in the cryptoasset industry, exchange services are often combined with custody of trading assets. Combining exchange services with custody of trading assets allows for real-time settlement. This benefit comes with no meaningful risk of misalignment between the incentives of the custodian and the exchange. The custodian holds the assets, and the exchange matches orders to buy and sell those assets. At any point in time, and unlike with traditional securities, a client can immediately transfer their cryptoassets to another custodian or an external wallet through an on-chain transfer. This flexibility is necessary to support the real-time consumptive use of cryptoassets, e.g., deployment in the protocols for which they are designed for specific purposes, such as paying gas fees to write smart contracts. The fact that many cryptoassets are meant to be actively consumed in this manner, rather than held passively only for investment purposes, is an important feature that differentiates them from traditional securities.
- **Custody.** Cryptosets and distributed ledger technology provide a wider range of permutations of how the control of assets can be distributed or shared among parties without relying on intermediaries, such as multi-signature, multi-party computation (MPC) and the use of smart contracts to hold the private keys. Regulators should recognize the distinction between actually custodizing an asset and merely providing wallet software so that a person may self-custody an asset via self-hosted wallets.⁷ Self-hosted wallets, which are the gateway to web3 and DeFi, should fall outside the scope of regulation.

Finally, we would suggest that further thought needs to be given around multi-signature and multi-party computation solutions for wallets, where private keys can be “sharded” and held by multiple parties, including a custodian or other service provider, and across different jurisdictions, creating a better security profile than one which has a single point of failure. More broadly, we believe that MPC and sharding have significant potential to enhance the level of security protection for customer assets held in safekeeping, taking the best from both worlds – the certainty and objectivity of cryptographic proofs and the

⁷ A self-hosted wallet is a software application that allows users to manage their own private keys and cryptoassets directly on the blockchain. Non-custodial wallets do not hold the private keys on behalf of their users. Instead, the user holds the private keys and is responsible for the security and safekeeping of those keys. Non-custodial wallets are often used by retail holders and others who prefer to have more control over their cryptoassets and are willing to take on the responsibility of securing their own private keys. A custodial service, in contrast, involves a third-party service provider that holds and controls the private keys on behalf of its clients. Custodial service providers are responsible for managing and securing their clients' cryptoassets by safekeeping the private keys.

considered judgment of individuals with appropriate authorization acting within specific parameters. We ask for further clarity on when these solutions might fall into the concept of custody versus when these solutions would be considered non-custodial, focusing on the level of technical control that the service provider has over the assets. It is important here to ensure that software solutions enabling customers to hold their own assets more securely are not subject to onerous custody regulation (e.g., if a MPC solution was designed so that a service provider cannot control the user's assets).

24. Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?

The requirements are only outlined at a general level, and while we agree with these requirements as set forth in the Consultation, we believe there remain many important details still to be clarified. For example, as discussed in the response to question 23, the custody regime should incorporate similar principles from the existing frameworks.

Chapter 9 **General market abuse requirements**

25. Do you agree with the assessment of the challenges of applying a market abuse regime to cryptoassets? Should any additional challenges be considered?

We broadly agree with Consultation’s assessment of the challenges, in particular, that due to the highly globalized, fragmented (there are multiple different liquidity venues trading the same assets around the world), and borderless nature of cryptoasset markets, identifying and controlling market abuse behaviors may be more difficult.

While the top-level challenges are common across traditional finance and cryptoasset markets, there may be different methods of perpetrating market abuse behaviors. We therefore believe that the ideal approach to addressing cryptoasset market abuse will combine learning from traditional finance with the tools capable of addressing cryptoasset markets’ particular characteristics, including 24/7 trading across multiple jurisdictions. Coinbase has invested substantial resources in developing sophisticated capabilities to monitor, identify, and control market abuse in cryptoasset markets, using trusted third-party software as well as tools and enhancements developed in-house. We have strong confidence in our tools for policing manipulative behavior – which are also integrated with our systems for anti-money laundering compliance and the prevention of financial crimes – and we believe they are as effective as the tools used in the traditional finance system for the same purposes (see responses to questions 27 and 28 below).

