

To:

Financial Conduct Authority
12 Endeavour Square
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Consultation on Guidance on Cryptoasset Financial Promotions: *Complex High Yield Models/Arrangements*

Coinbase Global, Inc. and its UK subsidiary CB Payments Ltd. (together, Coinbase) welcome the opportunity to respond to the FCA's consultation on Guidance on Cryptoasset Financial Promotions, and the important discussion questions on complex yield models and arrangements (specifically, staking).

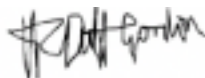
Coinbase started in 2012 with the idea that anyone, anywhere, should be able to send and receive Bitcoin easily and securely. Today, we are publicly listed in the US and provide a trusted and easy-to-use platform relied on by millions of verified users in over 100 countries around the world to access 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 UK has taken a leadership role globally in its approach to crypto assets 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.

While this vision is important, it is critical that it is matched by good regulatory outcomes, which protect consumers but are also proportionate to the risks involved. This is particularly true for the regulation of staking. Without broad retail participation in staking we risk losing proof of stake blockchains, and with them a significant part of the entire Web3 ecosystem and the innovation that accompanies it.

We look forward to engaging with the FCA's work on the regulatory treatment for staking, which is critical to the future growth, resilience and sustainability of blockchain technology.

Yours sincerely,



Tom Duff Gordon, Vice President, International Policy

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 offer the potential to exponentially expand opportunities for the financial system. Yet, cryptoassets are more than a financial innovation; they have the potential to transform any sector of the economy that relies on efficient and decentralized record keeping and value transfer. This can transform today's internet, which is dominated by a handful of companies that profit from monetizing their users' personal data. The next phase of the internet, web3, based on token-gated commerce, will enable builders and users to take control and monetize their information and activities outside of the current walled gardens that dominate today's internet.

Staking protocols are integral to the growth of the crypto economy

Staking is a critical technology that ensures the accurate, secure, and efficient operation of many blockchains. At its most basic level, staking is the process by which users can contribute to the network by securing the blockchain, creating blocks, and processing transactions. Users are compensated for performing this work in the form of transaction fees and consensus rewards by the protocol itself. Aside from Bitcoin, most major blockchains today leverage a proof of stake model because it is open, secure, and environmentally friendly. Staking rewards users who participate.

Staking should not be confused with lending

There has been some misuse of the term staking in the market to describe both centralized and decentralized lending activity. In a lending transaction, one party gives up ownership of an asset to another party, who promises to return the asset at a later date, usually with interest. The lender puts those assets at risk for the duration of the loan. In contrast, stakers never relinquish their ownership of the assets staked. Instead, they temporarily lock up these assets by staking them, but always retain the right to un-stake their assets, and always remain the owners of those assets. There is no investment or counterparty risk associated with staking.

Staking is open and decentralized by design

Securing blockchains is a community activity that ensures fully decentralized applications and broader access and ownership over data and assets. Through staking, everyone can participate in administering the crypto economy. Proof of stake protocols distribute the process of block creation to a large group of individual validators, making it possible for

token holders to directly engage in securing the network. Millions of dispersed users around the world earned an estimated \$3bn from staking their assets in 2022.

Staking is environmentally friendly

Proof of stake has already demonstrated that it validates blockchain transactions at huge scale and with minimal environmental impact relative to other consensus mechanisms. All it takes to become a staker is some crypto, an ordinary computer and free, open-source software. Because validation work is broadly distributed, this model is more resilient than a traditional data center and more energy efficient than the proof of work model used on other crypto networks. For example, the entire Ethereum network consumes an estimated 0.00026 TWh annually – significantly less than the energy consumption of Netflix.¹ This energy efficiency is only possible because of staking. Before Ethereum adopted the proof of stake model, it used about 30,000 times more energy a year.

