FinReg

EXEC. SUMMARY

Cryptoasset businesses in the UK are regulated for anti-money laundering (AML) purposes, while cryptocurrencies are regulated depending on their nature and type. This means that some types of tokens are subject to specific regulations while others are not. The Financial Conduct Authority (FCA) is the primary financial regulator in the UK, and has – along with HM Treasury – taken a constructive stance on crypto asset policy making by grounding its principles on balancing financial stability with competition and innovation.

FinReg business tip:

The FCA is currently (as of May 2022) developing a regulatory framework to address how cryptocurrency businesses can operate in the country. Additional measures are being explored with regards to capital requirements and enhanced AML/KYC measures. Stay tuned on FinReg to learn more about these changes when they are implemented.

REGULATORY STANCE

UK regulators, including HM Treasury and the UK Cryptoasset Task Force have outlined its objectives in crypto asset regulations.

According to HM Treasury

- **Objectives**
    - **Protecting financial stability and market integrity.** This includes maintaining the appropriate regulatory standards, ensuring infrastructure is operationally resilient and that safeguards are in place to mitigate any risks to financial stability.
    - **Delivering robust consumer protections.** This means ensuring consumers benefit from the same of level of protection they would when other regulated instruments are being used for the same purpose (e.g. payments).
    - **Promoting competition, innovation and supporting UK competitiveness.** This means continuing to encourage and support UK fintech firms, and ensuring consumers and businesses have access to a variety of high-quality services and products

The UK has relied on consultations and public-private collaborations towards regulatory decision making. This results in a risk-proportionate approach with less uncertainty than other jurisdictions that may otherwise rely on regulatory arbitrage or outright bans on cryptoassets.

RECOGNITION OF CRYPTOCURRENCIES IN THE UK

The UK framework of crypto assets consists of "regulated tokens" and "unregulated tokens". Regulated tokens include "security tokens" and "e-money tokens" only, while unregulated tokens include everything else including "utility tokens", "exchange tokens" and NFTs.

Exchange tokens consist of the coins we are familiar with that are traded on exchanges such as ETH, SOL and BTC. Consumers who purchase exchange tokens are unlikely to have recourse to the Financial Ombudsman Service or the Financial Services Compensation Scheme (FSCS).

Security tokens on the other hand, do fall under the FCA's regulatory remit. A token is considered a security token if it provides:

- Ownership position
- Repayment of a specific sum of money
- Entitlement to a share in future profits

Essentially, security tokens are like digitised, tokenised versions of traditional securities.

According to FCA

- **Regulated tokens**
    - **Security tokens:** These are tokens that amount to a 'Specified Investment' under the Regulated Activities Order (RAO), excluding e-money. These may provide

rights such as ownership, repayment of a specific sum of money, or entitlement to a share in future profits. They may also be transferable securities or other financial instruments under the EU's Markets in Financial Instruments Directive II (MiFID II). These tokens are likely to be inside the FCA's regulatory perimeter.

- **E-money tokens:** These are tokens that meet the definition of e-money under the Electronic Money Regulations (EMRs). These tokens fall within regulation.

- **Unregulated tokens**
  - Any tokens that are not security tokens or e-money tokens are unregulated tokens. This category includes utility tokens which can be redeemed for access to a specific product or service that is typically provided using a DLT platform. The category also includes tokens such as Bitcoin, Litecoin and equivalents, and often referred to as 'cryptocurrencies', 'cryptocoins' or 'payment tokens'. These tokens are usually decentralised and designed to be used primarily as a medium of exchange. We sometimes refer to them as exchange tokens and they do not provide the types of rights or access provided by security or utility tokens, but are used as a means of exchange or for investment.
- You can find out more about which cryptoasset activities we regulate in PS19/22: Guidance on Cryptoassets. Any firm carrying on a regulated activity will need to be authorised by us. Find out more about the authorisation process.

Tokens that constitute a security token will thus be regulated much like securities, whereby issuers will need to adhere to the markets/securities laws of the UK (outlined in the following paragraph).