26. Do you agree that the scope of the market abuse regime should be cryptoassets that are requested to be admitted to trading on a cryptoasset trading venue (regardless of where the trading activity takes place)?

Cryptoassets are not listed in the same way as traditional securities, and this approach would likely make the regime unworkable. Instead, it would make more sense to limit the scope to actions and activities taken by UK residents, or in relation to UK venues. Assets listed on a UK venue will likely be listed on hundreds of other venues around the world, and therefore taking the approach suggested would introduce an unduly broad perimeter that will be unworkable in practice because the UK would not have jurisdictional authority or oversight over non-UK venues.

The FCA would retain significant authority to administer the market abuse regime even if the scope were limited to actions and activities taken by UK residents or in relation to UK venues. These powers would include the ability to temporarily or permanently remove a cryptoasset from trading and take enforcement actions against trading venues or persons professionally arranging or executing transactions (e.g., financial penalties, public censure, and powers to vary or cancel regulatory permissions).

While we agree that market abuse on non-UK platforms does have the potential to affect UK cryptoasset markets, we ultimately believe that the most practical and effective way

to address these concerns is not through setting a broad perimeter for the FCA (which will not be workable in practice) but through global coordination among trading venues as well as regulatory authorities, as the Consultation suggests.

27. Do you agree that the prohibitions against market abuse should be broadly similar to those in MAR? Are there any abusive practices unique to cryptoassets that would not be captured by the offences in MAR?

We believe the prohibitions against market abuse should be broadly similar to those in MAR. The behavior we already monitor for in cryptoasset markets is not dissimilar to the behavior monitored in the traditional financial markets. In fact, we use the same alerting surveillance logic deployed at regulated exchanges and traditional financial institutions. This is in addition to surveillance unique to crypto markets, which includes, for example, monitoring around the Bitcoin Reference Rate (BRR).⁸

28. Does the proposed approach place an appropriate and proportionate level of responsibility on trading venues in addressing abusive behaviour?

Generally we agree with the approach suggested that trading venues should be the first line of defense against abusive behavior and that requirements should be put in place to ensure that trading platforms engage in cross-platform monitoring to address market abuse that is carried out across platforms. We support an industry-led approach that places requirements on trading platforms to communicate on market abuse but with some caveats, in particular:

- Related to the response to question 27, in many cases trading platforms will be required to engage with non-UK platforms that may not apply the same standards of market abuse surveillance. Any rules drafted in this vein should therefore reflect best efforts obligations on platforms where they are engaging with non-UK firms;
- It should be clear that, if trading platforms are the first line of defense against market abuse, there are clear standards to be met in relation to surveillance, so firms can easily comply and manage their responsibilities under the regime. Unclear or broadly subjective requirements will lead to suboptimal regulatory outcomes; and
- Related to the point immediately above, there should be clarity relating to liability placed on trading platforms in relation to market abuse. A pragmatic approach would be that, provided firms have put in place measures to detect and prevent market abuse and are managing them in accordance with the clear requirements provided, the trading venue would not be liable for any market abuse that does take place notwithstanding these measures. The obligation should clearly be to run

⁸ The Bitcoin Reference Rate is a daily reference rate of the U.S. dollar price of one bitcoin as of 4 p.m. London time. See CME Group, [Introduction to Bitcoin Reference Rate](#).

appropriate operations to detect and prevent market abuse, not a strict liability to prevent market abuse entirely, which is not possible in reality and does not reflect the standard applied in traditional finance.

29. What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?

As we have seen with initiatives such as the Travel Rule, market participants will step up to develop and adopt RegTech solutions once regulatory requirements have been clarified. We similarly believe that, in cryptoasset markets, the financial incentives will motivate developers to deliver solutions that enable entities to comply with applicable requirements. For this opportunity to be realized, however, there must be a sufficient period between the point at which the requirements become clear and the point at which they take effect. More lead time will enable the market to respond more successfully with better solutions to enable large-scale compliance.

