DIGITAL CURRENCIES
Governance Group

DIGITAL CURRENCIES GOVERNANCE GROUP

VIA ELECTRONIC SUBMISSION

28.04.2023

Re: Response to Request for Consultation on HM Treasury's proposed Future Financial Services Regulatory Regime for Cryptoassets

I. About Digital Currencies Governance Group

Digital Currencies Governance Group (DCGG) is an advisory firm that represents digital assets issuers and service providers in both the UK and EU. Our mission is to facilitate an open dialogue and encourage communication between policymakers and digital asset experts to support the design of a sound and proportionate regulatory framework that ensures safety for all market participants. Our Members include Tether – currently the largest stablecoin issuer worldwide, Ledger – a leading technology service provider for self-custody, Bitfinex – a crypto-assets exchange, ZKV - a leading proof-of-stake validator, and Iden3 - a company working on self-sovereign identity management. Our team of former government officials, lawyers, and cryptoasset experts regularly engage with policy-makers and regulators both at the national and international level. For any general enquiries or to request information, please do reach out to info@dcgg.co.uk.

II. Introduction

Digital Currencies Governance Group ("DCGG") welcomes the opportunity to comment on HM Treasury's proposed framework for the future regulation of crypto-asset activities. DCGG applauds the process undertaken by HM Treasury to solicit public engagement on this important topic, and welcomes the opportunity to be part of the ongoing dialogue. Recent market events and turbulence in crypto-asset markets and related businesses, including events such as the collapse of FTX and the Terra/Luna project, highlight the need for significant standards setting, professionalisation, regulation, and reform across the digital asset space. The fallout from these events highlight the need for a comprehensive, coordinated, international approach to the regulation of crypto-asset related activities within Centralised Finance. This will require ongoing collaboration across industry, government, and the relevant supervisory bodies.

In general, DCGG supports the incremental development of proportionate regulation to ensure that consumers are adequately protected from harms arising from crypto-asset activities. It is right that effective regulation can create the conditions for crypto-asset service providers to thrive in the UK, and give consumers and businesses the confidence to interact with crypto-asset services with an understanding of the risks involved, where relevant. The government's approach towards developing a proportionate regulatory regime following consultation with industry is a positive process in understanding the specificities of different business models, and the potential opportunities of getting the right regulations in place. We believe that the design of a regulatory regime should first consider whether intervention is necessary, and, if so, to what extent, given the diverse array of emerging business models within the sector.

Overall, we support the objective of HM Treasury's consultation and call for evidence to establish a proportionate, clear regulatory framework which enables firms to innovate at pace, while maintaining financial stability and clear regulatory standards. We believe bringing further crypto-asset activities, such as centralised exchanges, custody, lending and borrowing within the regulatory perimeter is needed to meet the government's ambition of making the UK a hub for crypto-asset technology and investment. However, it is right to consider where a light-touch approach to regulation may be sufficient for certain activities that are more nascent, or where they already offer higher levels of consumer protection provided through underlying technologies, such as the blockchain. In some instances, we believe the government should continue to monitor how certain markets develop before attempting to regulate in the absence of clear regulatory standards or threats to financial stability. An example, acknowledged in the call for evidence, is Decentralised Finance (DeFi), which presents complex and unique challenges compounded by the globalised and borderless nature of the technology and business models operating in the space.

III. Development of this consultation response

In responding to this consultation and call for evidence, we have taken into account a variety of views from crypto companies, including directly through our Members and through facilitating roundtable discussions with internationally domiciled organisations (particularly US-based companies). We have also held discussions with academic professors and legal professionals to help refine the views outlined in this response. Further communication between policymakers, regulators, and industry stakeholders will continue to be important in designing a world-leading regulatory regime. DCGG, and our Members, are available to engage with government officials via the forthcoming crypto-asset engaging working group meetings, or via any other forum of communication.

IV. Executive Summary

As we approach the one-year anniversary of the Government's ambition to make the UK a crypto hub, DCGG welcomes the clear understanding of the market demonstrated by HM Treasury in this consultation document. This is important to building on the opportunity of digital assets and crypto in future-proofing the competitiveness of UK financial services. We are particularly encouraged by the long-term thinking and forward-leaning stance taken by the government in this consultation, and recognise that further discussions and consultation with industry will be forthcoming on more specific and appropriate regulations and oversight.

We believe crypto-assets can offer enormous potential to position and extend the UK's competitive advantage for attracting and growing innovative businesses and look forward to seeing the outcomes from this consultation and call for evidence.

While we have addressed our specific views to HM Treasury's questions in more detail throughout this response document, we have also outlined some of our key points in more detail below:

1. **HM Treasury and the FCA should provide clear definitions and guidance on the cryptoasset services and products that will be captured by future cryptoasset regulations**

The definition of cryptoassets is broad in the Financial Services and Markets Bill (FSMB) while there are a complex range of services and products under each economic activity. These may present a different and unique set of risk characteristics that should be considered to avoid overly prescriptive regulations. This should also clarify what specific activities will be captured in different phases of HM Treasury's proposed approach (e.g., between different types of stablecoins).

2. **HM Treasury and the FCA should consider developing a digital taxonomy for a principles-based approach that can be updated to reflect market developments and business models that will be captured by the regulations**

As highlighted in one of the FCA's cryptosprint outputs[1], a clear and detailed digital taxonomy could help in developing a regime for cryptoassets that is clear and can be updated regularly, enabling regulators to classify cryptoassets and apply relevant rules based on product types, relevant activities, and underlying technology. This will also support timely communication and

[1] https://www.fca.org.uk/firms/cryptoassets/cryptosprint

collaboration with industry on the requirements and timelines, as well as the relevant supervisory oversight body.

3. A transition period of at least 8 months should be implemented for each phase of the proposed regulations for cryptoassets

This will enable firms and regulators to effectively prepare for the regulatory regime. A set of industry-standards, or participation within a self-regulatory organisation (SRO) could be considered as an interim measure to provide confidence within the market.

4. HM Treasury should clarify whether other financial services activities will also be subject to the location-based requirements proposed in this consultation document. If not, we believe the proposal places a disproportionate burden on cryptoasset companies

We also encourage further exemptions that recognise the unique digital nature of digital asset platforms, and that provide for further alignment to competing proposed international frameworks, by accommodating for Reverse Solicitation and the Overseas Persons Exemption that should apply to any location-based requirements facing the cryptoasset sector.

5. Hardware self-custody wallet providers should not be subjected to the same regulations proposed in this document as software wallet solutions that have access to client keys and accounts

This will encourage the development of safer consumer products that are more akin to physical wallets. The list of activities and services that will be captured within the regulatory scope should be well defined via secondary legislation, rulebooks, and a digital taxonomy.

6. A dual responsibility should be established between trading venues and regulators in defining detailed content requirements for admission/disclosure documents and monitoring of market abuse

We believe establishing greater public-private partnerships will be most effective to ensure best practices are shared across industry and market abuse is managed in the most appropriate way (e.g., regulator publishes public blacklists and encourages use of STORs).

7. The issuer of a cryptoasset should be held liable for the admission disclosure documents for trading venues

As the issuer is most familiar with the cryptoasset, it is sensible that they hold responsibility for ensuring the information provided is accurate. In the event there is no central issuer, we agree liability should sit with the trading venue.

8. Any regulatory requirements related to cryptoasset lending should consider the different forms of lending activities and underlying asset used as collateral when defining the scope of covered activities in this product category, and the resulting requirements therein.

As an example, it would be most effective for the regulatory regime for peer-to-peer cryptoasset lending to draw from the existing peer-to-peer lending regime. DeFi liquidity provision is more difficult to regulate at this stage and the Government would benefit from ongoing monitoring and promoting international dialogue. Other forms of cryptoasset lending could draw from more traditional lending regulatory regimes.

It is important that the applicable requirements and rules facing lenders consider the volatility of the underlying asset. Stablecoins, for example, present significantly less volatility risk than other unbacked exchange tokens where more burdensome prudential and regulatory requirements would be more appropriate in promoting consumer safety.

9. 'Staking' should be further differentiated between 'staking to secure blockchain networks' (e.g, layer 1) and 'staking to provide provision of DeFi liquidity'

These are two separate forms of staking with completely different risk characteristics and purposes. We believe the Government and regulator should recognise this by applying light-touch regulation to the first form, given the security and safety it provides, and the second form which is inherently riskier given this form of activity is more vulnerable to hacks and exploitation, as well as impermanent loss and market volatility which may cause additional investment risk for the consumer. However, given the cross-border nature of DeFi, we encourage coordinating international dialogue on how regulations could best apply.

10. DeFi and validators should not be subject to regulation at this stage. Centralised on/off exchanges are the best first step towards regulating DeFi, although further consultation and international dialogue is required

We believe regulating validators at this stage would prove to be ineffective and potentially promote regulatory arbitrage, weakening the UK's overall competitiveness. Regulating DeFi in general will take more time, and the Government would benefit from ongoing and additional monitoring of the DeFi industry as well as promoting further dialogue with industry.

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V. Questions and Responses

CHAPTER 2

Definition of cryptoassets and legislative approach

Question 1. Do you agree with HM Treasury's proposal to expand the list of "specified investments" to include cryptoassets? If not, then please state why.

Digital Currencies Governance Group (DCGG) **supports HM Treasury's proposal to expand the list of specified investments** to bring additional cryptoasset activities within the regulatory perimeter. We believe this is necessary to protect consumers that choose to access cryptoasset products and services and ensure fairness and orderliness in the cryptoasset market.

DCGG acknowledges the reasons behind HM Treasury's decision to not opt for a bespoke regulatory regime but emphasise the importance of **applying proportionality in defining each regulated activity given the range of business models that exist**. There are a range of cryptoasset products and services that have potential to be misinterpreted and categorised as a specified activity, or as belonging within a certain regulated activity that is not most appropriate. As an example, certain jurisdictions, such as Canada, have classified stablecoins as instruments of indebtedness (and therefore as a security). We believe this to be an incorrect approach given stablecoins are not investment contracts and should not be considered as subject to the same regulatory approach. Therefore, it is important for the UK to avoid such a misinterpretation to encourage internationally mobile innovation and investment, as well as the development and use of cryptoassets in the UK.