Any token that is not a *security token* or an *e-money token*, is currently ***unregulated***. What being unregulated essentially means is that the purchase, sale and exchange of such tokens do not fall under the following laws/regulation:

- Financial Services and Markets Act (Regulated Activities) 2001
- Second Markets in Financial Instruments Directive 2004 (MiFID II)
- Electronic Money Regulations 2011 ("EMRs")

Regardless of the status of the tokens being dealt with, all firms/businesses engaged in crypto asset activity have to be registered with the FCA for money laundering purposes. This is in line with the 5th EU AML Directive published in 2018 and is transposed (implemented) into UK law via The Money Laundering and Terrorist Financing (Amendment) Regulations 2019. (Despite the UK's departure from the EU in 2020, there have been no deviations from the money laundering regulations to date.)

FinReg business tip:

Speak to your lawyer about the specific aspects of your coin to see if it may fall under any of the above definitions.

OPERATING A CRYPTO ASSET SERVICE PROVIDER IN THE UK

Money Laundering Regulations

Firms engaged in certain cryptoasset activities are required to be registered with the FCA, regardless of the tokens being dealt. *If your crypto related activity falls within the definition of "cryptoasset exchange provider" or "custodian wallet provider" under the UK Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017 (MLR), it will need to be registered with the FCA.*

As such, these firms will need to comply with the MLR, which prescribes AML/KYC measures such as Customer Due Diligence and recordkeeping requirements. The MLR defines the scope of crypto asset activities to encompass the following:

According to the MLR

- In these Regulations, "cryptoasset exchange provider" means a firm or sole practitioner who by way of business provides one or more of the following services, including where the firm or sole practitioner does so as creator or issuer of any of the cryptoassets involved, when providing such services—
    - **(a) exchanging, or arranging or making arrangements with a view to the exchange of, cryptoassets for money or money for cryptoassets,**
    - **(b) exchanging, or arranging or making arrangements with a view to the exchange of, one cryptoasset for another, or**
    - **(c) operating a machine which utilises automated processes to exchange cryptoassets for money or money for cryptoassets.**
- (2) In these Regulations, "custodian wallet provider" means a firm or sole practitioner who by way of business provides services to safeguard, or to safeguard and administer—
    - **(a) cryptoassets on behalf of its customers, or**
    - **(b) private cryptographic keys on behalf of its customers in order to hold, store and transfer cryptoassets, when providing such services.**

As outlined above, the definitions of "cryptoasset exchange provider" and "custodian wallet provider" seem to include a wide spectrum of crypto related business activities.

Registration

Once it is determined that your crypto asset business falls under the scope of the MLR, it will need to be registered. “Operating in the UK” means a crypto-asset provider or custodian service provider that maintains a physical presence in the UK (such as an office or ATMs) or is engaged in or facilitates crypto-asset activities needs to be registered with the FCA. Those who don’t have an office or other activity in the UK, beyond having a client in the UK, are unlikely to be considered by FCA as they are not conducting their business in the UK.

The FCA also considers whether the cryptoasset activity is “carried on by way of business” as stipulated in Regulation 14A(1) of the MLR. That is to say, whether or not your business aligns with the FCA’s definition of essentially running a cryptoasset business.

