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FSbriefing

Cryptoassets – what you need to know

Introduction

It's been impossible to avoid talk of cryptocurrencies over the past year. The highly volatile price of the most well-known cryptocurrency, bitcoin, has been a news story in itself. Even among the broader population of cryptocurrencies – increasingly referred to as 'cryptoassets' in the regulatory discourse, reflecting most regulators' view that these are not strictly currencies – the popularity of similarly volatile tokens offered through initial coin offerings (ICOs) and security token offerings (STOs) has been keeping commentators, investors and regulators (not to mention lawyers) busy.

In the UK, the Financial Conduct Authority (FCA) has recently published a consultation containing draft guidance that will help firms determine whether cryptoassets fall within the FCA's regulatory perimeter. The consultation was published in response to industry calls for regulatory clarity in this area. In its draft form, the consultation provides a high level walkthrough of the steps that market participants should take to understand whether particular cryptoassets comprise 'specified investments' and thus whether those participants need to be authorised (or subject to an exemption) to carry out particular activities. The final guidance is expected this summer.

This is the first of two briefings relating to cryptoassets – in the second, *Cryptocustody – what you need to know*, we consider the application of the UK regulatory regime to those offering custody services for cryptoassets.

What are cryptoassets?

The vast number and huge variety of new cryptoassets that have sprung up in the last few years have caused headaches for regulators trying to define cryptoassets.

Around the world, most attempts at a regulatory definition of 'cryptoassets' have been fairly broad. This has also been true for alternative terminology, which usually amounts to a combination of 'virtual-', 'digital-' or 'crypto-' and '-currencies', '-assets', '-coins' or '-tokens'. The term "cryptoassets" is currently the favourite among regulators and is the term we've chosen to use in this briefing.

International and EU approach

In the regulatory context, the term first appeared in a March 2018 letter from the Financial Stability Board (FSB) to the G20, but was left undefined. The FSB later hinted at the term's meaning in July ('*a type of private digital token*') and defined it in October as '*a type of private asset that depends primarily on cryptography and distributed ledger or similar technology as part of their perceived or inherent value*'.

In a recent report on cryptoassets, the European Securities and Markets Authority (ESMA) took its cue from the FSB, defining cryptoassets as '*a type of private asset that depends primarily on cryptography and Distributed Ledger Technology (DLT) as part of their perceived or inherent value.*'

UK approach

While the international definitions portray the essential elements of a cryptoasset, a more comprehensive definition was put forward last year by the UK's Cryptoassets Taskforce (the Taskforce, consisting of HM Treasury, the FCA and the Bank of England) and has been adopted in the FCA's recent consultation paper. In the UK regulators' view, a cryptoasset is:

'a cryptographically secured digital representation of value or contractual rights that uses some type of DLT and can be transferred, stored or traded electronically. Examples of cryptoassets include bitcoin and litecoin (and other "cryptocurrencies"), and those issued through the Initial Coin Offering (ICO) process, often referred to as "tokens".'

This definition builds upon the FCA's previous definition, used for the purposes of its *Dear CEO* letter about cryptoassets and financial crime. In the letter, the FCA used the term 'cryptoassets' to refer to '*any publicly available electronic medium of exchange that features a distributed ledger and a decentralised system for exchanging value (such as bitcoin or ether).*' The Taskforce's addition of a limb of the definition that relates to ICOs reflects the growing popularity of the use of ICOs for company funding, and a desire to bring the resulting cryptoassets within the regulatory perimeter.

Technologically speaking, in their simplest form, cryptoassets are mathematical codes representing an amount of a virtual asset. They can be recognised and verified by users of a (public) platform using distributed ledger technology (DLT) as belonging to a particular address. A holder of a cryptoasset will typically have an address to which cryptoassets can be sent (referred to as a *public key*) and a form of passcode (known as a *private key*) that allows cryptoassets to be extracted from that address. The private key is required to control and affect a transfer of cryptoassets to another user of the DLT system.

The public and private keys which allow holders to send and receive cryptoassets can be held on a *digital wallet*. Strictly speaking, the cryptoasset itself is not typically held *in* the digital wallet; rather it is stored and maintained in the DLT system.

Regulatory taxonomy

Regulators' broad definitions of cryptoassets mean that not all cryptoassets are created equal – some may be subject to significant regulatory scrutiny, while others could escape regulators' gaze altogether.