Furthermore, we have concerns regarding the broad definition of cryptoassets in the Financial Services and Markets Bill (FSMB). **The definition, especially Part B, has the potential to capture a broader set of activities than intended**, such as security systems that use cryptographic technology or NFT collectibles (although DCGG recognises government's understanding that NFTs can represent a wide array of different assets which may constitute non-financial services products). It also has the potential to, in our opinion, incorrectly classify other types of assets such as stablecoins, as a type of security instrument. Therefore, we recommend further evaluation to avoid unintended consequences resulting from the proposed legislation, as HM Treasury will have new powers under the FSMB to amend this definition.

We believe HM Treasury could consider and provide further clarity on the **different business models that will be captured across all the proposed regulated activities to promote a proportionate approach**. This would demonstrate a degree of openness to the market, attracting future cryptoasset technology and investment in the UK. For instance, hardware cryptoasset wallet products and services that promote self-custody offer higher levels of consumer protection in comparison to other centralised wallet products that have access to client's keys or assets. The UK has a significant opportunity to attract investment and encourage products that offer significant levels of consumer safety applying a light-touch regulatory approach, which would demonstrate a clear understanding of the different business models and associated levels of consumer risk within each regulated activity. This will be important as the cryptoasset sector continues to develop and new business models emerge.

We believe clear definitions and guidance through detailed secondary legislation and future rulebooks are crucial to provide clarity to firms and avoid regulatory arbitrage resulting from potentially unclear definitions. DCGG also suggests **the development of a clear and detailed digital taxonomy** for regulated cryptoasset activities that can be amended to reflect emerging market developments and business models, enabling regulators to classify cryptoassets and apply relevant rules based on product types, relevant activities, and underlying technology. We believe that a shared understanding of what activities will be captured is important for effective and proportionate regulation, which will also ensure the timely design of regulatory safeguards.

Ongoing dialogue between government, industry, and regulators will be crucial in developing proportionate regulation. As part of this process, DCGG looks forward to engaging with the FCA on their new rule-making powers for cryptoassets and recommends that any **newly designed and tailored rules are supported by adequate impact assessments**. We also recommend that HM Treasury establish a reporting mechanism to maintain regular oversight of FCA rules for cryptoassets to respond adequately through the new powers enabled under the FSMB to either amend or reject any overly-burdensome rules.

Recommendations

- HM Treasury should monitor the impact of the definition of cryptoassets in the FSMB in the event of unintended overreach
- Clear definitions and guidance should be provided through detailed secondary legislation and future rulebooks
- The development of a clear and detailed digital taxonomy will also provide market clarity
- Proportionality should be applied in defining each regulated activity
- HM Treasury should have in place effective oversight mechanisms over FCA rules

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

DCGG agrees with HM Treasury's proposal.

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

DCGG believes the DAR can be a useful legislative tool to regulate activities that may not fit neatly into the RAO regime (e.g., narrow cryptoasset services provided by non-financial service firms), while still achieving the right regulatory outcome from a consumer perspective.

Legislating through the DAR can also provide HM Treasury with greater flexibility and agility to respond to market developments, allowing for a more light-touch regulatory approach that would support ongoing monitoring and evaluation of market developments for certain activities where full authorisation under Part 4A of the FSMA would be considered too onerous an approach. We believe that **it is crucial that timely communication with industry is maintained** to allow companies to develop relevant compliance procedures or adjust services provided to the UK market accordingly should they become subject to legislation through the DAR.

DCGG would also welcome further information on the cryptoasset activities being monitored by HM Treasury as most appropriate for legislating through the DAR and the timelines under consideration, including **whether and for how long a transitionary period will apply**. Furthermore, it is essential to determine whether the FCA will become the sole supervisory and regulatory oversight body for designated activities following new powers that will be enabled under section 71N of the FSMB. The market will be keen to ensure a level playing field amongst FCA authorised and dual authorised firms and it is essential to develop a clear understanding of the role of relevant supervisory bodies that can designate and oversee any applicable regulatory rules.

DCGG understands that the use of the DAR does not present any immediate challenges, However, its effectiveness will depend on how it is applied, given that HM Treasury will have more powers outside of the Parliamentary process. Therefore, we would **encourage the implementation of a suitable oversight mechanism** such as regular departmental Committee sessions to monitor and assess any decisions to legislate through the DAR. Overall, we believe legislating through the DAR can provide many benefits subject to oversight and engagement with both industry and regulators. It is essential to implement suitable oversight mechanisms to monitor the application of the DAR, facilitate timeline communication with the industry, and ensure a level playing field amongst authorised firms.

Recommendations

- HM Treasury and the FCA should maintain timely communication with industry on requirements and timelines
- HM Treasury should provide additional information on the activities being monitored as suitable for regulating through the DAR
- HM Treasury should clarify whether the FCA will be sole supervisory oversight body and establish a suitable oversight mechanism

CHAPTER 3

Overview of the current regulatory landscape for cryptoassets

Question 4. How can the administrative burdens of FSMA authorisation 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?

DCGG recognises that HM Treasury's consultation document notes that firms that are already authorised under the MLRs and intend to undertake new regulated activities will need to apply for a variation of their permission from the FCA (and the PRA for dual-regulated firms). DCGG welcomes the ambition that firms that are already authorised will undergo a "timely and proportionate authorisation process" that will aim to take into account the supervisory history of businesses and avoid any duplicative processes during the application period. DCGG also supports HM Treasury's commitment to collaborating with industry and regulators to ensure **clear approval guidelines and standards are available to firms** seeking to provide cryptoasset services in or to the UK.

We believe that both MLR-registered firms seeking to undertake regulated activities, and the appropriate regulator conducting regulatory oversight, would benefit from an element of 'grandfathering', whereby **existing firms are provided with a specific accommodation to continue providing services within a set transition period**. This would ensure minimal disruption to consumers and businesses, while also supporting the regulator in managing a potential bottleneck of authorisation requests. We also believe additional support could be provided through regular working group discussions and engagement, roundtable events, webinars, and general written communication to outline the authorisation process and support available. This should include providing further information and clarity on when regulations will come into force, whether a transition period will apply, and how long such a period will last.

Recommendations

- Firms that are already authorised under the MLRs should be able to continue providing services within a set transition period
- Additional support should be provided to firms through wider engagement (e.g., webinars)
- HM Treasury and the FCA should work with industry/regulators to ensure clear approval guidelines and standards are available

Question 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.

DCGG believes that further clarification is needed regarding the activities that will fall under the proposed regulatory regime's phase 1. For instance, it is unclear whether stablecoins that mainly serve as a bridge between fiat and cryptoasset markets will be subject to the same regulatory requirements as stablecoins whose primary purpose is to serve as a form of payment. DCGG suggests that the classification of these types of stablecoins should be separated from phase 1, as their primary function is to improve the process for consumers seeking to exchange fiat for other cryptoassets, typically for investment purposes rather than as a payment instrument. It is important to note that certain fiat-pegged stablecoins, such as Tether, provide a price-stable option for moving assets between blockchains, and are not predominantly used by retail customers as a means of payment. Therefore, **it is essential to differentiate the regulatory treatment of stablecoins based on their use-case rather than token type.**

Another area where further clarity is needed in HM Treasury's proposal is the reasoning behind treating "other cryptoassets" used for payment purposes within phase 2, given their potential similarities and increased volatility compared to stablecoins. Although they are less likely to be systemic at this stage, it would be helpful for the industry to **understand when a payment activity will be captured within phase 1 or phase 2**. This is particularly relevant for algorithmic stablecoins designed to mirror the price or movement of a certain fiat currency without the same degree of over-collateralisation (and in effect consumer safety) as stablecoins. DCGG anticipates that further consultation on the scope of phase 1 regulations is forthcoming and looks forward to closely engaging with HM Treasury and the regulator on this matter.

Recommendations

- HM Treasury should clarify the activities that will fall under the proposed regulatory regime's phase 1. This includes providing further information on the following:
  - Whether stablecoins that mainly serve as a bridge between fiat and cryptoasset markets will be subject to the same regulatory requirements as stablecoins whose primary purpose is to serve as a form of payment.
  - The reasoning behind treating "other cryptoassets" used for payment purposes within phase 2.
- HM Treasury should also provide further clarity on when a payment activity will be captured within phase 1 or phase 2. This would help firms to understand their regulatory obligations and to comply with them in a timely manner.

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

DCGG has identified potential challenges with the phased approach to regulation, particularly with regards to complications that may arise should a range of activities become subject to authorisation requirements and FCA rules at different times.

We believe that one of the key risks is the uncertainty a phased approach could create for market participants. For example, cryptoasset businesses may be unsure on whether their activities will constitute a certain specified activity, how that activity will be regulated in the future, and how and when each regulatory phase will be implemented and in effect. This could create a challenging environment for market participants to plan appropriate controls to adhere to future regulatory requirements and without certainty or clarity, this could result in a loss of competitiveness as companies choose to wait until more details are provided on future phases of the regulation before beginning operations in the UK. As a result, we believe there **should not be a significant delay between communicating the requirements and expectations between the different phases.**

Furthermore, while we understand HM Treasury has prioritised the approach by risk and opportunity, there are **challenges in interpreting why certain activities are being regulated in the first phase over what can be considered more inherently risky products and services**. For example, the issuance of a new cryptoasset could be considered to be a stablecoin activity in the first phase, if the cryptoasset is designed to be stable in value against another asset, such as the US dollar. However, if the cryptoasset is not designed to be stable in value, and therefore could be considered more volatile, it could be considered to be a non-stablecoin activity in the second phase. HM Treasury may have reasons for the prioritisation proposed in the consultation document but we would welcome further information on why similar activities are being regulated at different points.

