

UK Cryptoassets Taskforce Publishes its Final Report

The Taskforce's final report outlines the UK's policy and regulatory approach to crypto-assets and distributed ledger technology in financial services.

Key Points:

- The Report provides an overview of crypto-assets and their underlying technology, assesses the associated risks and potential benefits, and sets out a new path for the regulation of crypto-assets in the UK.
- The Report states that the most immediate priorities for the three authorities comprising the Taskforce are to mitigate the risks to consumers and market integrity, and to prevent use of crypto-assets for illicit activity.
- By the end of 2018, the FCA will consult on: i) additional perimeter guidance specific to crypto-assets; and ii) a potential ban on the sale of derivatives referencing cryptocurrencies like Bitcoin to retail customers.
- In early 2019, the Treasury will consult on potential changes to the regulatory perimeter to bring crypto-assets that have comparable features to existing regulated investments within the scope of regulation, and explore how cryptocurrencies like Bitcoin might be regulated if necessary.
- During 2019, the Treasury will also consult on proposed gold-plating in relation to crypto-asset activity of the UK implementation of the EU Fifth Anti-Money Laundering Directive.
- HM Revenue and Customs is also expected to issue revised guidance on the tax treatment of crypto-assets by early 2019.
- The Report indicates that the existing UK regulatory approach to crypto-assets will broadly continue.
- The Report contains no proposals to regulate utility tokens or cryptocurrencies like Bitcoin in the UK.
- The UK will maintain a technology-neutral approach to regulation and will not introduce a specific legal and regulatory framework for DLT.

The UK Cryptoassets Taskforce — comprising the Bank of England, the FCA and the Treasury — was established by the Chancellor of the Exchequer in March 2018 to investigate crypto-asset activity and applications of distributed ledger technology (DLT) in financial services in the UK. The Taskforce's [final report](#) (the Report) reflects existing work and new analysis conducted by the Taskforce, as well as engagement with industry stakeholders across the crypto-asset and DLT sectors.

Overall, the Report strikes a more measured tone than the recent [report on crypto-assets by the House of Commons Treasury Committee](#) (discussed in this prior Latham [Client Alert](#)), which called for all crypto-asset activity in the UK to be regulated as a matter of urgency (apparently including utility tokens and cryptocurrencies like Bitcoin, in addition to crypto-assets that amount to existing regulated investments). Conversely, the Taskforce's Report is focused on ensuring that the regulatory perimeter appropriately addresses the regulation of crypto-assets that have features meaning that they amount to existing regulated investments only, as well as dealing with anti-money laundering (AML) concerns across all types of crypto-assets.

In one way or another the consultations proposed in the Report will impact all participants in the crypto-asset sector, including issuers, exchanges, other intermediaries (such as wallet providers and crypto brokers), and investors. It is likely that the true impact of the Report on the sector will only become apparent in the detailed proposals put forward by the authorities in consultation. Given the potential impact on the sector in terms of possible restrictions on clients and product types, enhancements to systems and controls requirements, and regulatory and compliance costs, Latham would encourage all market participants to engage fully with the forthcoming consultations.

Key Aspects of the Report

Crypto-assets

AML

Consistent with the UK government's previous assessments in [2015](#) and [2017](#) of crypto-assets as being relatively low-risk for both money laundering and terrorist financing, the Taskforce concludes that the use of crypto-assets for illicit activity remains low. However, the Taskforce notes that certain features of crypto-assets are particularly attractive to criminals and that the risk of use of crypto-assets for illicit purposes is increasing as crypto-assets become more accessible. In response to this perceived increase in risk, the UK government proposes to develop a "robust regulatory response", which will go "significantly beyond the requirements set out in the EU Fifth Anti-Money Laundering Directive (5MLD)".