Not all cryptoassets are created equal… security tokens may be financial instruments under the EU's MiFID 2 rules

Within the broad definitions set out above, both ESMA and the Taskforce have identified three types of cryptoassets (styled by ESMA as 'investment-type', 'utility-type' and 'payment-type' cryptoassets):

- *security tokens*, which provide rights to ownership, repayment of a specific sum of money, or rights to a share in future profits (among others). In an attempt to line up the taxonomy of cryptoassets with the existing regulatory perimeter, the Taskforce defines security tokens as those cryptoassets that amount to specified investments under the Regulated Activities Order (RAO). These cryptoassets may also be financial instruments and thus fall into the EU's revised Markets in Financial Instruments Directive (MiFID 2) regime, as well as other EU financial markets legislation;
- *utility tokens*, which provide a right to a particular product or service (other than products or services that would bring tokens in scope of the RAO or MiFID 2); and
- *exchange tokens*, which are designed as digital alternatives to currencies (and, therefore, do not give rise to rights or access in the same way as security or utility tokens) and may be used as a means of exchange or for investment. These cryptoassets are often referred to as cryptocurrencies. However, the Bank of England, in line with many other G20 central banks, has confirmed that exchange tokens do not constitute currency or money (hence the Taskforce's use of the moniker 'exchange token' rather than 'cryptocurrency').

As outlined further below, the definition and taxonomy of cryptoassets are widely expected to change over coming years, given the potential grey area for cryptoassets that sit just outside the regulatory perimeter (although the European Banking Authority (EBA) and ESMA have both suggested that, at a minimum, anti-money laundering provisions should apply to all three types of cryptoassets – though this would require legislative change).

ICOs and STOs make use of DLT to offer cryptoassets to the public, and often closely resemble initial public offerings of shares. While the terminology is not necessarily consistent in all circumstances:

- *ICO* is generally understood to cover any type of cryptoasset offering, whether or not subject to prospectus requirements, prospectus liability and ongoing disclosure, trading and transparency requirements (as may be the case for an initial public offering of shares); and
- *STO* has a narrower meaning, which stems from the classification of 'securities tokens' as being those cryptoassets which are subject to securities regulations. It is therefore understood to cover regulated offers of cryptoassets (which will adhere to prospectus requirements etc).

Native and non-native tokens

The Taskforce report references, but does not engage with, an alternative sub-division of cryptoassets into 'native' and 'non-native' tokens:

- *native tokens* are cryptoassets that exist solely within a DLT platform and derive their value from that DLT platform. bitcoin and ether are both prominent examples of these intangible, non-physical assets; and
- *non-native tokens* are cryptoassets that represent tangible or financial assets that exist outside the DLT platform. Non-native tokens would include cryptoassets that purport to represent ownership of shares, houses, or rights to a product or service.

> "There is not a 'one size fits all' solution when it comes to legal qualification
>
> *ESMA*

By not engaging with this distinction, the Taskforce report reinforces the position that cryptoassets will be regulated with an emphasis on substance over form (as it does not matter if a cryptoasset is a tokenised version of a 'real world' asset). However, the distinction is brought into stark relief when considering the legal treatment of cryptoassets. It is far from clear whether and how cryptoassets should be characterised in terms of the existing taxonomy of property rights, and it is possible that native and non-native tokens could be characterised in markedly different ways.

Analogy with depositary receipts

Non-native (security) tokens representing rights to shares arguably share certain attributes with depositary receipts, which therefore provide a potential model as to how non-native tokens could be treated under English law – noting that not all depositary receipts are necessarily structured in the same way.

Depositary receipts are issued by a depositary holding immobilised shares, and give entitlements to benefits such as dividends which are similar (if not always identical) to those benefits attaching to the underlying shares. In this respect it is important to note that depositary receipts are a separate security to the underlying shares, and holders of depositary receipts derive their rights from the depositary receipts rather than the shares. This is demonstrated by the fact that the issuer of the shares often enters into a deed in favour of the depositary receipt holders, giving them direct rights of enforcement against the issuer (because the depositary bank will not usually enforce rights on behalf of the depositary receipt holders).

In its recent report, ESMA notes that a number of national competent authorities have stated that it would be desirable to set out new rules relating to the custody of the underlying assets that have been 'tokenised' in a cryptoasset. For its part, the FCA has confirmed in draft guidance that a non-native token representing a right to a specified investment could fall within the same category of specified investment as a depositary receipt.