Regarding stablecoins in particular, we also believe there is a degree of ambiguity in interpreting figure 3.A in the consultation document that should be addressed. Specifically, we have concerns that trading venues will lack a clear legislative framework that allows for the listing of authorised stablecoins until Phase 2. Given 'Exchange/Trading' will not be addressed until this period, it appears this may be the case. UK consumers have a significant interest in being able to trade in cryptoassets on trading venues, to which stablecoins can play a vital role in acting as a bridge between fiat currency and cryptoassets.

As a result, we believe it is important for HM Treasury to confirm that **a transitional arrangement will be in place for stablecoins and other cryptoassets that are currently listed on trading venues.** Providing this certainty will be welcomed by businesses, consumers, and the market in general, where more information can protect against swings in volatility. We also believe that a simplified process should be in place for these cryptoassets authorised in Phase 1 to become authorised in Phase 2 to minimise disruption for businesses, trading venues, and consumers.

In general, it is our view that **a transition period of at least 8 months should be in effect legislation and compliance of each phase.** This will support firms in developing robust internal controls and procedures, including relevant governance arrangements, clear organisational structures, sufficient regulatory and compliance expertise, and abilities to review key policies and data reporting requirements. In addition, we believe implementing **a transition period would support the regulator's preparedness** to ensure that the appropriate resources, including relevant skills, are in place. This will support the regulator in establishing sufficient expertise and bandwidth to consider new rules, responsibilities related to new supervisory activities, and oversight mechanisms, as well as providing ongoing and regular communication with industry.

Managing applications in a timely manner is important to prevent an application bottleneck and protect the UK's overall market competitiveness and we support the FCA's commitment in their recent Business Outlook to upskill staff that work with the cryptoassets market. **We would also encourage further consideration on an approved set of industry-set standards, or participation within a self-regulatory organisation (SRO)** that can encourage good practices and report directly to the regulator during the transition period. Such an approach could use existing standards, such as the Cryptocurrency Security Standard (CCSS), which augment standard information security practices and complement existing standards (e.g., ISO 27001) to provide greater consumer confidence in interacting with cryptoasset services and activities.

Lastly, we believe that firms that conduct multiple activities that may fall within different phases of the regulation could benefit from developing authorisation through an earlier phase. We urge communication on whether firms will be expected to require separate authorisation if there is regulatory overlap. We also believe authorised firms would be effective in supporting the design of future regulations given the existing relationship and commitment towards UK authorisation.

Recommendations

- HM Treasury should provide more clarity on the activities that will be regulated in each phase of the proposed approach without significant delay
- A transition period of at least 8 months should be implemented for each phase of the proposed approach
- Ongoing and regular communication with industry will be beneficial, while staff working on cryptoassets within regulatory agencies should be upskilled

CHAPTER 4

Cryptoasset Activities

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

DCGG supports the proposed scope of the cryptoasset regulatory regime but suggests that the government and regulator consider providing additional exemptions to reduce the regulatory burden facing cryptoasset firms and service providers, similar to other financial service activities. **DCGG recommends including the "overseas person" exclusion in the RAO**, which is widely regarded as a contributing factor to the success of the wholesale financial services sector in the UK. **DCGG also supports the concept of "reverse solicitation".** It is our view that these provisions are necessary for the UK to maintain a competitive advantage in cryptoassets and support UK customers' ability to access global markets. The alternative risks firms taking the decision to not engage with the UK market given the increased scope of the regime in comparison to other financial service activities and markets.

It is clear that the proposed territorial scope for regulating cryptoasset services provided *to the UK* differs from how certain other regulated activities have been dealt with under FSMA. The FCA stated in recent Guidance that it would not expect a payment services provider located outside the UK to be within the scope of regulations if it only provides internet-based and other services to UK customers from that location. While DCGG views the proposed territorial scope as a departure from the approach for regulated payment services under the UK Payment Services Regulations 2017 (PSRs), we also recognise that defining when a regulated activity is deemed to have taken place in the UK for cryptoasset services is challenging, as is the case for multiple sectors within the economy. **We would welcome clarity as to whether the proposed territorial scope will also apply to other financial service activities**. It is our view that the alternative would be disproportionate.

Furthermore, DCGG supports exemptions such as the "Overseas Person Exclusion" and a defined concept of "reverse solicitation" to ensure a level playing field with other financial service activities and comparable frameworks being developed internationally. **We suggest defining 'reverse solicitation' in accordance with international rules,** such as those provided under MIFID II, which could provide a more shared understanding to prevent misuse and/or regulatory arbitrage. This is also important for UK customers' ability to participate in the global market and seek products and services based on their own initiation. Providing this clarity will also support a firm's understanding on when an activity is deemed to be carried on or to the UK in the first place and therefore subject to regulatory requirements. While this seems straightforward, it is worth highlighting that no express guidance currently exists on whether and how certain activities are considered to be carried on in the UK, such as firms 'dealing' or 'arranging deals' in relation to securities.

Recommendations

- HM Treasury should provide additional exemptions to reduce the regulatory burden facing cryptoasset firms, including the ‘overseas person’ exclusion and reverse solicitation, which should be defined in accordance with international rules
- HM Treasury should provide clarity and definition on when an activity is deemed to be carried on or directed to the UK

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

DCGG supports the proposed list of economic activities to be regulated by HM Treasury and particularly commends the approach towards regulating lending activities following recent market developments. However, we believe **the proposed regulatory framework is not yet sophisticated enough to take into account the key differences between certain business models and services within certain economic activities.** We believe it is important to consider this in more detail given any unintended regulatory overreach may act as a deterrent to good market actors and weaken the UK’s competitiveness in attracting innovative companies that provide higher levels of consumer protection.

As an example, the current definition of safeguarding and/or administration (custody) activities and the associated applicable regulatory regime should take into account the fundamental differences between hardware self-custody solutions and other forms of software wallet products or services where the providers of access can themselves access the consumer’s funds. Hardware wallets afford higher levels of consumer autonomy and safety for custodial and safeguarding activities and DCGG believes it is important for **HM Treasury to clarify that these solutions will not be captured by the same regulatory framework as software wallets** that are inherently more at risk to cyber-hacks or wider mismanagement. We believe this is important to not only recognise the different governance characteristics over who is actually provided means of access to the cryptoasset (e.g., it is only the customer in the use-case of a hardware wallet), but also to encourage the development of more secure customer solutions as more of the UK population is attracted to the sector.

Furthermore, certain hardware wallets, such as Ledger Nano, makes use of a specialised Secure Element chip to ensure industry leading security to protect consumers data and embed intrinsic countermeasures to make it tamper-proof and resistant to hacks. We believe it is important to encourage the development of these solutions through making a clearer distinction on the regulatory requirements between software and hardware solutions. A lighter touch regulatory approach towards the latter will incentivise the development of more secure solutions which will benefit UK consumers and the overall sophistication of the UK's regulatory framework. In our earlier response we addressed the potential benefits of developing a digital taxonomy which could support providing market clarity over the scope of the economic activities and the relevant business models that will be captured. We believe this will help to avoid any unintended regulatory overreach.

Recommendations

- HM Treasury and the FCA should define the economic activities and business models that will be captured in more detail (e.g., through the development of a digital taxonomy)
- HM Treasury should take into consideration the differences between hardware self-custody wallets and software wallets (with the former providing greater consumer safety and therefore a lesser requirement for regulation)

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

We agree.

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

We agree.

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

It is difficult to say definitively whether or not certain commodity-linked tokens would not be within scope given the regulatory landscape is constantly evolving and there is no single framework that applies to cryptoassets. Ultimately, whether commodity-linked tokens will be captured will depend on the characteristics of the token, including:

- The nature of the underlying commodity;
- The structure of the token;
- The rights and obligations of the token holder(s);
- The intended use of the token.

As HM Treasury's consultation document outlines, certain commodity-linked tokens could fall within the definition of a specified investment of a financial instrument. We believe a more definitive list of which types of commodity-linked tokens would be considered within scope would be welcomed by the market.

DCGG understands that some commodity-linked tokens may not be considered to require authorisation under existing regulatory frameworks under FSMA. For example, a token that is simply a receipt for a physical commodity, such as gold, may not be considered a financial instrument or specified investment. We believe further clarity should be provided on whether it would then be captured if the token gives the holder the right to receive a future delivery of a physical commodity.

We believe commodity-linked tokens that are held and distributed by a central company or issuer for speculative purposes should not fall under the existing or proposed regulatory framework. We understand that the FCA is aware of the existence of such tokens and does not consider tokens held for speculative purposes to be a specified investment subject to authorisation requirements[2]. DCGG agrees with the FCA's assessment and recommends that **HM Treasury provides a more detailed view of the government's interpretation and definition** to prevent unintended regulatory consequences.

DCGG has held discussions with a company that is currently in the design phase for developing a commodity-linked token to facilitate access to investing in gold (with the value of the coin representing the associated value of gold stored in a vault). However, we understand the company to be wary of investing in the UK given the lack of regulatory clarity over whether they will be captured by the proposed cryptoassets regulations. We believe their coin (in development phase) is more akin to a marketing tool rather than something that can be transferred peer-to-peer, or used for payment purposes. As a result, we believe the government could attract investment in this area by developing a detailed description of the subset of activities that are intended to be regulated, and what will not be considered within scope.

Recommendations

- Define the economic activities and business models that will be captured in more detail (e.g., through the development of a digital taxonomy)
- Take into consideration the differences between hardware self-custody wallets and software wallets (with the former providing greater consumer safety and therefore a lesser requirement for regulation)

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

[2] https://www.fca.org.uk/publication/consultation/cp19-03.pdf para 3.3 and 3.52

We agree.

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

The proposed treatment of NFTs and utility tokens is not entirely clear and DCGG believes it is a priority to provide more clarity and specification to the market on how these tokens will be regulated. We believe that additional guidance should be clear and concise, as well as updated regularly to reflect market changes as these nascent sectors continue to grow and develop.