To that end, the Treasury will consult in early 2019 on proposals to gold-plate 5MLD in the UK in order to address the risk of use of crypto-assets for illicit activity. This will include extending AML and counter-terrorist financing (CTF) obligations to:

- Exchange services between different crypto-assets, to prevent anonymous "layering" of funds to mask their origin
- Platforms that facilitate peer-to-peer exchange of crypto-assets, which could enable anonymous transfers of funds between individuals
- Crypto-asset ATMs, which could be used anonymously to purchase crypto-assets
- Non-custodian wallet providers that function similarly to custodian wallet providers, which may otherwise facilitate the anonymous storage and transfer of crypto-assets

The consultation will also include proposals to extend UK AML/CTF obligations to firms based outside the UK when providing services to UK consumers, and a proposal for the FCA to be appointed as the supervisor of otherwise unregulated firms engaged in crypto-asset activity in relation to their AML/CTF obligations.

A key barrier to the growth of crypto-assets as an asset class has been uncertainty around the appropriate AML and “know your customer” (KYC) measures to be adopted by issuers, exchanges and other intermediaries (such as wallet providers and crypto brokers). The Treasury’s proposal to implement specific requirements and guidance relating to AML and KYC obligations in relation to crypto-assets that will gold-plate the requirements of 5MLD should bring certainty as to the steps market participants need to take.

Classification and Regulation

The Taskforce classifies crypto-assets by reference to three broad types:

- “Exchange tokens” — crypto-assets that are not backed by a central bank or other central body, and do not provide the types of rights or access provided by security or utility tokens (often referred to as cryptocurrencies, e.g., Bitcoin, Litecoin)
- “Security tokens” — crypto-assets that fall within the definition of an existing regulated investment in the UK, typically providing rights such as ownership, repayment of a specific sum of money, or entitlement to a share in future profits
- “Utility tokens” — crypto-assets that can be redeemed for access to a specific product or service that is typically provided using a DLT platform

Whilst the Taskforce emphasises that each crypto-asset must be assessed on a case-by-case basis to determine whether or not it has features that bring it within the scope of existing financial regulation, the Taskforce recognises that utility and exchange tokens (cryptocurrencies like Bitcoin) generally do not fall within the current regulatory perimeter. The Report also reaffirms the current regulatory position in the UK that crypto-assets are not considered to be a currency or money. These statements are consistent with the approach taken towards crypto-assets by the UK financial regulators to date that crypto-assets are only regulated if the rights and obligations attaching to those assets bring them within the definition of an existing regulated investment. The proposal by the FCA to consult by the end of 2018 on additional perimeter guidance providing further clarity on the application of the current regulatory perimeter to crypto-assets indicates that this approach to regulation is likely to continue.

However, the Treasury will consult in early 2019 in order to understand whether there are crypto-assets on the UK market that have comparable features to existing regulated investments but are structured in a way that means they avoid regulation. If examples of such crypto-assets are found to exist, the Treasury may enact legislation to prevent this kind of circumvention of the current regulatory perimeter. The Treasury will also consult in early 2019 on whether and how exchange tokens and firms providing services in relation to exchange tokens (such as cryptocurrency exchanges and wallet providers) could be regulated effectively, if other measures proposed by the Taskforce do not adequately address all relevant risks.

Notably, the Report does not contain proposals to extend the regulatory perimeter to utility tokens or exchange tokens, which are currently unregulated in the UK (unless following the consultation mentioned above in relation to exchange tokens the Treasury finds that other measures proposed by the Taskforce do not adequately address all relevant risks). This contrasts with the recent House of Commons Treasury Committee report on crypto-assets, mentioned above, which called on the UK government to regulate all crypto-asset activity (including all initial coin offerings (ICOs) and crypto-asset exchanges).