In our view, current RegTech offerings are quite strong for algorithmic trading on CEXs. In this area, there already exist several high-quality vendors offering strong products with proven track records in traditional finance. Similarly, we believe there exists robust tools for AML compliance and on-chain surveillance of fund flows. There is, however, further need to develop tools for monitoring decentralized exchanges and, specifically, on-chain activity as it relates to trading versus fund flow. This includes potential manipulative trading aspects of on-chain activity within decentralized exchanges.

30. Do you agree with the proposal to require all regulated firms undertaking cryptoasset activities to have obligations to manage inside information?

Broadly, we disagree with the requirement for regulated firms in cryptoassets to disclose inside information and maintain insider lists, which – as the Consultation notes – is a departure from MAR. We disagree with this for a number of reasons, including because:

- This would be administratively unworkable in practice, particularly for larger firms that have large international operations;
- Crypto-native employees of regulated firms may hold inside information on new projects within crypto without the knowledge of the firm they are employed by, simply because of the nature of the crypto markets and the ecosystem; and
- Given the unique “direct to consumer” nature of crypto trading, applying traditional finance concepts of insider lists, for example, may not be effective in practice.

We believe many leading market participants are already addressing these concerns through current practices and procedures, and an industry-led approach to insider activity appropriately reflects the unique ways in which the cryptoasset ecosystem operates.

Chapter 10 Regulatory outcomes for operating a lending platform

31. Do you agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities? Are there any additional challenges HM Treasury should consider?

We broadly agree with the assessment of the regulatory challenges. We think it is important, however, to distinguish the regulatory approach for lending activities based on whether they are provided to retail or professional clients.

Retail clients have traditionally received a higher level of protection compared to professional clients because they may be less experienced and knowledgeable about financial markets and products. We broadly agree with the assessment of the regulatory challenges in this context. This is particularly the case when retail clients are transferring title of their assets to a service provider and taking credit risk on its insolvency (as in the Celsius bankruptcy).

One area we believe needs further consideration is in the context of Title Transfer Collateral Arrangements (TTCAs). In traditional financial markets, retail clients are typically not allowed to enter into TTCAs, which involve transferring the title of their assets to a firm for collateral purposes. This understandably helps protect retail clients from being exposed to a lender's credit risk. However, in the cryptoasset industry, TTCAs may be necessary to ensure collateral enforceability or to achieve the client's economic objectives (akin to a customer transferring its cash to a credit institution). We would caution against any similar prohibition in cryptoasset markets without proportionate consideration of alternative risk mitigations that permit service providers to (1) maintain effective collateral arrangements and (2) empower retail clients to meet their economic and commercial objectives.

Professional clients, on the other hand, have a greater need to access overseas liquidity pools and service providers, and they should be free to enter into TTCAs and grant rights of use (i.e., rehypothecation). In cryptoasset lending markets, professional clients (e.g., hedge funds, proprietary trading companies, investment firms) currently seek products similar to traditional intermediated wholesale financial markets, including lending arrangements that resemble securities lending, repo arrangements, and prime brokerage. We consider it important that institutional cryptoasset lenders offering services to professional market participants are not unduly constrained as these service offerings continue to grow and the institutional lending market matures.

With regard to collateral arrangements, a critical foundation for effective liquidity and credit risk management for any lender is the ability to take robust and enforceable collateral arrangements. While it is possible to take enforceable security interest and title transfer collateral arrangements in respect of cryptoassets, as a matter of English law, these do not currently benefit from the same protections upon a borrower insolvency as

traditional financial collateral under the UK Financial Collateral Regulations. We therefore draw attention to the important work of the Law Commission’s Digital Assets consultation and the response provided by the International Digital Assets Counsel Association, where Coinbase and other market participants argued that:

“There is an urgent need for a robust regime for crypto collateral arrangements with similar effect to the Financial Collateral Arrangements Regulations (FCARs). The FCARs have been highly successful in traditional financial markets providing market participants with increased certainty, and an enhanced toolkit to take and enforce in-scope collateral arrangements for financial obligations. In our view, the same policy considerations that apply to ‘financial collateral’ arrangements also apply to ‘crypto collateral’ arrangements. For crypto markets to scale in a safe and efficient manner it is essential that crypto market participants, especially institutional market participants in crypto lending and borrowing markets, have the same toolkit available to effectively mitigate their credit and liquidity risks and in doing so reduce the potential for systemic risks. We submit that crypto asset market participants should benefit from the same advantages and protections as traditional financial market participants when structuring their collateral arrangements. Our position is that we would like crypto-assets covered by a targeted amendment to the FCARs (solving for centralized finance or ‘CeFi’ in the short term) with a fuller consultation on a standalone crypto regime (solving for decentralized finance or ‘DeFi’) in the longer term. In our view ‘perfect should not be the enemy of the good’ and the inclusion of crypto within the existing FCAR regime as a starting point is an important leap forward for the industry.”

32. What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?

The biggest takeaway from the well-publicized failures of Celsius and certain other cryptoasset lenders in 2022 is that strong risk management is of paramount importance.⁹ In our view, these failures were not crypto-specific in nature, but rather credit-specific. These businesses were engaged in some version of borrowing short and lending long, with risks exacerbated by an excess of leverage, and they failed to take adequate collateral in exchange for the credit they extended. The risks involved are, at a fundamental level, the same as the risks that have materialized in previous crises in the traditional financial system.

The turmoil experienced in cryptoasset markets in 2022 is also instructive in that the on-chain DeFi ecosystem navigated the volatility with a very strong track record. For example, a number of DeFi collateralized lending protocols successfully maintained smooth functioning throughout this period. This was generally because they had good

⁹ For more information, see Coinbase blog, [Institutional Insights: Our Approach to Crypto Financing](#) (July 2022).

risk management: their exposures were over-collateralized, to protect against volatility of the collateral assets, and they had automatic mechanisms in place that would trigger liquidations if the value of the collateral dipped too low. The fact that these protocols continued operating as designed is also an important takeaway from the events of 2022.

We agree that many of the proposed safeguards would have gone some distance in preventing the collapse of certain cryptoasset lending platforms. Important safeguards include restrictions and/or clear disclosures on rehypothecation for retail customers, as well as requirements to maintain effective systems, controls, and accounting practices to ensure that firms are able to appropriately manage their risk. The suggested risk warnings would also have reduced the exposure to retail customers in particular.

33. Do you agree with the idea of drawing on requirements from different traditional lending regimes for regulating cryptoasset lending? If so, then which regimes do you think would be most appropriate and, if not, then which alternative approach would you prefer to see?

We note that the consumer credit regime is not mentioned in the Consultation as a potential basis for regulating the lending of cryptoassets. We believe that there is a difference in lending to institutional clients who are sophisticated and aware of the risks when compared to retail clients. It may be worth considering permitting institutional clients to engage in certain activities without the same authorizations that would be required to lend to retail customers.

34. Do you agree with the option we are considering for providing more transparency on risk present in collateralized lending transactions?

We agree with the proposal to provide more transparency on risks present.

35. Should regulatory treatment differentiate between lending (where title of the asset is transferred) vs staking or supplying liquidity (where title of the asset is not transferred)?

The processes, purpose, and risks involved differ greatly between these two activities. Staking is required for many cryptoasset governance structures and does not have the same risk to customers losing assets as title transfer lending. Title transfer lending exposes the lender to the credit risk of its counterparty, which is not the case in staking where the staking party only delegates certain rights but retains title to the cryptoasset.

This difference between lending (title transfer) and staking or supplying liquidity (no title transfer) may not be as clear to retail customers as to institutional customers. Disclosure to retail participants should describe in detail this difference and the resultant risks. That type of disclosure is less critical for institutional counterparties, who likely have experience with the implications of title transfer in the traditional financial markets.

Chapter 11 **Call for evidence: decentralized finance (DeFi)**

36. Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?

DeFi offers enormous promise. Through openness, interoperability, and transparency, it can increase competition, promote innovation, and facilitate inclusion in new forms of financial services. DeFi also presents novel challenges for regulation and supervision. It is critically important not to restrict innovative technologies at this early stage of development.