The consultation document outlines that all cryptoassets, including NFTs and utility tokens, *could* fall within the regulatory perimeter if they are used in any of the economic activities listed in Table 4.A. However, as previously discussed these definitions are currently high-level and broad, and it may be too burdensome an approach to subject safeguarding of NFTs and utility tokens to the same full FSMA authorisation requirements as other financial services activities. We suggest a value threshold could be considered as to when this will be applicable, or use of the DAR for a more light-touch approach.

In general, we believe the government should focus on developing a simple, clear and predictable regulatory framework and definition. This should include when a particular structure or characteristic of an NFT or utility token means it constitutes a specified investment or regulated activity that falls within the existing perimeter.

In particular, DCGG believes the following would provide additional market clarity:

- The government should provide more clarity on how it will determine whether an NFT or utility token is used for investment purposes;
- The status of governance tokens that are also tradeable;
- The government should provide more guidance on how businesses can comply with the proposed regulations;
- The government should work with industry stakeholders to fully consider the range of products and services to ensure any proposed regulations are practical and based on risk

<u>Recommendations</u>

- HM Treasury and the FCA should provide additional guidance on how these tokens will be regulated, which should be regularly updated to reflect market changes

CHAPTER 5

Regulatory Outcomes for Cryptoasset Issuance and Disclosures

Question 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 believe the proposed regulatory trigger points are reasonable as they are designed to capture the most significant risks associated with cryptoassets, including market abuse, fraud, and money laundering. The proposed regulatory trigger points will help to address these risks by requiring cryptoassets to be admitted through regulated trading venues or offered to the public through regulated channels. This will ensure they are traded in a fair and orderly manner, while protecting investors from fraud.

Further clarity on the expected implementation timelines would be welcomed by the market, given the expected significant information gathering exercise faced by large trading platforms to capture information on the full suite of tokens. This is also relevant for the market to understand the requirements facing either trading venues or issuers in regard to tokens already listed on exchanges once the regulations come into force. We have addressed the benefits of implementing a transitional arrangement that would allow exchanges to remediate rather than have to remove or halt trading of existing tokens until such time as all information is gathered and regulations are in effect.

Recommendations

- HM Treasury could provide further clarity on the expected implementation timelines and transitional arrangements for already listed tokens

Question 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?

DCGG believes that trading venues should not hold sole responsibility for defining the detailed content requirements for admission and disclosure documents. We believe it would be more appropriate for a government or regulatory agency, or another independent body, to work with trading venues to establish a shared list of content requirements. This would support fair and objective requirements, and ensure they are not designed in a manner that would favour any particular trading venue or cryptoasset. This would also align more closely to the existing process for admitting securities to trading venues, which would help to ensure only legitimate and well-regulated cryptoassets are traded on these platforms.

Recommendations

- A dual responsibility should be established between trading venues and a governmental/regulatory agency in defining the detailed content requirements

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

DCGG believes that the options HM Treasury is considering for liability of admission disclosure documents for cryptoassets are reasonable. They provide a framework for who is liable for the accuracy of these documents, and should help to protect investors.

DCGG believes there are several realistic options to consider for where liability should sit:

- The first option is to make the issuer liable for the accuracy of the admission disclosure document. We believe this is a sensible option, as the issuer who is most familiar with the cryptoasset is then held responsible for ensuring that the information provided to investors is accurate. This approach also supports any of the FCA's future or ongoing disclosure requirements to ensure a minimum standard of information is available to investors.

DCGG views this approach to be more closely aligned with the current Prospectus regime and approaches taken in other jurisdictions. It may also provide several related benefits in terms of issuers giving greater consideration to the necessary safety and governance procedures outlined in admission disclosure documents, which we outlined in our response to Question 15 could be defined jointly between trading venues and regulatory or governmental bodies. In instances where there is no 'central issuer' and for truly decentralised tokens we believe this approach of whitelisting certain 'blue-chip' tokens by the regulator would be beneficial in providing exemptions to disclosure forms and allowing for platforms to list without the need for them. We agree that some form of liability would need to remain, which could sit with the respective trading venues.

ave we considered the scenario of truly decentralised tokens and who would be responsible for completing any required disclosures e.g. Bitcoin. One way to possibly overcome this is through whitelisting of certain 'blue-chip' tokens by the regulator which would allow for exemptions to disclosure forms and allow for platforms to list without the need for them. Just a thought.

- The second option is to make the person who prepares the admission disclosure document liable for its accuracy. We also understand this to be sensible, as it ensures the person who is responsible for drafting the document is also responsible for ensuring it is accurate.

However, DCGG believes there is a risk with this approach that certain venues will leverage their market dominant position by requiring issuers to become the responsible party for the underlying liability. This could create additional risk within the system, even with the presence of a degree of prudential requirements in place. Smaller trading venues may also be incentivised to bear higher levels of risk as a means to develop a competitive advantage by assuming the liability, and through offering more risky cryptoassets.

- The third option is to make both the issuer and the preparer of the admission disclosure documents liable for its accuracy. We believe this is too conservative an approach and risks the UK losing a competitive advantage, as well as causing unnecessary regulatory burden.

It is our view that the best approach is for the issuer of the cryptoasset to be liable for the accuracy of the admission disclosure document if they have made a reasonable effort to ensure that the information provided is accurate. This would allow issuers to avoid liability if they can demonstrate a reasonable effort and steps to ensure the accuracy of the information, even if there were errors in the document. This will place more responsibility on trading venues and regulatory authorities to ensure that the required information about the cryptoasset is accurate and complete, and that it is disclosed in a timely manner.

This approach also significantly reduces the administrative burden on trading venues, whereby they would not be required to prepare the disclosure documents for each asset listed, which would grant these venues the necessary room to conduct their day-to-day operations. Should HM Treasury continue under the proposed approach for admission documents and liability to sit with either the issuer or trading venue, DCGG would welcome regular engagement from the government in developing an understanding of the intention of different trading venues.

Lastly, we believe further information on the scope of the liability will be important given that not all tokens on trading venues should be considered ‘investments’. For example, Bitcoin could be considered as a speculative investment or as a means of payment depending on the consumer’s intention. As a result, additional consideration should be given to how the necessary information test can be used to determine the relevant or applicable liability.

Recommendations

- The issuer of the cryptoasset should be liable for the accuracy of the admission disclosure document (if reasonable efforts are made to ensure accurate information)
- Further information and definition on the scope of the liability is needed
- HM Treasury and the FCA should regularly engage with industry to develop an understanding of the intention of different trading venues in the event of liability sitting with either the issuer or trading venue

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

DCGG agrees with the proposed necessary information test.

Question 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 consider the intended reform to be sufficient and capable.

CHAPTER 6

Regulatory Outcomes for Operating a Cryptoasset Trading Venue

Question 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.

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

In principle, DCGG overall agrees with the proposed trading regime and its key elements. However, we would specifically like to address certain concerns related to the data reporting requirements. DCGG's members support a comprehensive framework for data reporting for AML/CFT purposes for example, as this is crucial for compliant operators of cryptoasset trading venues to mitigate risk and prevent market abuse. Nevertheless, we would like to stress that requirements for data reporting should not go beyond relevant risk factors, such as ML/TF. It is important that the proposed rulebook adheres to the principles of consumer privacy and protection of personal data, i.e., not requiring operators to report all transactions or users/personal identifiable information. DCGG's members are highly committed to the protection of their users, and believe that the aforementioned concerns should be taken into account by the Government to ensure the future framework is as consumer-oriented as possible.

Furthermore, in our view, more detailed guidance and context on the proposed provision for the relevant authorities for "regular and wider reporting over time" would be of key importance in the drafting of this framework for cryptoasset trading venue operators. We would like to highlight that it is necessary that proper balance is established between the overarching prevention of illicit activities and user protection, and avoiding placing disproportionate administrative burdens in relation to reporting requirements for trading venue operators.

Noteworthy, we further address the key elements related to the proposed market abuse and data reporting requirements in more detail in our response to Chapter 9.

Recommendations:

- The proposed data reporting requirements should be geared toward mitigating relevant risks, e.g., ML/TF, and avoid the disclosure of all users' transactions and personal identifiable information.

CHAPTER 7

Regulatory Outcomes for Cryptoasset Intermediation Activities

Question 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?

DCGG agrees that it is sensible that the MiFID derived rules are applied to cryptoasset intermediation activities, as long as these are proportionately transposed to the activities proposed in this consultation. It is important that HM Treasury continues to consult with industry stakeholders to ensure these are practical and workable, including whether the MiFID derived rules need to be amended to specifically address risks posed by new and innovative intermediation activities.

Recommendations

- Ongoing monitoring and consultation on whether MIFID derived rules need future amendments would be beneficial

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

The proposed regime for cryptoasset intermediation is comprehensive enough to situate these market participants within the broader financial ecosystem. Still, we welcome the opportunity of sharing our views on some of the key elements of the proposed framework, in the context of the industry perspective.

Firstly, DCGG agrees with the highlighted **regulatory trigger points**. However going beyond the three definitions, the industry would appreciate more specifics on the services in scope in order to facilitate compliance. As already mentioned in Questions 1 and 8, a more thorough, clear taxonomy of what constitutes a regulated activity for operators with diverse business models that could be captured is needed to ensure the entities in scope comply with a framework that is proportionate:

1. On the **basis of the regime**, as highlighted in Question 21, the MiFID derived rules should be proportionately applied to establish a regime that is fit for purpose. Furthermore, industry participants would appreciate more detailed guidance on the investment services and activities in scope, and requirements that are adapted to the nature of these products and provision of cryptoasset intermediation services that would promote, rather than stifle, compliance and investor protection.