Potential Ban on Retail Cryptocurrency Derivatives

By the end of 2018, the FCA will consult on a ban on the sale of all kinds of derivatives which reference cryptocurrencies like Bitcoin to retail customers. Currently, the sale of contracts for differences (CFDs) that reference crypto-assets to retail customers is restricted across the EU by temporary product intervention measures enacted by the European Securities and Markets Authority (ESMA). However, the FCA proposals would go beyond the ESMA intervention in that the FCA ban would be permanent and would apply to all kinds of derivatives (including CFDs, futures, options and transferable securities embedding a derivative).

The Report also sets out the FCA's position that, for the time being, it is unlikely to approve the listing of securities or funds that reference cryptocurrencies like Bitcoin.

Prudential Regulation and Financial Stability

The Taskforce concludes that crypto-assets do not currently pose a material threat to UK or global financial stability. The Bank of England will continue to monitor the development of the crypto-asset market to identify potential implications for financial stability.

Indications of Other Areas for Potential UK Regulatory Intervention

The Report notes a number of areas in which, owing to the early point in the lifecycle of this nascent sector, there are concerns around market integrity and potential divergence in the standards that market participants are adopting across the industry. The Report also notes disparity with standards of market conduct and robustness of market infrastructures in traditional financial markets.

The Report identifies the following areas which, if not adequately addressed by industry-led initiatives such as voluntary codes of conduct, are likely to be at the top of the regulatory agenda should the authorities comprising the Taskforce take further action once the specific actions identified in the Report have been completed:

- **Market abuse** — The Taskforce notes concerns around “market abuse-style activities” currently occurring in relation to crypto-assets, and the potential for new abusive behaviours not captured by current monitoring tools to arise
- **Governance, systems and controls, and conflicts of interest** — The Taskforce notes the potential for poor governance arrangements, a lack of systems and controls, and conflicts of interest, given the lack of maturity of the crypto-asset market and market participants
- **Reliability, availability and accessibility of market infrastructure** — The Taskforce notes that risks to consumers may result from immature market structures and potential failings by services providers such as crypto exchanges, trading platforms, and wallet providers. In particular, the Taskforce recognises that immature market structures and operational risk issues associated with these service providers “may delay or deny consumers easy access to their invested funds and/or secondary market trading” and can result in “significant delays in the payment chain ... which may result in consumers missing buy/sell opportunities”

DLT in Financial Services

The Taskforce recognises that crypto-assets are just one application of DLT, and that not all applications of DLT in financial services involve crypto-assets. In particular, the Report outlines a variety of financial services use cases that the Taskforce has been involved with, including applications of DLT relating to digital funds, RegTech, securities issuance, trade finance, tokenisation of financial instruments, and insurance.

The Report reaffirms the UK authorities' technology-neutral approach to regulation. Further, the Taskforce agrees with the FCA's conclusion in its [Discussion Paper on DLT](#) that no changes to UK regulation are required in order for financial services firms to adopt DLT. It is, therefore, unlikely that the UK will introduce a technology-specific legal and regulatory framework for DLT as some other jurisdictions have done (for example, Malta and Gibraltar). Nevertheless, the Taskforce sets out its commitment to support innovation in the financial services sector and to continue to encourage and enable the development and adoption of DLT in financial services through a number of initiatives (such as the FCA's regulatory sandbox and RegTech initiative, the Global Financial Innovation Network, government investment through Innovate UK, and the government's Shared Platforms initiative).

The Taskforce does conclude, however, that DLT requires further development before it could be used at scale, and discusses some of the potential barriers to the wider adoption of DLT. Of these, legal and regulatory considerations include:

- Competition issues — The Taskforce notes the potential for competition law issues to arise in relation to the use of DLT in financial services. The Report includes the example of access by market participants to a permissioned DLT network in a scenario in which the network has developed to become an essential market infrastructure. Similar considerations are likely to arise if firms collaborate (for example through consortia) to facilitate development or adoption of a DLT solution across a sector.
- Legal challenges — The Taskforce highlights civil law and data protection legislation as presenting potential challenges to DLT. The possibility of tension between the legal “right to be forgotten” and the immutable nature of data storage on some DLT networks is referenced, as is the question of enforceability of smart contracts in the UK (a question which is currently subject to [consultation](#) by the UK Law Commission).
- Settlement finality — In payment and other settlement systems, it is essential to know the point at which a payment becomes final and irrevocable. As the Taskforce notes, this could present interpretative challenges for certain DLT systems (in particular, permissionless networks) as to the precise moment when a transaction processed by the system has been submitted to, or completed by, the network.
- Governance challenges — As the FCA previously noted in its Discussion Paper on DLT, the Report highlights that firms will have to pay careful attention to allocating individual responsibilities where they use a DLT network that does not have a central point of authority. The requirements on UK regulated firms to have in place effective systems and controls to ensure the continued availability, reliability, and security of key regulated services will also need to be carefully considered by firms wishing to use DLT to facilitate regulated financial services.

Promotion of a Coordinated International Response

The Taskforce makes clear that it is committed to ensuring, as far as possible, a coordinated international approach to crypto-assets and applications of DLT in financial services. The Report states that the authorities comprising the Taskforce will continue to be actively involved in international efforts relating to the sector. Moreover, the UK will advocate for the particular challenges presented by crypto-assets to existing financial regulatory frameworks to be addressed through the G20 and G7.

There are a number of notable international initiatives addressing crypto-assets and applications of DLT in financial services, including a project by the Financial Action Task Force to update global AML/CTF standards to apply to crypto-assets, discussions in relation to crypto-assets at the International Organization of Securities Commissions, and various EU-level initiatives (including the ESMA taskforce on ICOs and virtual currencies, industry participant initiatives such as the Securities and Markets Stakeholder Group's [own initiative advice to ESMA](#) on ICOs and crypto-assets, and the potential inclusion of ICOs in the proposed EU regulation on crowdfunding). Other regulators around the globe are also considering the most appropriate way to classify and regulate crypto-assets — for a recent update on US considerations in relation to the regulation of utility tokens, please see this [article](#) authored by Latham lawyers.

This level of international engagement shows an increasing willingness by global bodies and regulators to consider a specific regulatory response to the development of this nascent asset class, and an acknowledgement that while certain types of crypto-assets do (and should) fall outside the regulatory perimeter, other crypto-assets which provide rights and obligations akin to existing regulated financial products should be regulated as such.

That the Taskforce also suggests in a number of places in the Report that effective regulation and good governance in the crypto-asset sector could enhance the UK's reputation as a digital centre also demonstrates a recognition that a lack of clarity in relation to the regulatory position may stifle innovation, and shows a willingness by UK authorities to try to correct this.

Next Steps and Timing

Consultation	Authority	Expected Timing
Consultation on additional perimeter guidance specific to crypto-assets	FCA	By end of 2018
Consultation on potential ban on the sale of derivatives referencing cryptocurrencies like Bitcoin to retail customers	FCA	By end of 2018
Consultation in order to understand whether there are crypto-assets on the UK market that have comparable features to existing regulated investments but are structured in a way that means they avoid regulation	Treasury	Early 2019
Consultation on whether and how cryptocurrencies and firms providing services in relation to cryptocurrencies (such as	Treasury	Early 2019

Consultation	Authority	Expected Timing
cryptocurrency exchanges and wallet providers) could be regulated effectively, if necessary		
Consultation on proposed gold-plating of the implementation of the EU Fifth Anti-Money Laundering Directive in the UK to provide a robust regulatory response to the use of crypto-assets for illicit activity	Treasury	Consultation in early 2019, with implementing legislation during 2019

In addition to the consultations set out above, the Taskforce will continue to monitor market developments and regularly review the UK’s approach to crypto-assets and DLT, and will meet every six months.

The Report also states that the Taskforce welcomes the work done by the House of Commons Treasury Committee on crypto-assets, and that the UK government will formally respond to the Treasury Committee in November.

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