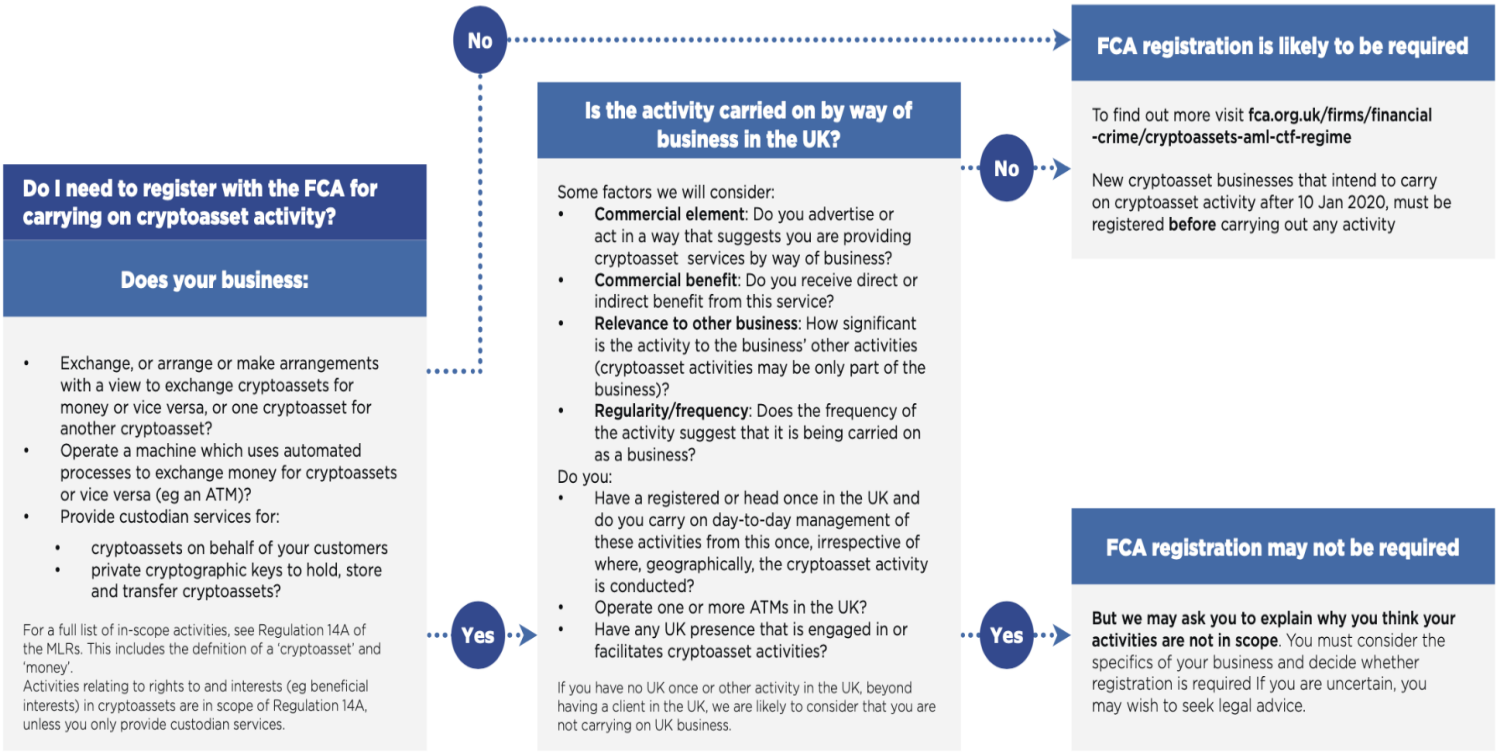
According to the FCA

- **Is the activity carried on by way of business?**
    - **Commercial element:** we will consider matters to assess whether the individual or organisation advertises, acts or holds itself out in such a way that suggests that they are providing services by way of business related to cryptoasset activities.
    - **Commercial benefit:** we will consider matters to assess whether the individual or organisation receives direct or indirect benefit from this service.
    - **Relevance to other business:** It is possible that cryptoasset activities form only part of the overall business activities. We will consider matters to assess the significance of the cryptoasset asset activity in relation to its other activities.
    - **Regularity/frequency:** We will also consider matters to assess whether the frequency of carrying on a cryptoasset activity suggests that it is being carried on as a business.

FinReg business tip:

Speak to your lawyer to identify key features of your crypto asset business that may fall under the MLR, as well as what you need to do to comply with its AML/KYC requirements.

Refer to the flowchart below to further determine if you need to be registered.



Source: Merkle Science

Registration process

The online application form can be found here. The process involves disclosing information about the applicant business and key individuals, as well as supporting information.

According to the FCA

- **Tips for applying for registration:**
    - Be prepared: you can see a copy of the cryptoasset registration forms on our Connect system prior to submitting an application. Review the forms and the information on our website so you know what information and documents you will require.
    - Complete applications: you must ensure that you fully answer every question on the application form, and provide all information requested. Any omission will result in further information requests to your firm, causing delays. Continued failure to provide requested information may lead to your application being refused.

- Provide up-to-date, specific information: the information and documents you supply should be up-to-date and specific – do not reuse older documents if they are not fit for purpose.

The FCA states that the following information is needed for a registration application.

- Programme of operations
- Business Plan
- Marketing plan
- Structural organisation
- Systems and controls
- Individuals, beneficial owners and close links
- Governance arrangements and internal control mechanisms
- Anti-Money Laundering/Counter Terrorist Finance framework and risk assessment
- Business-wide risk assessment
- All cryptoassset public keys/wallet addresses
- Customer on-boarding agreements and process
- Customer due diligence and enhanced due diligence procedures, meeting the minimum standards required in the regulations
- Transaction monitoring procedures
- Record-keeping and recording procedures
- Business continuity plan
- Outsourcing arrangements policy and service license agreements
- Budget forecasts and financials for the first three financial years
- Money Laundering Reporting Individual forms for all directors, executives and officers
- Beneficial Owner forms for shareholders

The FCA also conducts a fit and proper check on the registering firm as well as its key personnel such as managers and beneficial owners.