2. We view the proposed **consumer protection and governance requirements** as clear and overall well-defined, but would appreciate further clarity on how the regulator would expect that the “appropriateness” of the cryptoassets subject to the intermediation activity is expected to be measured by crypto operators. In particular, if a cryptoasset is considered appropriate only if it is defined as a regulated product under the future regime, or if other cryptoassets that are not subject to this regulation or are non-financial in nature would fit into the proposed criteria. Furthermore, it is important that expectations of intermediaries are made clear from the outset in relation to due

diligence, and in particular that these expectations are proportionate, taking into account how requirements could supplement or disrupt the business model and daily operations of these service providers. For example, we advise against placing requirements on intermediaries to conduct financial assessments of each of their users or assess the appropriateness of each cryptoasset, and would rather recommend that rules consist of identifying whether the products in question meet public disclosure requirements or not. Such an approach would significantly facilitate consumers' process of making informed decisions.

Overall, it is important that these consumer protection requirements are clarified at the consultative stage, as well as what necessary due diligence would need to be conducted by cryptoasset intermediaries (and cryptoasset issuers in relation to disclosure requirements) to both protect their consumers, and allow them access to a more diversified pool of assets.

3. We support the proposed **data reporting requirements**, as these are crucial for compliant market participants in the area of cryptoasset intermediation to facilitate the exchange of information and cooperation to mitigate risk and prevent market abuse. We would however note that more detailed guidance in the long run would be appreciated on the requirement of the relevant authorities for "regular and wider reporting over time", so that proper balance is established between preventing illicit activity, and avoiding placing disproportionate administrative burdens in relation to reporting for these market participants.

4. In relation to **insolvency**, given that current insolvency frameworks are tailored to reflect the level and nature of risks of business models from the traditional finance sectors, we believe that a separate regime would more adequately capture the crypto industry, including different thresholds, distinctions between use-cases of products and services, etc.

5. Finally, our view is that the proposed **authorisation rules, location, prudential and operational resilience requirements** are sound, and we look forward to how these would fit into the overarching architecture of the future regime for cryptoasset intermediation, taking into account the specificities of the sector.

Ultimately, the effectiveness of the proposed regulatory regime will depend on how it is implemented and enforced. The government and the FCA will need to be vigilant in monitoring the market and in taking action to address any emerging risks.

Recommendations

- We agree with the highlighted regulatory trigger points, but recommend more specific information is provided on the services in scope
- The MiFID derived rules should be proportionately applied with further clarity given on how the regulator would expect that the 'appropriateness' of the cryptoassets subject to the intermediation activity is expected to be measured
- More detail would be welcomed on the proposed data reporting requirements and the requirement of the relevant authorities for 'regular and wider reporting over time'

CHAPTER 8

Regulatory outcomes for cryptoasset custody

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

DCGG's members agree that, if fairly and proportionately applied, Article 40 of the RAO could be a sound option for a basis for a regime for cryptoasset custody. Nevertheless, we would like to point out that only operators that have access to clients' assets and keys should be subject to that regime, as this is essentially what the custodial nature of a service entails. By contrast, there are market participants, such as Ledger, that merely provide the cold hardware to enable self-custody for their users, which means that the user is responsible for safeguarding the assets. We would welcome further clarity as to whether these solutions will be subject to regulatory requirements.

Recommendations

- HM Treasury and the FCA should separate the regulatory treatment between hardware self-custody wallet solutions and software providers that have access to clients' assets and keys
- Hardware self-custody solutions and providers should not be subjected to stringent regulatory or prudential requirements

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

Given the important role custodians play within the cryptoasset ecosystem, we welcome the Government's efforts to outline comprehensive requirements to assist the compliance of these providers in the context of the expansion of the cryptoasset regulatory remit. With this in mind, DCGG's members are keen to provide some additional feedback to the key elements proposed to ensure the framework is thorough and innovation-friendly in order to accommodate custodial activities across the sector:

1. In terms of suggested **regulatory trigger points**, DCGG agrees with the proposed activities (i.e., safeguarding cryptoassets, granting means of access to a cryptoasset wallet, etc.), as these are indeed the primary services of custodians in the crypto ecosystem. We do, however, note that technological providers in the self-custody sector merely provide the means for customers to safeguard their own assets, without any ability of the provider to administer or tamper with these pools of assets. In this sense, with such providers the possibility of insolvency does not in any shape or form cause any concern or risk for loss or general misuse of the assets. There is a large difference in risks, and our recommendation is that this distinction should be reflected in the Government's legislative approach, and therefore that such providers should not be in scope of this proposed regime.

2. Looking at the **basis of the regime**, DCGG members would welcome further clarity on the definition of custody in the context of the UK crypto market, considering the diverse existing business models within the ecosystem. As outlined in our response to Question 23, it is crucial that the future regime is geared toward actual custodians, rather than technological providers that enable self-custody for their clients via hardware wallets. The consultation paper outlines that the very definition of custody is to hold assets on behalf of another person. There is a need for clarity in this taxonomy so that this regulation captures custodial activities adequately, and does not overburden providers that do not actually have access or controls to their users' assets, but simply provide them with the technology to do so themselves at their own accord (also highlighted in Question 8).

3. We agree with the proposed **licensing rules**, and appreciate that these mirror what is proposed or currently enforced in other jurisdictions, which provides much needed clarity for custodians in a cross-border context.

4. By similar logic, DCGG views the proposed **location requirements** as sound, as long as the rules placed on international (non-UK based) firms are proportionate and not excessively burdensome, thus taking into consideration the inherently cross-border nature of cryptoasset services.

5. We agree with the Government's rationale on the matter of **insolvency** for custodian firms. We believe this approach is worthwhile to capture such service providers, given that **controlling the means of access to the cryptoassets (i.e., a private key)** could impact consumer's assets in the case where a custodian goes insolvent.

6. Finally, DCGG agrees with the proposed **prudential requirements**, rules for **governance, CASS, consumer protection and operational resilience**.

Recommendations

- Further clarity on the definition of custody in the UK market would be welcomed.

CHAPTER 9

General Market Abuse Requirements

Question 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 agree.

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

We agree.

Question 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 agree.

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

DCGG welcomes HM Treasury's clear understanding of the complexities in designing, applying and monitoring market abuse in cryptoassets given the fragmented and borderless nature of existing and highly-accessible activities, and we support the development of additional regulation that protects consumers from malevolent actors and practices. We recognise that placing a greater emphasis on market abuse obligations on trading venues rather than the regulator could incentivise new innovative technological approaches to detecting and limiting market abuse, and commend HM Treasury's ambition to address such behaviour.

It is right that more responsibility is placed on trading venues to identify and prevent insider trading and manipulation practices. However, **we would encourage more involvement from the regulator and government in terms of managing public blacklists and criminal and administrative sanctions**, as well as through developing better standards and **ongoing data sharing mechanisms with trading venues to establish a dual competency for the development and monitoring of market abuse practices.**

In accordance with the above, we believe the regulator could perform the following role:

1. **Authorisation** of trading venues responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset

2. **Supervisory** arrangements put in place to ensure the maintenance of sufficient skills and insider lists and Director/PDMR dealings within the trading venue, shared with the regulator on an ongoing basis

3. Market **monitoring by trading venues** through UK MAR requirement to detect and report suspicious transactions and orders to the regulator without delay via STORs, or via a market observation form if the trading venue is not involved in the activity and therefore does not have complete information

4. Proactive **market activity monitoring**, by conducting algorithmic analysis on market data using order book data provided by trading venues and new metrics, including blockchain analytics, to assist in the measurement and assessment of market cleanliness and level of market abuse activities (e.g., through the abnormal trading volume metric and potentially abnormal trading volume ratio)

5. **Publish public blacklists** and communicate and share with authorised trading venues and international regulators (e.g., via the GFIN mechanism). **Apply criminal and administrative sanctions** to persons suspected of market abuse practices

We recognise the pragmatic approach HM Treasury is proposing and the difficulties in offering market integrity or enabling the same protection as in traditional markets for financial instruments. However, we believe the **current proposals will be overly burdensome** for trading venues in terms of the requirements to sanction individuals with public blacklists and become the sole competency for the development of market abuse practices. It is our view that **the FCA possesses a more coherent status for the successful identification and prosecution of market manipulation**, as well as an ability to build international supervisory and enforcement networks with other regulators. These cooperative networks can extend to information exchange, joint investigations, enforcement, and lead to more effective protection of financial markets from manipulative schemes conducted cross-border.

The recent complications experienced via the implementation of the Financial Action Task Force's (FATF) Travel Rule demonstrates the vulnerabilities of private sector-led solutions towards self-regulation and interoperable governance arrangements. The 'Sunrise Issue', which refers to the period during which the Travel Rule was not in effect across jurisdictions, has caused multiple issues for cryptoasset businesses with a range of international partners attempting to comply with the rule. We understand that this resulted in multiple firms suspending transactions in dealing with noncompliant companies in other jurisdictions due to a lack of clarity over the requirements. **We believe the best approach is for the regulator to retain a greater degree of responsibility in regard to enforcement and oversight,** with trading venues cooperating with the regulator to share information via STORs or market observation forms.

Our Members are focused on improving investor protection and prohibitions against market abuse, which we believe will increasingly become a competitive outcome shared across the sector. However, **it is right that the threat of imposition of sanctions and public blacklists for the perpetration of market manipulation remains the competency of the regulator**. DCGG believes the regulator should also establish and employ separate market surveillance technologies to assist in the protection and prevention of market abuse given the involvement of the regulator can also provide vital resources to address the highly fragmented nature of the modern marketplace, including on the internet where a high degree of market manipulation schemes are often conducted. Furthermore, information efficiency and integrity is a matter of public interest which reaches beyond the relationship between the operators of the market and traders. It is our view that the requirements for trading venues to become authorised will provide an initial screening of the integrity of persons employed in senior position or with a significant influence on intermediary activities, and ongoing supervisory arrangements will be vital for the FCA (or appropriate regulator) to ensure the maintenance of sufficient levels of skill, with clear rules imposed on market transparency requirements and mandatory disclosures (e.g., STORs, insider trading).