Regulatory Treatment of Staking Services

Coinbase supports the Government's commitment to establishing a regulatory framework for crypto assets, and HM Treasury's most recent consultation is a significant step in the journey to providing legal certainty to the market. At present there exists significant uncertainty regarding how the FCA plans to treat staking services offered by UK cryptoasset firms.

It is important to note that Coinbase does not currently offer any lending products to retail customers in the UK - our staking solution is a true staking offering, where rewards are earned solely from validation activities, and customers retain full ownership of their assets. When designing the appropriate regulatory approach for staking services, we ask that the UK consider the following:

- **Appropriately recognize what constitutes true staking.** Staking in the true sense of the term allows users to participate in network validation activities. Rewards are earned from the blockchain network itself – through transaction fees or protocol distributions – and staked tokens remain the users' property at all times. However, some platforms use the term "staking" to refer to lending services, where returns can come from undisclosed counterparty risks or economic exposures to volatile price fluctuations. These risks are not present when participating in a network staking protocol. DeFi lending protocols and product offerings by crypto service providers that entail these risks should not be labeled as staking.
- **Staking does not pose financial risk.** There is no investment of money in staking and, in contrast to lending, staked assets do not leave the protocol. Nor are

¹ See

<https://ethereum.org/en/energy-consumption/#:~:text=Ethereum's%20energy%20expenditure,across%20the%20entire%20global%20network>

consumers subject to any counterparty risk from staking, since they retain ownership of their staked assets at all times. While network penalties (“slashing”) are possible (if the validator validates incorrect transactions), they are extremely rare. Coinbase has offered staking services since 2019, and no customer has lost assets. Coinbase’s staking service has never been slashed, and even if slashing did occur, Coinbase’s User Agreement indemnifies the loss of slashing due to Coinbase’s error.

- **Individuals can stake assets on their own, but it is less convenient and safe than using a staking service.** Today, even if companies like Coinbase did not offer staking services, individuals can still stake directly on the protocol, using open source and freely available software. No intermediary is required. However, direct staking by an individual requires storing their own keys, configuring their own computers, and patching their own software. This introduces operational risk that can otherwise be mitigated by a professional service provider like Coinbase. Fee-based staking services thus provide a more efficient and safer way for less technically resourced individuals to participate in staking and earn rewards. Restricting staking services would therefore not protect retail investors. Rather it would simply deny consumers access to safe and secure IT infrastructure to participate in staking.
- **Staking services do not implicate a Collective Investment Scheme (CIS).** True staking services, including those offered by Coinbase, allow users to retain full ownership and control of their assets. Most notably, there is no investment of money. Customers incur an opportunity cost of pledging their assets for the purpose of validating transactions. Staking services can perform this function on behalf of customers in exchange for a fee. To provide regulatory clarity to the market, and as we recommended in our response to HM Treasury’s February consultation, the UK should introduce a new regulated activity of providing a staking service, and thus enable mainstream customer participation in proof of stake consensus mechanisms outside the CIS framework ‘test’.

Staking activity should be broadly encouraged as it is critical to the infrastructure of many layer 1 blockchains, and allows the community of digital asset users to accrue economic benefits from their participation in the blockchain ecosystem while improving the security, sustainability, scalability, decentralization and efficiency for blockchain activities. Regulatory certainty on staking services is crucial to protect consumers and support the development of blockchain technology and its use cases.

Finally, we note that staking is not a “controlled activity” and therefore does not fall within the scope of the Financial Promotions regime, unless it has already determined to invoke a CIS. We disagree with the proposition that staking is a CIS, and we elaborate on this point further in our answer to question 7 on the appropriate regulatory treatment of staking as a service.