We note that introducing legal liability where it is not appropriate may discourage participation and have unintended consequences for the market, particularly at this early stage of development. We strongly agree with the statement in the Consultation that “parts of the value chain may not be practical to regulate, for example the underlying protocol if that has become truly open sourced and decentralized over time.”

We applaud the UK for seeking a proportionate, innovation-friendly approach, which recognizes the opportunities of new business models and encourages a thriving UK DeFi ecosystem. We believe that any regulation should allow sufficient flexibility in how the desired regulatory outcomes are achieved, to recognize the crucial differences between centralized and decentralized offerings and to preserve the latter’s unique benefits.

We also agree with the challenges set out in the Call for Evidence for regulating DeFi. Historically, regulators have overseen financial markets by imposing and enforcing rules on market intermediaries. DeFi applications rely on automated protocols to facilitate transactions between parties, with no centralized intermediary, and therefore it is not possible to regulate them using existing regulatory frameworks. As recognized by Professor Tarik Roukny in a paper for the European Commission:

“The combination of permissionless access to the consumption and provision of financial services by (legally) unidentified agents through automated protocols constitute an unprecedented setting where standard intervention tools may simply not be appropriate nor implementable”¹⁰.

In addition, DeFi is global and borderless by nature, and therefore it is inherently problematic for policymakers in any one jurisdiction to apply regulation in isolation. If countries come up with inconsistent and overlapping regulatory approaches, there will be lack of legal clarity and regulatory certainty around which rules apply. The work of the global standard-setting bodies and international coordination more broadly are critical in this regard. We commend the UK for clarifying that it does not intend to front-run global

¹⁰ European Commission, [Information frictions and public policies: approaching the regulation and supervision of decentralized finance](#) (June 2022).

standard-setting processes, in which we hope the UK plays a prominent role. We also note that the approach taken in the EU to monitor and assess the evolution and impact of DeFi in the Markets in Crypto Assets (MiCA) legislation is sensible.

37. How can the size of the “UK market” for DeFi be evaluated? How many UK-based individuals engage in DeFi protocols? What is the approximate total value locked from UK-based individuals?

The total value locked across DeFi globally was approximately USD 50 billion as of the end of April 2023,¹¹ and this figure is projected to increase significantly over the coming decade.¹² While it is challenging to estimate the size of the “UK market,” we expect it to be likely closely tied to the UK's relative share of the CeFi market. In 2022, the UK ranked first in Western Europe and 17th globally in the Chainalysis Global Crypto Adoption Index, having received over \$230 billion worth of crypto value, with a significant portion coming from DeFi. The UK accounts for about 20% of Western Europe's DeFi web traffic.¹³

Recently, the Coinbase Institute conducted a survey in 16 countries to determine the level of interaction with web3 products, including staking, borrowing, lending, and gaming.¹⁴ The results showed that 88% of respondents in the UK are aware of cryptocurrencies, ranking fourth among the 16 countries surveyed. Additionally, a significant portion of UK respondents were familiar with a range of web3 services, such as creating and owning NFTs, staking, crypto borrowing and lending, and 20% of the population had used at least one of these services. Centralized exchanges are the most common web3 service used (11%), followed by paying for goods and services with crypto (4%) and crypto staking (4%). The primary barriers to adoption are concerns regarding the volatility of digital assets, platform security and regulation.

38. Do you agree with HM Treasury's overall approach in seeking the same regulatory outcomes across comparable “DeFi” and “CeFi” activities, but likely through a different set of regulatory tools, and different timelines?

Given the evolving nature of cryptoassets and blockchain technology, a fit-for-purpose regulatory regime should focus on outcomes¹⁵ and should be technology neutral; as the Consultation states, “the objective is not to regulate the activity of developing,” and we agree with this approach. We accordingly wish to emphasize crucial differences between DeFi and CeFi, most importantly with respect to self-hosted wallets. A self-hosted wallet

¹¹ See [DeFiLlama](#), DeFi Overview, last accessed 25 April 2023.

¹² For example, Grand View Research estimates that the DeFi market will expand at a compound annual growth rate of 46% from 2023 to 2030. See Grand View Research, [Report Overview](#).

¹³ See Chainalysis, [2022 Geography of Crypto Report](#) (September 2022).