According to the FCA

- **Any officer, manager and beneficial owner must pass the fit and proper test before the business can be fully registered, or remain registered, with us. This can include:**
  - the Sole Proprietor of the business
  - a partner in the business
  - a director of the business
  - the Board member or Nominated Officer responsible for compliance with the Regulations
  - the Nominated Officer for reporting suspicious activity reports to the National Crime Agency

    - a beneficial owner, who owns or controls more than 25% of the shares or voting rights in the company and
    - other person performing a role of similar influence or responsibility
- An applicant must disclose to the FCA any issues as to why it may not be fit and proper.
- When disclosing any matter under this requirement you may also, if appropriate, make representations explaining why the person should now be treated as fit and proper.
- The FCA carries out checks on applications for fit and proper status and treats non-disclosure very seriously. The success of your application could be affected if we find that you have withheld information deliberately or provided false or incomplete facts. Giving us false or misleading information may be a criminal offence. We suggest that, if after reading the guidance you remain uncertain about disclosing convictions, you should seek legal advice.

Details on the requirements outlined above can be found on the FCA website

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AML/KYC MEASURES

As a business registered with the FCA, you are also required to adhere to the measures stipulated in the MLR. The MLR sets out the obligations required of businesses that deal in sectors with higher money laundering risks. The scope of the MLRs requirements are set out below but ***are not meant to be exhaustive.*** Do consult with your lawyer with regard to the specific provisions of the MLR and how that applies to your business.

Conduct a money laundering/terrorist financing risk assessment

According to the Law Society

- Under regulation 18, you must carry out a written risk assessment to identify and assess the risk of money laundering and terrorist financing that your firm faces. This will:
    - assist you in developing policies, procedures and controls to mitigate the risk of money laundering and terrorist financing
    - help you apply a risk-based approach to detecting and preventing money laundering and terrorist financing
    - inform your assessment of the level of risk associated with particular business relationships and transactions and enable you to make appropriate risk-based decisions about clients and retainers
- When you carry out your risk assessment, you must take into account information on money laundering and terrorist financing risks made available to you by the Law Society and/or the SRA, and risk factors relating to:
    - your customers

    - the countries or geographic areas where your firm operates
    - your products and services
    - your transactions
    - your delivery channels

Implement systems and policies to combat ML risks

According to the Law Society

- You must establish and maintain written policies, controls and procedures to manage and mitigate the money laundering and terrorist financing risks identified in your risk assessment. These must be:
    - proportionate to the size and nature of your business
    - approved by senior management
    - regularly reviewed and updated
    - communicated internally within your firm
- Your policies controls and procedures must cover:
    - your risk management practices
    - the controls you have adopted in accordance with regulation 21 to 24 (or, where appropriate, why you have not adopted those controls)
    - how you conduct customer due diligence
    - your reporting and record keeping systems
    - monitoring, internally communicating and managing compliance with your firm's policies controls and procedures
    - the identification and scrutiny of complex and unusually large and unusual patterns of transactions that have no apparent economic or legal purpose and other activities you think are likely to be related to money laundering or terrorist financing
    - the taking of additional measures, where appropriate, to prevent money laundering or terrorist financing in relation to products and services that favour anonymity
    - taking appropriate steps to assess and, if necessary, mitigate the risk of money laundering and terrorist financing when you adopt new technology
    - the making of disclosures under part 3 of the Terrorism Act 2000 and part 7 of the Proceeds of Crime Act 2002

Adopt appropriate internal controls

According to the Law Society

- The MLR 2017 provide that, where appropriate with regard to the size and nature of your business, you must:
    - appoint a person at the level of the board of directors, equivalent management body or "senior management" to be responsible for compliance with the MLR 2017

(a person will meet the definition of senior management if they have sufficient knowledge of your firm's money laundering and terrorist financing risk exposure and sufficient authority to take decisions affecting your firm's risk exposure)

- carry out screening of relevant employees prior to their appointment and during the course of their appointment
- establish an independent audit function to examine, evaluate and make recommendations about the adequacy of your policies controls and procedures and monitor your firm's compliance with them

Provide training to staff

According to the Law Society

- As with the MLR 2017, you will need to provide staff with appropriate training on money laundering and terrorist financing.
- This includes an obligation to make staff aware of the law on data protection, where it's relevant to the implementation of the MLR 2017.