Questions on complex yield models/arrangements

Coinbase does not currently offer any borrowing or lending products to consumers in the UK. Our response to the questions below focus on staking services only, which we suggest that the FCA defines as follows:

- Staking is the process by which token owners participate in a blockchain's proof of stake consensus mechanism. Stakers follow protocol rules to create and validate new blocks on the chain. They are compensated for this work in the form of transaction fees and rewards issued by the blockchain itself.
- Staking services are an additional feature that some crypto custodians provide, allowing token owners to participate in staking without operating their own computers or storing their own keys. A staking service provider will typically manage staking software on behalf of a token owner, passing along any rewards received from the relevant blockchain network. For performing this IT function, staking service providers are typically paid a fee, often denominated as a percentage of the rewards the token holder receives from the blockchain network.

Q1: What are the benefits and opportunities of crypto asset borrowing, lending and staking models/arrangements for consumers?

The shift from proof of work to proof of stake is a significant development in the operational efficiency of the blockchain, bringing significant benefits to consumers:

- Staking is a valuable network activity that strengthens the blockchain for the benefit of all consumers. Wider participation in staking as a consensus mechanism increases the resilience of the blockchain for everyone. Networks are designed to be owned and controlled by their users, and to be open and decentralized. The more people staking, the stronger the network is.
- The software to operate a validator node can be downloaded and installed by anyone. This makes participating in proof of stake blockchain networks much more accessible than proof of work networks to individuals who wish to participate. It strengthens the individual staker's position as a contributor to the chain, and stakers see a specific monetary reward for their contribution. Our research suggests that staking activities resulted in \$3bn being paid out globally in 2022.
- While it is possible for a crypto owner to stake on their own, staking service providers offer an easier and safer means to operationalize staking activities for all users. Leading staking service providers are equipped to protect assets from hackers and ensure all staking systems are working properly with minimal downtime (see answer to Q2).

- The very limited risks involved are IT risks which are relatively predictable for consumers of staking services. While “slashing” risk is possible, it is extremely rare for protocols to impose these penalties. In nearly 4 years of operating our service, no Coinbase customer has ever lost assets as a result of slashing.
- Staking brings environmental benefits by decreasing the energy and computational demands compared to other consensus mechanisms. Ethereum has become approximately 30,000 times more environmentally efficient since its transition from a proof of work to proof of stake consensus mechanism.

Staking activity is set to increase and this should be encouraged as it presents significant advantages in terms of security, sustainability, scalability, decentralization, and cost-efficiency for blockchain activities.

Q2: Which type of crypto asset borrowing, lending and staking models/arrangements provide the greatest benefit to consumers?

Staking in the true sense of the term allows users to participate in network validation activities. Rewards are earned from the blockchain network itself through transaction fees or protocol distributions. Although some platforms use the term “staking” to refer to lending services, in true staking users’ assets remain their property at all times.

Staking is a valuable network activity that strengthens the blockchain for the benefit of all consumers. Wider participation in staking as a consensus mechanism increases the resilience of the blockchain for everyone. Networks are designed to be owned and controlled by their users, and to be open and decentralized. The more people staking, the stronger the network is. Users who participate in staking earn rewards for helping to secure the Web 3 ecosystem and the innovation that accompanies it.

The proliferation of proof of stake blockchains have resulted in the development of staking service providers, offering an easier and safer means of participation by giving customers basic IT and administrative support. Without staking service providers, individuals must hold their own private keys (loss of keys means loss of assets), and there is a risk of slashing if there are mistakes in the software configuration. For less tech savvy retail customers, staking service providers will protect their assets, provide IT infrastructure and cold storage, and offer the ability to earn rewards. This is a safe and convenient way for retail customers to participate in blockchain validation rewards.

Leading staking services offer dedicated computers with reliable internet connections, and up-to-date software to enhance the security of the staked crypto assets. Staking services are a form of cloud computing services: a traditional technology concept where shared data centers are made available to users over the internet. Users avoid the cost and complexity of running hardware and managing software updates by paying a fee to

the cloud computing services operators who perform these tasks without discretion on their behalf.