¹⁴ Coinbase Institute, [International Survey of Web3 Adoption](#) (28 April 2023).

¹⁵ As noted above, IOSCO Secretary General has advocated for a similar approach. See [Regulatory Insights Session - Interview with Martin Moloney, IOSCO Secretary General](#) (13 June 2022).

enables a user to retain control and possession of cryptoassets held in the wallet, without entrusting the assets to any other person or entity. In this respect, a self-hosted wallet is not like a bank or brokerage account, it is the digital equivalent of a physical wallet that a person may use to hold paper currency in their pocket. A self-hosted wallet application is a software product, not a financial service.

In developing a regulatory approach for DeFi, different tools will likely be required to preserve the unique characteristics and to achieve the same outcomes as compared to CeFi. The UK should take the necessary time to explore different options in order to ensure it achieves its objective of adopting a risk-based and innovation-friendly approach.

39. What indicators should be used to measure and verify “decentralization” (e.g. the degree of decentralization of the underlying technology or governance of a DeFi protocol)?

We agree with the conclusion that there is a “spectrum of decentralization among current DeFi offerings.” We also believe that there are no bright line criteria for determining whether an offering is decentralized or not. A case-by-case approach may therefore be most appropriate to assessing degrees of decentralization, particularly at this early stage in the development of the ecosystem as a whole.

The most important feature in assessing the degree of decentralization of a particular project or protocol is dispersion of control – the extent to which an individual person or entity is able to make changes to core functions or underlying code of a protocol. In a more decentralized protocol, agreement must be reached across a large number of disparate stakeholders for updates to be made; in a less decentralized protocol, updates could potentially be made unilaterally, or by a small number of persons or entities.

In practice, a protocol is likely to proceed through phases of increasing decentralization, at each phase enabling greater levels of participation from stakeholders beyond its initial development team. Two key variables in this respect are the mechanisms for authorizing updates, and the time given for proposed updates to be reviewed. Early in a protocol’s development, the necessary changes may be frequent and straightforwardly technical in nature. The best method for authorizing such changes is most likely a multi-sig, i.e., a mechanism requiring cryptographic signatures from a small number of well-informed experts, with immediate effect or with only a short window for review. Over time, as a protocol matures, governance tokens can be distributed based on the extent of individuals’ use of the protocol, and the best method of authorizing updates to the protocol would be a vote by the holders of governance tokens. Governance token holders can be given a period of seven days, 30 days or even longer to review the proposed updates and decide how they want to vote, and optionally “exit” from the protocol if they don’t agree with the changes.

The Ethereum network is highly decentralized, as demonstrated in its September 2022 shift from a proof-of-work to a proof-of-stake consensus mechanism. This feat took years to achieve, not only because of the technical complexity of the engineering, but because the wide dispersion of control across the Ethereum network necessitated a great deal of work to achieve alignment across many stakeholders.

Another important aspect of decentralization is transparency. DeFi protocols should be transparent, with all of the underlying code made public and auditable by anyone who wishes to do so. Where key features of a protocol (e.g., procedures for allocating tokens that are newly created or released over time) are not publicly known, that would be a strong signal that a protocol has a high degree of centralization.

We agree that business models should not dishonestly brand themselves as DeFi in order to circumvent regulatory obligations, and that such businesses should be subject to the same treatment as centralized organizations irrespective of whether or not they claim to be DeFi.

40. Which parts of the DeFi value chain are most suitable for establishing "regulatory hooks" (in addition to those already surfaced through the FCA-hosted crypto asset sprint in May 2022)?

We appreciate the desire to find a suitable structure for regulating DeFi activities and commend the UK for recognizing that the mere act of developing software is an insufficient hook. In the first instance, the focus of regulation should be centralized entities, as the "on and off ramps" for the cryptoasset ecosystem. Further exploration is needed on whether, in the future, entities traditionally outside the regulatory perimeter could or should be regulated in some way. For example, DeFi interfaces could reinforce specific safeguards, such as through wallet screening or a "blacklist" that denies services for sanctions enforcement or other illicit activity. The ability of decentralized protocols to maintain compliance on an ongoing basis – even as applicable requirements evolve over time, e.g., with the addition of new names to sanctions lists – is a promising area that certainly warrants further exploration.