As discussed, the requirements for disclosure requirements outlined in earlier chapters of HM Treasury's consultation document will play a fundamental role in the deterrence of market abuse by raising the information efficiency of market prices, as well as ensuring the integrity of cryptoasset corporate disclosures. We emphasised in our earlier response the supervisory advantages for the issuer of the cryptoasset to prepare the admission documents and take on the associated responsibilities, including ongoing disclosures to ensure a minimal standard of information is available, which, in our view, will reduce information asymmetries and raise standards related to market fairness and integrity. As a result, we believe the exchange of counterfeit cryptoassets, or ones created directly for the purposes of manipulation, will be significantly reduced. It will also increase oversight of the actions of centralised market actors to which enforcement actions can then apply.

Overall, **ongoing communication between the regulator and trading venues will be important to understanding the processes each trading venue has in place to prevent certain acts of market abuse**. DCGG believes there will still be a need for the regulator to conduct market monitoring where trading venues do not have complete information and the wider exchange of information with other authorised firms and international counterparts, in order to facilitate an effective deterrence regime for market abuse.

Recommendations

- The regulator and/or Government should hold more responsibility in managing public blacklists and applying criminal/administrative sanctions
- The regulator should also develop better standards for ongoing data sharing mechanisms with trading venues to establish a dual competency for monitoring market abuse
- In regards to market abuse, it would be effective for the regulator to hold responsibility for:
    - authorisation of trading venues;
    - supervisory duties related to skills/insider lists/Director/PDMR dealings;
    - market monitoring through STORs submitted by trading venues;
    - proactive market monitoring, and
    - publishing of public blacklists

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

DCGG supports the role of the FCA sandbox initiative to promote collaboration between regulatory authorities and industry participants. We believe the new powers enabled through the FSMB to allow HM Treasury to introduce financial markets infrastructure (FMI) sandboxes to facilitate the testing of the effectiveness of certain activities should be leveraged to promote the development of RegTech activities. **We would also encourage a greater role for the UK in promoting international collaboration** on similar efforts, such as through the GFIN initiative.

The Government should also consider **providing additional funding for research and development of RegTech solutions**. This could be delivered through UKRI or other governmental or quasi-governmental agencies, which could also be used to facilitate further public-private collaboration, including sharing information and best practices, as observed through the ongoing Digital ID and Attributes Governance Framework alpha testing stage.

Furthermore, **we would encourage the government to take a less prescriptive approach in regards to KYC/AML requirements** given the emergence of new forms of new technology, such as Zero-Knowledge Proof. This technology can help companies to comply with these regulations without collecting or storing as much personal data through a cryptographic technique that allows one party to prove to another that they know something without revealing the actual information. This can be used to verify a customer's identity or to check for suspicious activity. A less prescriptive approach could help to reduce the burden facing companies, encouraging innovation and the adoption of new technologies that can improve compliance and protect customer privacy.

Supporting certain KYC standards that allows for the use of this, or similar, technology will decrease the danger of data breaches, as well as the cost and effort spent keeping certain records. We believe this could be delivered through the encouragement and **development of industry standards for compliance and setting broader principles and objectives for KYC/AML compliance**, rather than specific rules and regulations. This could include requirements for companies to conduct risk assessments and to implement measures appropriate to the levels of risk they face.

Recommendations

- The UK should take a greater role in promoting international collaboration to facilitate the testing of RegTech through 'sandbox' initiatives
- The Government should encourage making additional funding and support (e.g., through access to certain datasets) for RegTech development projects

- Self-sovereign technologies, such as Zero-Knowledge Proof, could be encouraged through a less prescriptive approach towards KYC/AML requirements, including setting broader list of principles and objectives for compliance

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

We agree.

CHAPTER 10

Regulatory outcomes for operating a cryptoasset lending platform

Question 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?

DCGG welcomes HM Treasury's understanding of the regulatory challenges posed by cryptoasset lending and borrowing activities. This is a developing sector that can provide numerous benefits, including widening access to financial services for underserved customers and using new forms of technology, such as self-executing smart contracts, to increase certainty and security for lenders, as well as providing a more innovative and accessible form of financing for borrowers.

It is right that customers understand the risks involved in accessing lending activities and that regulatory safeguards are in place to provide greater protection and processes in the event of losses, insolvencies, or malpractices involved in the collateralisation of assets and where and how customer's deposits are invested and integrated with wider wholesale markets.

It is our view that HM Treasury has provided a comprehensive assessment of the regulatory challenges. We would encourage further consideration of the information available to customers and an assessment of lending platforms' ability to maintain a degree of loss-absorbing capital, including limiting any potential exposure to concentration risk and underlying volatility. In particular, **DCGG encourages further consideration and consultation of restrictions on the types of cryptoassets that can be eligible as collateral**, **or the minimum loan overcollateralisation thresholds associated with the cryptoasset provided as collateral**. It is also important to consider the volatility of the collateralised asset, with stablecoins for example offering better security and less risk of volatility for consumer's assets.

Furthermore, providing information on lender's concentration ratios and exposure will be important to improving customers understandings of the risk, while heightening the presence of publicly-available risk and lending information (e.g., ratings) that will support the development of a transparent and ultimately more secure cryptoasset lending and borrowing activities.

Recommendations

- The Government should ensure more information is available to customers about the risks involved in cryptoasset lending and borrowing activities
- We encourage further consideration and consultation of the restrictions on the types of cryptoassets that can be eligible as collateral, or minimum loan overcollateralisation thresholds associated with the cryptoasset provided as collateral
- Information about lender concentration ratios and exposure could be important to increasing customer knowledge and safety

Question 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?

In June 2022, Celsius stopped customer withdrawals due to concerns about liquidity. A significant factor contributing to the liquidity concerns was the risk of an asset-to-liability mismatch. Celsius had staked a significant portion of its customers' Ether (ETH) deposits through a decentralised finance (DeFi) platform called Lido. The staked ETH was utilised to validate software as part of the Ethereum blockchain's shift to proof-of-stake validation. Stakers earned a yield on their staked assets, but were unable to withdraw these assets immediately.

By staking ETH through Lido, Celsius received stETH tokens, which represent the ETH staked through Lido on the Ethereum blockchain. These tokens can be traded or used as collateral on DeFi platforms, and prior to the recent downturn, their value was closely tied to the value of ETH. However, the value of stETH dropped below its peg, and insufficient liquidity in stETH tokens put Celsius' ability to meet customer ETH withdrawals at risk.

Engaging in bank-like activities without liquidity requirements, or additional safeguards such as a minimum loan overcollateralisation threshold, government support, or deposit insurance, creates an environment of heightened risk for depositors to face potential losses when 'runs' on platforms occur. This can lead to a scenario where depositors rush to withdraw funds, forcing lending platforms to sell assets at distressed prices to meet redemptions. Such fire-sale dynamics can also cause contagion, affecting other market participants in a similar position, either through direct exposure or through creating volatility for collateralised assets underpinning the borrower/lender relationship. Celsius, for example, had a capital ratio of 0.1

percent before it was hit by stress and had to freeze withdrawals and eventually declare bankruptcy.

Lending platforms with thin capital and concentrated exposures are especially vulnerable, as the default of even one borrower can cause significant harm. For instance, Voyager Digital lent a large amount to a single counterparty (3 Arrows Capital, or 3AC), which represented 58 percent of its loan book and more than twice its total capital. When 3AC defaulted, Voyager had to suspend withdrawals and secure an emergency line of credit. However, it couldn't stay afloat and ultimately declared bankruptcy. The experience of FTX and Alameda Research also demonstrates the importance of ensuring that correct safeguards are in place, including conduct of business requirements and robust risk management practices.

Overall, we believe the regulatory safeguards and requirements outlined by HM Treasury will be effective in preventing consumer and business exposure to similar risk related to cryptoasset lending activities. Further consideration should be given to **creating effective safeguards according to the risk associated with the volatility of the collateralised loan**. We would encourage direct engagement with crypto lending platforms on this to ensure a more comprehensive understanding of the full spectrum of risk and potential role of regulation in managing potential consumer detriment.

Recommendations

- Further consideration should be given to creating effective safeguards according to the risk associated with the volatility of the collateralised loan

Question 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?

DCGG understands in most cases there are existing regulatory models that can apply to cryptoasset lending activities. For example, peer-to-peer (P2P) lending was added to the RAO as a new regulated activity under Article 36H, which included regulatory requirements that we believe would be applicable to similar cryptoasset lending activities, including:

- Minimum prudential requirements that firms must meet in order to ensure their ongoing viability;

- Rules that firms must follow when holding client money, to minimise the risk of loss due to fraud, misuse, poor-record keeping and to provide for the return of client money in the event of a firm failure; and
- Rules on the resolution of disputes.

However, we believe there are a number of unique circumstances applicable to blockchain-based crypto lending, which offers more efficacy in privacy preservation and borrower quality distinction. The origination fees present in P2P lending are also replaced with a smaller tokenisation cost, and borrowers can present a more accurate financial incentive in the form of a smart contract. **It is also important to consider the different forms of cryptoasset lending in designing and applying appropriate regulations**, including P2P (whereby regulations from the existing P2P lending regime would be most relevant), DeFi liquidity provision, and centralised lending, which offers new forms of access to financing for millions of consumers and businesses. We address the potential need for a light-touch and internationally coordinated approach to DeFi liquidity provision in our response to Q35. For centralised lending, we believe there is a stronger case for borrowing from traditional lending regulatory requirements, including concentration requirements and liquidity backstops.

As discussed, **we believe the underlying collateral presented in crypto loans may require a more bespoke approach of the applicable prudential and operational requirements**, or additional considerations in any application from existing requirements from lending regimes. The development of this will require further consultation to take into account the different specificities of lending business models, mainly because lending could require a level of intermediation necessary to carry out the process in certain events. This is to avoid regulatory overlap whereby activities within a business model are subject to several sets of requirements while these do not fit completely within one definition under the future regime. It is crucial, for the purposes of legal clarity for crypto operators, to study existing business models and take those into consideration in order not to disincentive firms from entering the UK market due to lack of regulatory understanding of their business models. This should take into account the volatility of the underlying asset and the appropriate level of necessary information shared with the consumer.