Similar to cloud computing services, core staking service providers operate blockchain software and manage underlying security, technology, and availability of the service. Staking rewards originate from the underlying protocol, not the staking service provider. Protocol rewards do not change based on whether a staker is using a service or doing so independently. Staking service providers perform a pass through function, taking a fee from users to pay for the service provided. These services allow more people to stake, adding more validating capabilities thereby strengthening the blockchain.

Restricting staking services would not protect consumers. Rather it would simply deny consumers a safe and secure way to participate in blockchain validation rewards while contributing to the security of the blockchain.

Q3: What are the risks associated with crypto asset borrowing, lending and staking models/arrangements for consumers?

In contrast to lending, there is no counterparty risk associated with staking. Although a staking validator can in rare, predefined circumstances be subject to penalties (slashing) for not adhering to the protocol rules, this risk is extremely low. Importantly, a user would face this risk if staking on their own, and the risk can be substantially mitigated by use of a staking service like that of Coinbase.

We note that there are often misconceptions around the risks associated with staking versus lending. To use Coinbase's staking services as an example:

- The assets always belong to the customer. When Coinbase stakes assets for a customer, the ownership rights do not change. The customer owns the assets, and Coinbase stakes them on their behalf. This is explicitly stated in the User Agreement, which governs the terms of the relationship between the user and Coinbase, including with respect to staking.
- The assets do not leave Coinbase custody. They remain in the customer omnibus wallet, which Coinbase holds the private keys to. When a customer requests that their assets are staked, Coinbase conducts additional blockchain transactions on the assets that are already held. Coinbase delegates these assets to a validator. The customer is not therefore required to accept any additional custody risk when they hold assets with Coinbase and choose to stake those assets using Coinbase's staking services.
- Staked assets are custodied in the same way as un-staked assets. Whether customer assets are staked or unstaked, they remain the property of the customer. Staked assets are never the property of Coinbase.

- Finally, Coinbase does not stake customer assets without consent. Users must explicitly instruct us to stake their assets to participate in staking.

The risks associated with staking are extremely low:

- **The primary risk comes from slashing.** If validators do not follow the rules of the underlying protocol, they can lose some of their staked assets as a penalty in a process known as slashing. To date, Coinbase has never been slashed. Even considering the performance of home stakers and our competitors, slashing is very rare. In terms of overall slashing rates, only 0.0000085% of staked ETH has been lost to slashing on Ethereum due to validator/operator errors.² If there is slashing, Coinbase fully reimburses any network penalties imposed due to Coinbase's operational error. No Coinbase customer has ever lost any assets as a result of slashing.
- **There is a lock up period associated with staking.** This lock up comes from the underlying protocols, and varies from a few days to a few weeks. Because of this protocol feature, a customer who chooses to stake may not be able to liquidate or transfer their staked assets immediately. Again, this risk is the same whether a user stakes on their own or with a staking service.
- **The level of rewards can vary over time.** The rewards depend on the operations of the underlying blockchain protocols. Under Coinbase's model, all rewards are passed onto customers, as codified in our user agreements around the world, after commission that is transparently disclosed. Coinbase does not use any discretion on the rewards paid out. However, there is no guaranteed rate of reward paid out by the network; the reward can vary depending on the operation of the network. We note that there are some models of staking in the market, whereby platforms retain full discretion to pass on as much or as little of the rewards as they see fit. In true staking, rewards are set by the protocol and must always be passed on to the customer, minus any commission (which Coinbase transparently discloses).

Q4: Which types of crypto asset borrowing, lending and staking models/ arrangements present the greatest risks to consumers?

It is important to ensure there is a clear distinction between staking services that allow users to participate in network validation activities and other services described as "staking" but which are in fact borrowing and lending platforms, such as where returns are generated from assets that the consumer lends to other counterparties. Lending and staking are not the same thing, and lending is not part of the validation activity that

² Calculated from network data on the Ethereum protocol provided by Rated.network

staking supports. Some platforms have used the term “staking” more broadly than its actual meaning to refer to services where a return is generated, but not from participation in network validation. This activity is mis-labeled, and introduces uncertainty for consumers around the risks.