41. What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?

As discussed above, we do not believe that it makes sense to regulate DeFi at this early stage of development, while it remains a nascent and quickly evolving ecosystem. However, we note that there are a number of possible approaches to DeFi, which would allow it to develop in a responsible manner. While further exploration is necessary, these might include:

- **Focus on "on and off ramps" like exchanges.** This approach would focus on the regulation of legal entities engaged in certain identifiable activities, such as

operating a centralized exchange for cryptoassets. This approach could also extend to aspects of DeFi activity, to the extent conducted by legal entities that are within the regulatory perimeter. In broad terms, this approach has the virtue of clarity but is likely to be both under- and over-inclusive in certain respects, and so should be supplemented with elements of other approaches.

- **Voluntary accreditation or certification system.** Regulators could oversee an accreditation system for smart contracts and applications that satisfy relevant operational, implementation and design standards. Accreditation would not be required for lawful operation nor be a guarantee from the regulator. It would, however, provide consumers and market participants some assurance that they are interacting with well-tested smart contracts and applications that have been subject to a degree of scrutiny and validation. It would also leave room for developers to continue to improve smart contracts and applications, including those that have not yet received accreditation.
- **Self Regulatory Organization (SRO).** The UK may also consider supporting the establishment of one or more SROs with the ability to create and enforce industry best practices standards and procedures pursuant to delegated regulatory authority. This approach may strengthen oversight and ensure standards remain fit for purpose and adaptable as the market evolves, while allocating a greater proportion of administrative costs to the industry and maintaining supervisors' authority to determine applicable requirements.

The UK should explore each of these options in more depth, including whether to pursue one or more of the approaches in isolation or in tandem. In each case, however, we caution that the freedom to engage in certain core activities – most importantly, the pure development of code – must be protected, so that DeFi can continue to innovate and flourish.

42. What other best practices exist today within DeFi organizations and infrastructures that should be formalised into industry standards or regulatory obligations?

As the Consultation recognizes, market practices are still evolving in the DeFi ecosystem, and, as such, we believe that cementing these practices as formal regulatory obligations would still be premature at this stage. That said, we believe there are areas of promising innovation, particularly in respect of governance and decision-making within Decentralized Autonomous Organizations (DAOs), that warrant further consideration and may in the future be appropriate to codify as industry standards. These include procedures by which updates to a DeFi protocol can be proposed, refined, voted upon and ultimately implemented by a decentralized group of stakeholders, as well as mechanisms for delegating specific authority from a large group to a smaller number of individuals.

Chapter 12 **Call for evidence: other cryptoasset activities**

43. Is there a case for or against making cryptoasset investment advice and cryptoasset portfolio management regulated activities? Please explain why.

There is no reason to require a new, additional authorization for firms to provide cryptoasset investment advice or cryptoasset portfolio management. As noted in the Consultation, these services are “relatively limited and geared towards High Net Worth client segments, presenting relatively little immediate risk of financial harms to retail consumers” and there are “important differences” between these activities and existing investment advice activities.¹⁶ Firms already regulated under the existing investment advice regime may be supervised for their advice related to cryptoassets, but regulators should let this nascent field develop before prematurely establishing any new authorization forms.

44. Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?

We strongly advise against subjecting mining and validation activities to financial regulation. Miners and validators – together with builders, pool operators, relays, searchers, and sequencers – are blockchain technology infrastructure providers that power crypto’s base layer. They produce cryptographically verified blocks of information to maintain the security of open, public blockchains. They are comparable to the role that internet service providers (ISPs) play in the operation of the internet. Just as ISPs are not subject to financial regulation, regardless of whether people might engage in financial transactions over the internet, it would be inappropriate to subject miners and validators to financial regulation merely because of the financial applications that are made possible by blockchain technology. Moreover, as observed by the Consultation, attempting to enforce regulation at the base level could simply push these activities abroad.¹⁷

45. Should staking (excluding “layer 1 staking”) be considered alongside cryptoasset lending as an activity to be regulated in phase 2?