Recommendations

- The Peer-to-Peer lending regulatory regime can be effective in regulating similar cryptoasset lending activities
- A light-touch and internationally coordinated approach is best placed in considering regulating other forms of lending, such as DeFi liquidity provision

- For centralised cryptoasset lending activities, borrowing requirements from more traditional regulatory regimes is more appropriate.
- However, consideration should be given to the volatility of the underlying collateral in terms of the requirements facing firms and customers

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

We agree and recommend further consideration is given to the underlying cryptoasset that is being used as collateral, given stablecoins offer less volatility than certain exchange tokens (e.g., Bitcoin).

Question 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)?

DCGG believes the regulatory treatment of lending, staking, and supplying liquidity should be differentiated and defined in more detail by HM Treasury. There are two separate use-cases for staking with different governance characteristics, utility, and consumer security that should be taken into account in more detail:

1. Staking when used for liquidity provision and locking up in DeFi
2. Staking to secure blockchain networks

In the liquidity provision case, the use of tokens after the act of locking them up is separate to 'staking' to secure the network. These tokens may be used in DeFi and so could be considered lent out, whereas staking activity to secure the network does not involve any lending activity and is used as a means of securing the network. We believe it is important for HM Treasury to clarify and separate these two different versions of staking in the design of appropriate and applicable regulations and oversight. For example: between i) staking to secure blockchain networks and ii) staking for DeFi liquidity provision.

Staking to secure blockchain networks is a necessary validation process that ultimately results in heightened security and consumer safety. It is our view that a light-touch regulatory approach would be most effective given the heightened security and consumer safety that such activity provides to the underlying proof-of-stake blockchain and asset. **This form of staking is also relatively lower risk than lending and staking for DeFi liquidity provision** and the risks are completely transparent (unlike lending) and are very well defined in the protocol as the details of slashing are consistent across the network, and clearly defined in the code and documentation of the network. We believe staking used to secure blockchain networks as beneficial. As a result, it is our view that this activity should not be subjected to regulation at this stage and encourage international collaboration to monitor and assess its development.

As highlighted, we believe that staking for DeFi liquidity provision is more akin to a lending activity with higher levels of risk in comparison to staking to secure blockchain networks. We believe regulation should focus on informing consumers of the risks and prevent misuse of how staking is promoted. In general, we believe **regulating DeFi activities is currently challenging and that a light-touch regulatory approach would be most beneficial** to promote innovation and international collaboration, which is vital given the cross-border nature of DeFi. This could include looking at ways to address consumer risk via the on/off ramps to DeFi networks. We address this in more detail in our response to the DeFi Call for Evidence.

Lending (where transfer of the asset is transferred) on the other hand, is a more traditional financial activity that carries with it a greater risk of loss for consumers. In lending, the borrower is typically taking on debt and may not be able to repay the loan which could result in the loss of the borrower's cryptoassets. In this scenario, the level of consumer protection that is appropriate for each activity will also vary depending on the specific circumstances, including value and the nature of the asset which is lent. We addressed the need for more in depth consultation in our response to Question 33, but ultimately **we agree that drawing on requirements from different traditional lending regimes is an appropriate method to regulate this form of cryptoasset lending activity**.

Recommendations

- It is important to separate two different versions of staking: i) DeFi liquidity provision and ii) staking to secure blockchain networks
- Staking to secure blockchain networks offers greater safety for consumers and should not be subjected to overly-burdensome regulatory requirements
- DeFi liquidity provision presents greater risk. However, given the difficulties in regulating this activity and the cross-border nature of DeFi we recommend further monitoring and collaboration with international regulators to assess the impact of regulation

CHAPTER 11

Call for Evidence: Decentralised Finance (DeFi)

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

Overall, DCGG agrees with HMT's assessment over the key challenges of regulating decentralised finance. We believe that taking into consideration the cross-border nature of DeFi and the differences in the structure and functions of underlying protocols is an important step for establishing a pro-innovation and clear architecture for a future DeFi regulatory regime. For the purposes of fairness and proportionality, we concur that a bespoke regime would be more suitable than amending existing frameworks, or applying rules for centralised crypto providers. This way, the user-preferred features of DeFi ecosystems, i.e., efficiency and transparency, can be effectively safeguarded, and the DeFi sector in the UK would be able to flourish.

We welcome the Government's efforts to gain a deeper understanding of this sector through this call for evidence, and we urge the Treasury to continue consulting with experts and industry participants through a phased approach in order to comprehensively address different business models within the DeFi ecosystem, rather than introducing an overarching umbrella regime that might wrongfully capture certain market participants.

Question 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 size of the UK market for DeFi can be evaluated through looking at the sum of the value of assets deposited, as well as the overall usage and engagement by UK customers with DeFi products and platforms, however due to the nascent nature of this sector and its inherently borderless nature, statistically estimating a concrete number of UK-based individuals that engage in different DeFi activities (swapping, trading, liquidity provision, etc.) proves difficult at the current stage of development of the sector.

For example, HMRC's 2022 call for evidence on the taxation of DeFi liquidity provision would be a useful tool for estimating the UK user base that engages in such activities, once the feedback is analysed and HMRC comes forward with the takeaways received. With the increased adoption of DeFi products, further calls for evidence over specific DeFi-related activities would be helpful in informing future policy and the level of market engagement in the UK, and ultimately objectively assess perceived risks and to what extent those could affect financial stability and examine and address international organisations' consumer protection-related concerns.

Question 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?

In DCGG's view, seeking the same regulatory outcomes across DeFi and CeFi activities that are similar or interconnected seems sensible to the extent that DeFi platforms are not overburdened by disproportionate regulation, and that reporting requirements are aligned with the operational structure of these platforms. **This will also likely require a different set of regulatory tools, and different timelines.** It is particularly difficult, especially in the context of emerging CeFi frameworks, to regulate DeFi effectively given its decentralised nature. We believe it is important to coordinate regulatory efforts with other jurisdictions.

This is also an approach that, in this instance, is considerably more productive than the usually proposed "same activity, same risk, same regulation" rationale on the basis that there is no equivalent activity to decentralised regulatory approaches. Finally, in terms of existing frameworks serving as a basis for DeFi activities, as already mentioned in Question 3, we support establishing a taxonomy for regulated activities under the DAR in the future, rather than the RAO, as it will allow for the necessary monitoring while the sector is still developing and innovating.

We therefore agree with the Treasury's view but also recommend that future requirements are drawn out during an extensive enough timeline in order to set out the most appropriate, innovation-friendly and future-proof operational resilience and compliance requirements for DeFi activities. This way, the Government would be able to strike the right balance between DeFi and CeFi in its regulatory objectives, while also allowing both sectors to flourish.

<u>**Recommendations**</u>

- The timeline for regulating DeFi should be longer to enable a more internationally coordinated approach
- Future regulation should be developed through the DAR, which will be most effective to ensure ongoing monitoring of the impact of regulation can take place

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

We appreciate HM Treasury's acknowledgement that developing a clear understanding of how decentralisation translates into the way particular financial services are carried out in the DeFi context is a crucial and meaningful step toward holistically addressing the sector. While degrees of decentralisation are difficult to estimate due to the lack of a standardised scale of measurement of such properties within the crypto sector, and DeFi in particular, **DCGG members suggest that the Government looks in-depth into how different DeFi protocols operate**. As suggested by the consultation paper, there could be varying numbers of actors involved in a DeFi protocol.

Based on this, it is DCGG's view that the underlying technology and governance mechanisms of a DeFi protocol can be considered truly decentralised when no one individual, entity or groups of entities holds majority power in any way, and that the protocol is driven equally by a network/community. Therefore, it is key to determine, to the extent possible, **whether there is a centralised/decision-making party involved within the protocol** (e.g., one individual holding a large percentage of governance tokens), in order to be able to establish the level of decentralisation.

Importantly, on this matter, it would be helpful for the competent authority to properly engage with DeFi industry participants in order to capture varying levels of centralisation and decentralisation correctly, without requesting substantial and altering changes to be made to the business model (e.g., the EU's initial proposal in the MiCA Regulation for an obliged legal entity for DeFi protocols). The industry is keen for regulatory certainty it will realistically and operationally be able to comply with.

Recommendations

- The degree of centralisation can best be measured through DeFi protocols, although it is important for the Government to properly engage with the industry

Question 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 cryptoasset sprint in May 2022)?

The takeaways from the FCA's crypto sprint in terms of regulatory hooks have laid the important groundwork towards developing an innovation-friendly regulatory regime for DeFi. DCGG concurs that initially looking into reducing risks on centralised on and off exchanges is a solid step toward addressing different strands of the DeFi sector. Noteworthy, if interface providers are to be brought into the scope of the future regime and these are to be considered a regulatory hook, DCGG's members believe that **a well-defined taxonomy and definitions of what entities are to be considered an interface provider is crucial** for the objective of avoiding overlapping regulation and inadvertently capturing providers that do not hold any influence over the DeFi arrangement. With this in mind, our view is that it is worthwhile to address the existing regulatory hooks now in order to get a holistic assessment of how this sector should be approached legally, along with following the work of international organisations.

As long as addressing different activities separately through consultations and engagement with the industry does not interfere or cause future issues with the FCA registration regime, our view is that enough time should be granted for the DeFi industry to be examined thoroughly in order to avoid premature regulation. This way, the Government could seize this unique leadership chance and implement a well-structured and proportionate bespoke regulatory framework for DeFi.

Recommendations

- Centralised on/off exchanges are a solid first step towards addressing the different strands of the DeFi sector from a regulatory perspective
- It is important to provide a well-defined taxonomy and definitions of which entities are to be considered an interface provider

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

In DCGG's view, the Government has considered sufficiently exhaustive options in light of the current stage of development of the DeFi sector. We have no further options to suggest beyond further in-depth engagement with the DeFi community on the development of industry standards and practices and how those can meet regulatory requirements.

