Digital Currencies
Governance Group

First approach to the UK Stablecoin Regulation

DCGG Position Paper

Digital Currencies Governance Group (DCGG) and our members, which include among others the global stablecoin issuer Tether and the digital asset exchange Bitfinex, strongly believe that the UK has the unique power to bring together disparate players in the cryptoasset community and to become a global hub for cryptoasset technology and investment. DCGG, on behalf of its members, welcomes the thought and effort put into this proposal, which aims at positioning the UK right at the centre of the nascent and vibrant crypto market. Furthermore, the deployment of best practices that guarantee the safe use of payment cryptoassets could make the UK a pioneer in the digital assets space.

DCGG believes that the UK is well placed to play a leading global role in the crypto market. The entrepreneurial drive of the UK's financial services ecosystem, coupled with an established market infrastructure and a well-functioning regulatory regime, gives the UK significant advantages. However, crypto moves quickly: developments happen in months, not years, and consequently, the UK will itself need to be flexible and fast-moving in order to take full advantage of the crypto market. There is a strong need to ensure that innovative technologies are implemented in a way that guarantees that all legal provisions rely on the most cutting-edge technology whilst ensuring they will stay future-proof and at pace with faster technological innovation.

The UK's first approach to digital assets is broadly good news for the industry because it demonstrates that flexibility and adaptability. However, there are a number of areas where DCGG believes more can be done to provide the regulatory environment that strikes the right balance between managing risks and fostering innovation. This is especially the case when considering the position of non-UK crypto providers interested in continuing or starting to provide cryptoassets services in the UK.

About DCGG

Digital Currencies Governance Group (DCGG) is an international trade association and consultancy, created to strengthen the voice of the digital assets industry. We provide practical insights and state-of-the-art expert knowledge to inform legislators and regulators on opportunities and policies concerning digital-assets. DCGG seeks to facilitate an open dialogue and encourages communication between political representatives and digital currency experts to ensure that legislation supports both political objectives and innovation in the digital-asset space.

PAYMENT CRYPTOASSETS: UK UPCOMING REGULATION ON STABLE TOKENS

Below is a summary of the key points DCGG has considered in relation to forthcoming Government activity around stablecoins and DLT:

1. HMT proposes to introduce a new class of cryptoassets, “payment cryptoassets” which will cover any crypto secured digital representation of monetary value stabilised by reference to one or more fiat and/or is issued or used as a means of payment. DCGG agrees with the proposed definition of “payment cryptoassets”. However, DCGG’s view is that the industry would benefit from further guidance on the classification methodology that will be used at the legislative and regulatory level to distinguish “payment cryptoassets” from stablecoins referenced to assets other than fiat currencies.

2. We understand that cryptoassets pegged to commodities or other assets will be part of a second wave of legislation (as will NFTs and DeFi). DCGG agrees with the staggered approach to regulating digital assets, as this will provide time to the industry to assess and comply without hindering competitiveness.

3. We understand that HMT’s proposal is to adapt existing payment services laws[1] that govern electronic money to cover payment cryptoassets, bringing them under the supervision of the FCA. Whilst DCGG agree that new legislation must be avoided to prevent double regulation and that certain aspects of the existing e-money regime can easily be adopted by the cryptoasset regime to avoid a potentially over- burdensome legislation, the following considerations stem from fitting in payment cryptoassets into the existing e-money and payment legislation:

    - Issuers of payment cryptoassets will have to hold 1:1 GBP reserves for tokens used for payments (custodied in the UK), so long as they address UK clients (even if on a cross-border basis). Convertibility will be 1:1 into GBP fiat at par and on-demand (as e-money currently are). DCGG highlights that by contrast, the EU intention in its upcoming digital assets regulation is to request that stable tokens used for payments shall be admitted to be backed by a foreign currency, such as USD, and shall have a reserve mechanism where 30% of reserves would be backed by the pegged fiat currency while 70% can be reinvested in HLFI. This proposal, supported by the Council of the EU, is materially less burdensome and more competitive than the HMT’s proposal of 100% reserves convertibility into GBP. This creates a significant competitive imbalance with the EU, and risks cryptoasset issuers being incentivised to move away from the UK market;

    - Wallet providers and stablecoins payment service providers will have to be authorised by the FCA, and if systemic, also by the Bank of England. We note that there is little detail what “systemic” means and how this parameter is to be measured.