We would strongly advocate for regulatory certainty in relation to staking. As the Consultation rightly points out, staking activity is set to increase and, given the environmental benefits of proof-of-stake over proof-of-work consensus mechanisms, this should be encouraged.

Primarily, an entity simply staking its own assets should not be subject to regulation – this is activity performed on an entity’s own balance sheet and should not be regulated. In

¹⁶ Consultation, p. 70.

¹⁷ Consultation, pp. 71-72.

relation to staking services (i.e., an entity performing validation services for customers in some way), we believe there are a wide variety of models of staking services that are not Collective Investment Schemes (CIS) in the UK, although at present in the UK there exists significant uncertainty regarding the FCA's views on the regulatory nature of staking services as a result of the FCA having sought to prevent registered UK cryptoasset firms from providing staking services to clients.

For example, the following characteristics would in our view put a staking service outside the UK CIS framework:

- users retain full ownership over their staked assets (i.e., no investment of money and no pooled ownership of staked assets)
- users retain day-to-day control of their staked assets, e.g., users retain full ownership and control over their staked assets and have the ability to unstake their assets at any time, consistent with the underlying protocol;
- the staking returns are determined by the underlying protocol, as opposed to the staking service provider's management of the staked assets;
- the staking returns represent payments for validation services provided to the underlying protocol, rather than a return on investment, and where the staking returns are set by the protocol and are the same whether the customer stakes on their own or through an intermediary service provider (less any service fee), i.e., no pooling of profits or income; or
- the service provider simply uses publicly available software and basic computer equipment to perform validation services, rather than providing management services with respect to the staked assets, i.e., the provision of IT services, not investment services.

All of the above highlight the many different potential forms of staking services, which cannot therefore all be fitted into existing regulatory frameworks. We would therefore suggest that, if regulators feel this is an area to focus on, the most sensible way to provide regulatory clarity would be to introduce a new regulated activity of providing a staking service, which would cover custodial platforms providing services enabling customers to participate in proof-of-stake consensus mechanisms, where these services fall outside the CIS framework. We would argue that, as with stablecoin trading and custody (see response to question 9 above), a staking services authorization should be a stand-alone activity but also covered as an ancillary activity under an exchange authorization.

The other option would be to leave non-CIS staking services outside the UK regulatory perimeter. However, in this scenario, we feel that additional FCA guidance would be required to ensure that firms understand what characteristics or features of a staking

service would cause the FCA to view it as a regulated CIS activity as opposed to a non-CIS activity. Without this additional guidance our concern would be that regulatory uncertainty could discourage firms from offering staking services in the UK. Even when a platform wanting to offer staking services has taken appropriate legal advice around the definition of a CIS, there is currently a risk of a regulator claiming that a Collective Investment Scheme is being operated in the UK, which for many firms is not a risk they are willing to take.

The last point we would make on this (related to the wording of this question which places staking and lending next to each other, conceptually) is to ensure there is a clear distinction between staking services that allow users to participate in network validation activities (which are what we consider to be staking services for the purposes of the response to this question) and services described as “staking” which are actually just lending platforms (where returns are generated from lending rather than validation activity). It is not uncommon to see platforms using the term “staking” to actually refer to services where a return is generated, but not from participation in network validation. Clearly any services described as staking should be considered on their individual merits from a regulatory perspective, with authorizations appropriately defined to cover staking services involving validation, and lending services described as “staking”, using the wider sense of the phrase.

46. What do you think the most appropriate regulatory hooks for layer 1 staking activity would be (e.g. the staking pools or the validators themselves)?

As described in our responses to questions 44 and 45, while validators operating on their own balance sheet should not be subject to financial regulation, if a validator provides a custodial service to customers enabling customers to participate in validation activities (and receive reward as a result), to provide regulatory certainty in the UK those activities should be subject to a new authorization category that allows those services to be provided to the validator’s customers. That authorization should be a stand-alone one but also be an ancillary activity to an exchange authorization, to allow an exchange to perform validation services for its customers within the bounds of its exchange authorization.