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

As already mentioned across this consultation response, the underlying technology of DeFi - the Blockchain - and the decentralised character, could significantly improve the overarching financial sector of the UK, including incumbent financial infrastructures, and address emerging consumer and market demands, should the right regulatory approach be applied.

The OECD has quoted[3] some of the main benefits of DeFi. These are applied across a wide variety of protocols and products, and DCGG's members believe that some of those functionalities and practices would aid in creating a more sustainable and future-proof set of industry standards and requirements within the UK remit. Characteristics such as **increased transparency** and **integrity of record keeping**, **reduced concentration risk in terms of service**

[3]https://www.oecd.org/daf/fin/financial-markets/Why-Decentralised-Finance-DeFi-Matters-and-the-Policy-Implications.pdf

providers, and **increased resilience due to the lack of a central point of failure** can make way for a sound set of standards to be applied across different DeFi products which would also facilitate the establishment of a proportionate regulatory regime for DeFi ecosystems, the measurement of the level of decentralisation, and more. As long as the industry is allowed to innovate under a lighter touch legislative framework, DCGG's members believe this would lead to a very positive and lucrative spillover into traditional finance that could strengthen and equip the larger financial market in the UK when faced with novel demands.

Recommendations

- Creating a future-proof set of industry standards can be applied to DeFi products that could facilitate the establishment of a proportionate regulatory regime for DeFi

CHAPTER 12

Call for Evidence: Other Cryptoasset Activities

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

DCGG agrees with the consultation paper's rationale about the limited scope of cryptoasset investment advice and portfolio management (addressed at sophisticated, high-net worth investors) and the potential risks outlined. In our view, cryptoasset investment advisors and portfolio managers adhere to certain standards, just as in traditional finance, and provide the necessary warnings on the value of the cryptoassets, liquidity, risks of losses, etc. in order to ensure their investors make an informed decision. With this in mind, given the more narrow scope of these activities, as well as the safeguards that are already enforced by providers of such services, **we do not believe that cryptoasset investment advice and portfolio management should be regulated activities at this stage**. Once the sector in the UK grows more widely and a pro-innovation and proportionate legislative framework is enforced, we would welcome further consultations from the Government, should further regulatory interest in these activities arise in the future.

Recommendations

- HM Treasury should allow for the cryptoasset investment advice and portfolio management sector to develop before applying a regulatory regime

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

DCGG's view is that, at this stage, mining should be regulated only to the extent of achieving sustainability objectives - enforcing disclosure requirements, specific energy sources, etc. As recognised in the consultation paper, this is an activity that is extremely challenging to regulate due to its borderlessness and anonymity. We believe that it is most productive to require operators to disclose the environmental impact of the consensus mechanism in order to provide the necessary information to customers to make informed investment decisions. We do not see further merit in regulating mining activities.

On validation, DCGG is of the opinion that there is no merit in regulating this activity. In terms of sustainability, validators are based on a Proof-of-Stake mechanism rather than Proof-of-Work, which represents little threat to environmental sustainability, as it is less energy-intensive. Furthermore, validation is an activity that is carried out under the complete agency of the users, whereas the operators of validators merely provide the technological solution itself. As a result of this, and the cross-border nature of the activities, we believe at present there is no merit in regulating validation activities in the UK and a more beneficial approach is to continue to monitor and promote international dialogue on a coordinated regulatory regime.

Recommendations

- Mining operators should only be regulated with regard to disclosing the environmental impact of the consensus mechanism
- Validation activities should not be subject to regulation at this stage

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

As outlined in our response to Question 35, it is important that the regulatory approaches to lending and staking are divergent and take into account their respective specificities. This includes the difference between staking to secure blockchain networks (layer 1) and staking that provides DeFi liquidity provision, which carries completely different risks and requires different treatments. We believe this form of lending should be considered within phase 2 since the risks are more unknown and the term staking is often misused to confuse consumers.

Recommendations

- Staking should be differentiated, as outlined in our response to Question 35
- The regulatory treatments and requirements should be separated accordingly

Question 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)?

In terms of layer 1 staking, we would like to reiterate the sentiment from our response to Question 44 and the lack of control of the providers of validator solutions over who chooses to use their protocol, as this is an inherently cross-border activity. As a result, there is a strong rationale for not regulating validators and staking pools given they are international and located in different places all over the world, which reduces the power of UK-based validators. One of our members has confirmed that they are unaware of other professional validators based in and paying taxes within the UK other than them (ZKV). However, there are thousands of validators around the world. As a result, bilateral UK regulation would clearly reduce the competitiveness of the UK and lose vital investment, and skills. This is furthered due to the low infrastructure overhead and mobile nature of validator businesses.

Recommendations

- Validators and staking pools should not be regulated given the risk of losing UK competitiveness

CHAPTER 13

Call for evidence: Sustainability

Question 47. When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?

Sustainability is a core value for DCGG and its members, and members of the Blockchain community are working on addressing the accelerating impact of climate change by creating sustainable solutions to achieve more climate-friendly ecosystems. Making transactions on the blockchain carbon-neutral is a real prospect in the near future as a number of blockchain networks have committed to drive innovation with a negative carbon footprint. DCGG believes that the UK should encourage such innovative solutions and provide a favourable regulatory environment, which incentivises blockchain members to participate.

The EU's MiCA regulation is a sound example of disclosure requirements for environmental impact that can not only achieve a more transparent market, but also, importantly, inform investment decisions. With this in mind and in alignment with the EU approach, we believe that UK investors would benefit from transparent disclosure on principal adverse environmental and climate-related impact of the consensus mechanism used to issue the cryptoasset they wish to invest in. This is a level of transparency that we believe would be the most useful for investors ahead of decision-making.

Recommendations

- Requiring written disclosure (i.e., whitepaper) of the environmental impact of the consensus mechanism underlying a cryptoasset from issuers would promote transparency

Question 48. What reliable indicators are useful and / or available to estimate the environmental impact of cryptoassets or the consensus mechanism which they rely on (e.g. energy usage and / or associated emission metrics, or other disclosures)?

DCGG agrees with this consultation paper's sentiment that it would be challenging to determine a set of reliable indicators for estimating environmental impact when no standardisation for measurement exists across the industry at this stage. Among the examples listed in this consultation, we view energy usage as a more reliable indicator, especially in terms of the particular energy source facilitating the consensus mechanism. While proof-of-stake (PoS) protocols are not a major environmental concern and are sustainability-oriented and comparatively more eco-friendly, proof-of-work (PoW) systems do require a large amount of energy in order to run. However, DCGG is of the view that, in order for ESG investors to continue their commitment to sustainability, it is important to take into account the type of energy used, and in particular whether the operations of PoW-based products are using alternative, renewable energy sources (e.g., hydroelectric, solar, wind). According to Chainalysis, increased reliance on renewable energy would have a positive impact on the environment, and could benefit both miners and exchanges listing PoW-based assets in the long run. We therefore recommend that the energy source is taken into account when estimating the environmental impact of energy usage.

Finally, in terms of general indicators, we would like to reiterate that MiCA's approach in the EU on disclosure of environmental impact of the consensus mechanism is expected to be sufficient enough to estimate the carbon footprint of a cryptoasset. The supervisory authorities in the EU are yet to develop technical standards specifying the content, methodologies and presentation of information in relation to sustainability indicators, and our view is that the UK Government should monitor this process, what sets of indicators and criteria are developed, how these could drive innovation, and ultimately assess to what extent those can be emulated, or improved upon.

Recommendations

- The energy source of PoW-based products should be taken into account when estimating the environmental impact
- Increased monitoring of other jurisdictional approaches prior to legislating would better inform an future-proof set of indicators applied in the UK context

Question 49. What methodologies could be used to calculate these indicators (on a unit-by-unit or holdings basis)? Are any reliable proxies available?

We recommend that once there are established minimum sustainability standards and indicators, the Government assesses the extent to which the levels of measurement of these indicators are similar or divergent from sustainability standards for non-crypto products, and what would be the best applicable framework for Blockchain market participants accounting for the specificities of these business models and their energy dependency. In terms of methodologies, we recommend the holding basis rather than the unit-by-unit basis to estimate climate impact, given that safekeeping and storing value (i.e., holding an asset) is a major use-case in the crypto market.

Recommendations

- Existing sustainability standards for non-crypto products could be a sound basis for a crypto-specific rulebook
- A holding basis for calculating sustainability indicators is more aligned with the way Blockchain products operate

Question 50. How interoperable would such indicators be with other recognised sustainability disclosure standards?

In order for the UK to achieve its objective for more sustainable finance, it is important that the established standardised indicators are aligned with other recognised disclosure standards, to the extent that this is possible and applicable to an inherently cross-border, decentralised industry.

Recommendations

- Harmonisation with existing disclosure standards, nationally and internationally, would better contribute to the Government's objectives

Question 51. At what point in the investor journey and in what form, would environmental impact and / or energy intensity disclosures be most useful for investors?

DCGG's view is that disclosures of environmental impact and energy intensity should be formulated in the form of a disclaimer in the cryptoasset whitepaper (similar to what is proposed in the EU MiCA). This would grant investors the necessary transparency and allow them to make an informed decision that is aligned with their sustainability commitments prior to the purchase of the asset(s).

Recommendations

- Disclosures should be required at the decision-making/initial stage of the investor journey, in particular through the cryptoasset whitepaper

Question 52. Will the proposals for a financial services regulatory regime for cryptoassets have a differential impact on those groups with a protected characteristic under the Equality Act 2010?

We do not expect that the proposed regime would have a differential impact on protected groups under the Equality Act 2010. DCGG's members are very consumer-oriented and are highly dedicated to user protection, and as long as that is reflected in the future regime, we do not foresee any discrepancies in terms of impact on groups with a protected characteristic.