Future developments

Potential legislative change

The legal position of cryptoassets has been described by Lord Hodge (of the UK Supreme Court) as an '*area of doubt*' that requires '*a degree of international legal consensus on* [cryptoassets'] *nature as property rights*'. In the UK, clarity in this area will most likely require new legislation – one possibility is to change the law to recognise cryptoassets as a 'virtual' asset that is capable of possession. The UK government and regulators have evinced a strong preference for ensuring that cryptoassets are regulated and a clear legal characterisation, set out in statute, would help to underpin any regulatory regime.

It is likely to be difficult to come up with hard and fast rules as to what constitutes legal title to a cryptoasset, and how title may be transferred. Indeed, in its report, ESMA stated its belief that '*there is not a "one size fits all" solution when it comes to legal qualification*'. What may work when moving legal title in a bitcoin transaction (by using the private key to create a 'digital signature' that authorises the transfer of a collection of 'unspent transaction outputs' held in one address by signing them over to another person's address) might not work for Ethereum's account based model, for example. Any legal rules are likely to have to be applied according to the particular facts relating to each cryptoasset. In some cases, there may be easier analogies to existing methods of legal transfer – for example, the Ethereum model looks much more like a typical bank or securities account than the bitcoin model (although there are still crucial differences caused by the decentralised nature of Ethereum and the lack of a central entity against which a claim could be made) – but it seems likely that many will continue to require case-by-case legal analysis.

> "Regulators [must] decide whether the current Wild West situation is allowed to continue
>
> *HM Treasury Select Committee*

Upcoming regulatory consultations

The deluge of recent reports on cryptoassets – including the FSB, ESMA, FCA and Taskforce papers mentioned above, as well as other publications by the EBA and the UK's Prudential Regulation Authority – all make it abundantly clear that regulators are no longer biding their time on cryptoassets. However, regulators will freely admit that it will take a significant amount of further work on their part to fully map out the rules that apply to cryptoassets.

From a European perspective, the EBA and ESMA reports identify the establishment of harmonized EU rules as a key objective for legislators. ESMA, in particular, highlights the pressing need to provide a level playing field between the EU member states and to more effectively address the perceived risks presented by cryptoassets. With the European Parliamentary elections in May fast approaching, it seems unlikely that any concrete legislative steps will be taken before this autumn, when the European Commission will set out the priorities for its new term (2019-2024). In the more immediate future, the EU's fifth Anti-Money Laundering Directive (MLD 5) will impose financial crime and registration requirements on firms providing certain cryptoasset-related services (ie fiat-to-cryptoasset exchange firms and custodian wallet providers – on which, please see our cryptocustody briefing). EU member states are required to implement the requirements of MLD 5 into local law by 10 January 2020.

In the UK, HM Treasury has advised that it may need to shift the regulatory perimeter for cryptoassets through legislation, in order to reflect policy concerns about the effect of a potential cliff edge: tokens not currently subject to financial services regulation are unlikely to fall under another regulatory regime. For example, the Taskforce indicated that the regulatory perimeter may need to be extended to cover ICOs and other issuance mechanisms for cryptoassets. In the short term however, the FCA will seek to manage the risk of a cliff edge through guidance, rather than by redefining the perimeter itself. We expect further clarity on the boundaries of current regulation in the coming months, as the FCA will finalise its guidance on the regulatory perimeter in the summer.

In relation to anti-money laundering legislation, the Taskforce paper also indicates the UK government's willingness to extend the scope of the requirements beyond that set out in MLD 5. HM Treasury is expected to consult on the transposition of MLD 5 requirements in the coming months and to seek industry views on including crypto-to-crypto exchanges,

cryptoasset ATMs, wallet providers and non-UK firms (when providing services to UK consumers) within the scope of UK anti-money laundering rules. Wallet providers and cryptoasset exchanges are also likely to sit in the crosshairs of a separate HM Treasury consultation exploring whether they should be subject to financial services regulation that extends beyond their activities relating to securities tokens. HM Treasury seems highly motivated to avoid a return to the 'Wild West' situation that characterised the early history of cryptoassets (and arguably still does).

For further information and up to date commentary on cryptoassets and other fintech topics, please see the Freshfields Digital blog (digital.freshfields.com). If you have any questions relating to cryptoassets or any other topics mentioned in this briefing, please contact:

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