[1] The Electronic Money Regulations 2011, the Payment Services Regulations 2017 and Parts 5 of the Banking Act 2009, and the Financial Services (Banking Reform) Act 2013 will be amended to cover the changes proposed. The changes will introduce a regulatory mandate in relation to stablecoins for each of the FCA, Bank of England, and Payment Systems Regulator.

REGULATORY CERTAINTY AND THE ADVANTAGES OF BLOCKCHAIN TECHNOLOGY

Alongside these specific comments on stable tokens used for payments, we would like to raise the following wider points:

4. DCGG would suggest regulatory clarity through explicitly stating that a fully licensed UK e-money Institution (EMI) can be a stablecoin issuer. For the purpose of prudential regulation, such an institution could deposit fiat (multiple fiat currencies) at the Bank of England for the scope of protecting both consumers and stable token issuers. This step would greatly enhance consumer protection whilst minimising market abuse regulation and financial risks to consumers found in when other regulated instruments are used.

5. We believe that DLT can be considered much safer than traditional payment systems. In comparison to traditional payment systems, DLT offers a number of benefits such as less counterparty risk, lower settlement fees, simplified operational processes, safe access to lending platforms and a higher level of transparency. In our view, this means that DLT does not require a more stringent regulatory approach as traditional payment systems, but that the regulatory approach should directly reflect risk.

6. DLT also offers great transparency tools that can smoothly ensure that payment cryptoassets and other stablecoins are safe for consumers. For example, the UK regulator could require that the information concerning rights of redemption is public with a regular publication of balance sheets on the blockchain. This will ensure that transactions stay fast and smooth whilst taking all necessary consumer protection measures. This would also decrease audit expenses for industry players who would not be forced to use traditional audit methodology that does not correspond with the modus operandi of such an industry.

UPCOMING REGULATION: DEFI AND WALLET PROVIDERS

DCGG understands that HMT has expressed the intention to regulate other areas of digital assets in the near future, particularly with regard to DeFi and NFTs. In this regard, DCGG would like to make the following observations regarding DeFi to highlight the risks connected to imposing legislation on a technology that is currently evolving and does not have the characteristics of the centralised entities that HMT intends to regulate.

- Unlike traditional service providers, DeFi entities do not hold client assets in centralised reserves.
- DeFi entities are typically not set up as centralised legal structures which have the power to comply with them and can be liable for non-compliance. Governance is conducted through tokens, or de-facto votes, which each user has in proportion to their level of transactions.
- Risk-management, including managing AML risk and consumer protection, are enshrined in the computer code of the algorithms.

Rushed DeFi legislation would obstruct the development of this emerging industry and drive it offshore to more favourable jurisdictions. The same principles apply to NFTs.

With regard to wallet providers, DCGG is concerned by HMT's statement that wallet providers will have to be authorised by the FCA regardless of the type of wallet they are. We believe the simple element of providing access to the token does not necessarily confer any obligation beyond providing access to the token. Also, the HMT proposal does not differentiate between "cold wallets" (e.g., hardware USB sticks) and assets custody wallets, which would be key to determining the scope of application of the upcoming rules. In fact, given that hard wallets are mere technological devices that do not have a custodial obligation, there is a strong argument that logically they should be kept out of scope indefinitely as this is not where the risk lies. DCGG, on behalf of the industry, would welcome further clarity on this.

CONCLUDING REMARKS

Outside the EU, the UK has a golden opportunity to seize the innovations of DLT finance and become a model jurisdiction in the deployment of these technologies. Welcoming innovation and competition whilst mitigating risks to consumers and maintaining the stability of the financial system will make the UK the most eminent, safest, and most sought-after digital assets regulatory jurisdiction worldwide. To get there, it will be vital to ensure that proposed legislation provides for precise categorisations of the digital assets to regulate, and clear guidance to the providers.

As representatives of some of the major players of the digital-asset scene worldwide, DCGG remains at your disposal for any further detailed information and technical suggestions on how to practically develop the propositions made in this text.

We encourage UK regulators to approach the topic of digital assets holistically by taking into consideration all aspects mentioned above and to grasp the unique leadership chance that the UK can seize when implementing this new regulation. We believe the above suggestions would greatly contribute to creating jobs, facilitating economic growth, and enabling major technological innovation in the sphere of digital finance. These benefits can help the UK achieve real and continuing leadership in the digital finance world.