The processes, purpose, and risks involved differ greatly between staking and other regulated activities. In particular, staking does not pose the risks to customers of lending that involves title (i.e., ownership) transfer. Title transfer lending exposes the lender to the credit risk of its counterparty (and subsequently their counterparties), which is different from staking, where the staking party delegates certain functions but retains ownership of the asset. In stark contrast to staking, there are examples of crypto lending services that have caused retail losses. There are no such examples with true staking services provided by platforms.

There is also no “investment” in staking because there is no financial risk taken in search of returns. Investment risk is completely absent from the use of core staking services, where customers’ assets remain safe/secure and not subject to financial loss (except, as noted, the remote risk of slashing). The purpose of staking is to provide a validation mechanism for a network or protocol. The rewards are paid for the validation services the asset owner participates in by staking the assets. Those rewards are not returns on investment; instead, they are akin to service fees, paid by the blockchain protocol, and are the same whether the customer stakes on their own or through a service such as that provided by Coinbase³.

Actual staking services should be distinguished from lending services from a regulatory perspective, even if a lending service is improperly labeled as “staking.” Disclosures to retail participants can and should describe in detail this difference and the resulting risks, much like Coinbase today explains to its staking services customers today that their assets are always their own.

Q5: If you are a firm that provides cryptoasset borrowing, lending or staking models/arrangements to retail investors please provide information on:

a. The different types of cryptoasset borrowing, lending and staking models/arrangements you offer to consumers and the form of related financial promotions.

Coinbase does not currently offer any cryptoasset borrowing or lending to retail customers. Coinbase offers true, on-chain staking services for six assets: ETH, DOT, SOL, ATOM, ADA and XTZ. Coinbase has offered staking services since 2019 and has never lost customer funds.

³ Note that the cost of staking may vary, depending on how a user chooses to stake

b. What data does your firm collect to calculate advertised rates of return?

Rewards are generated solely from validation activities and depend on the operations of the underlying blockchain protocols. Under Coinbase's model, all rewards are passed onto customers, as codified in our user agreements around the world, after commission that is transparently disclosed. Coinbase does not use any discretion on the rewards paid out. However, there is no guaranteed rate of reward paid out by the network; the reward can vary depending on network conditions.

Our User Agreement and marketing materials make clear that advertised rates of rewards are based on historical reward rates received by Coinbase customers for a given network. To be as transparent as possible to users, we consistently present these as annualized rates after our fees (i.e., APYs). We also explain that this is an estimate only, may change over time, and that no reward is due unless it is received by Coinbase.

Our experience is that protocol rates can appear to vary across service providers for two reasons. First, as explained, some services marketed as "staking" activities are in fact engaged in lending activities and generate a rate of return that may be different from the actual rewards paid by the staking protocol itself. Second, even when the gross protocol receipts are on par between providers, marketed APYs may vary as a result of different fees charged by different providers.

c. What modeling does your firm undertake to calculate advertised rates of return?

We do not perform any forward-looking modeling or predictions for purposes of advertising. Rather, we calculate historical rates based on recent network activity because network activity – rather than any kind of investment activity – is the sole determiner of rewards for Coinbase staking services customers.

d. What steps does your firm take to assess and mitigate the risks to consumers associated with these models/arrangements?

Because we do not lend consumers' crypto assets, our customers face no investment or counterparty risk. As for our staking services, we:

- Begin with best-in-class key storage and reliable crypto asset custody.
- Take extensive precautions to ensure our validator nodes are operating correctly.
- Diversify our vendor, hardware, and software selections to reduce the risk of overlapping failure points. This reduces the risk of downtime or network penalties. To be clear, the risk of such penalties is already very small at the protocol level. For

example, on the Ethereum network only 0.0000085% of all staked ETH has been lost to slashing.⁴

- Indemnify customers' slashing losses due to an event within our reasonable control. If such a highly unlikely event were to occur, Coinbase has committed in its terms and conditions to make clients whole, and would do so by paying clients from our own funds. No Coinbase customer funds have ever been lost due to a slashing event.
- Transparently and proactively communicate the risks of staking to our customers. See, e.g., our Help Center.

As a result of these precautions, Coinbase has never lost any customer cryptoassets for any reason. In almost four years of staking, no keys have been lost and no customer has lost assets, including due to slashing.

Q6: Please provide any data, including details of the source and time period for the data, you have or are aware of related to:

a. The number of UK consumers who invest in cryptoasset borrowing, lending and staking models/arrangements and the average amount invested.

We can only speak to our own staking business. As of 31 March 2023, we had just over 450k staking customers in the U.K., with approximately \$170M USD equivalent of crypto assets staked across the networks we support.

b. The number of firms who provide cryptoasset borrowing, lending and staking models/ arrangements to UK consumers.

N/A

c. Gains or losses experienced by UK consumers in relation to crypto asset borrowing, lending and staking models/arrangements.

In the first quarter of 2023 (3 months), our UK staking customers received just over \$1.18M USD equivalent of staking rewards (after our fees). No Coinbase customer in the UK – or anywhere in the world – has ever lost any crypto by participating in staking.

⁴ Calculated from network data on the Ethereum protocol provided by Rated.network

Q7: Are there any other issues we should take account of when considering our approach when developing regulatory requirements for cryptoasset borrowing, lending and staking models/arrangements?

We welcome the opportunity to share our perspective on the appropriate regulatory treatment of staking services.

In relation to staking services (i.e., an entity performing validation services for customers in some way), we are aware of the FCA's concerns around Collective Investment Scheme structures within staking, but we believe there are a wide variety of models of staking services that are not a CIS in the UK. 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, according to the terms of the underlying protocol;
- The staking rewards offered by the underlying protocol do not depend in any way on the staking service provider's management of the staked assets;
- The staking rewards represent payments for validation services provided to the underlying protocol, rather than a return on investment. Staking rewards 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; and;
- 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.

Further, it is worth considering the risk position here, and how staking is different to a traditional CIS. In our view it is not appropriate for staking to be regulated as a CIS for two additional reasons:

- Turning the CIS analysis around and looking at it from the perspective of how a CIS is structured, it is difficult to see for example: (a) where the "manager" of the CIS is; (b) what "management" of the underlying assets is taking place; (c) what "investment" is occurring; (d) what the defined investment policy is; and (e) where customers can suffer negative returns. In our view this clearly illustrates the fundamental differences between a CIS and a staking service.
- Following the "same risk, same regulatory outcome" approach, the risks in relation to staking products are entirely different from a traditional CIS. With a CIS, the risk

is primarily downside from poor investment management leading to either flat or negative returns. With staking services, the risk is technological - will there be slashing, and will my assets be safe in custody? Therefore, it is inappropriate to seek to regulate staking as a CIS as the regulatory regime for a CIS does not address the specific nuances of a staking service.

All of the above highlight the specific characteristics of on-chain staking services, which in our view cannot be retro-fitted into existing regulatory frameworks. Moreover, covering staking as part of the CIS framework effectively prohibits retail participation (units in a CIS cannot be offered to retail investors in the UK), which for all the reasons set out above, is counter-productive and does not reflect the risks associated with staking. Staking activity is low risk to retail customers, and is crucial to the future of blockchain activities.

One option would be to leave non-CIS staking services outside the UK financial services regulatory perimeter. 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 will not be a risk they are willing to take.

To the extent that the UK wants to implement rules, these rules should reflect the risks associated with staking. The most sensible way to provide regulatory clarity would be to introduce a new regulated activity of providing a staking service, which would cover platforms providing services enabling customers to participate in proof of stake consensus mechanisms, where these services fall outside the CIS framework. Customers will be at risk of harm if staking is mis-categorized.