Customer Due Diligence

According to the Law Society

Type of due diligence	Requirements
Customer Due Diligence	Under the MLR 2017, you're required to: • identify your client and verify their identity on the basis of a reliable independent source (such as a passport) • where applicable, identify the beneficial owners of the client, take reasonable measures to verify their identity so you know who they are and, if the beneficial owner is an entity or legal arrangement, take reasonable measures to understand its ownership and control structure • assess and where appropriate obtain information on the purpose and intended nature of the business relationship or transaction and • identify and verify the identity of a person who purports to act on behalf of a client and verify that they are authorised to act on behalf of the client
Enhanced Due Diligence (EDD)	Regulation 33(1) sets out a list of circumstances in which EDD measures must be applied. It includes any transaction or business relationship involving: • a person established in a "high-risk third country" • any transaction or business relationship involving a "politically exposed person" (PEP) or a family member or known associate of a PEP

	• any other situation that presents a higher risk of money laundering or terrorist financing • Regulation 33(6) sets out a list of factors that must be taken into account in assessing whether there is a higher risk of money laundering and terrorist financing present in a given situation and the extent of EDD measures that should be applied. Under the MLR 2017's EDD measures must include, as a minimum: • examining the background and purpose of the transaction • increasing your monitoring of the business relationship
Simplified Due Diligence (SDD)	Simplified due diligence is permitted where you determine that the business relationship or transaction presents a low risk of money laundering or terrorist financing, taking into account your risk assessment. This is a change from the Money Laundering Regulations 2007, under which SDD was the default option for a defined list of entities. Regulation 37(3) sets out a list of factors to be taken into account in determining whether a situation poses a lower risk of money laundering or terrorist financing, such that SDD measures can be applied. However, you should be aware that the presence of one or more of the factors in 37(3) is not necessarily indicative that a given situation is low

Other obligations under the MLR include:

- Making sure your record keeping and data protection systems, policies and procedures meet the requirements of the regulations
- Complying with new obligations relating to record keeping and the provision of information about beneficial ownership if you act as a trustee of a relevant trust

TAX

Individuals and businesses dealing in cryptocurrencies are subject to normal tax principles. Her Majesty's Revenue and Customs (HMRC) has also set forth guidance stating that a capital gains tax may apply to the sale, exchange, use (for payment), transfer, and donation of cryptoassets.

According to The Law Reviews

- There is no specific UK tax legislation applicable to cryptoassets, although two HMRC Policy Papers (in respect of individuals and businesses respectively) set out HMRC's view of the treatment based on normal principles.
- **Income tax**
    - Receipt of cryptoassets from an employer will be treated as 'money's worth'. Income tax will fall due in respect of the sterling value of the cryptoassets at the time of receipt.
    - Where the cryptoassets are readily convertible assets (e.g., they are tradable on a recognised investment exchange), UK-resident employers will need to operate PAYE and Class 1 National Insurance in the usual way based on the value of the cryptoasset. If the cryptoassets are not readily convertible assets, the provision of the cryptoassets by UK-resident employers will be treated as a benefit in kind subject to Class 1A National Insurance contributions; PAYE will not operate but the employee must declare any amount received under the self-assessment rules and will be liable to income tax on that income.
- **Capital gains tax**
    - Where cryptoassets are held as personal investments, holders will be liable to pay capital gains tax upon disposal. The ordinary rules concerning disposals, allowable costs and pooling apply.
    - On rare occasions, an individual may trade cryptoassets so frequently as to amount to a financial trade, in which case income tax rather than capital gains tax will fall due.
- **Taxation of hard forks**
    - A 'fork' is a change in the underlying protocol of a virtual currency, requiring users to update the software used. A 'hard' fork can result in new virtual currencies being created. By contrast, a 'soft' fork will often not lead to new virtual currencies. In the UK, it might be thought that the receipt of new cryptocurrency as a result of a hard fork would be taxable as a capital gain; however, it is HMRC practice to treat this as the division of an asset, and therefore not a taxable event in itself (with the original base cost apportioned between the two new assets).
- **Corporation tax**
    - Chargeable gains treatment of cryptoassets held by companies mirrors the capital gains tax analysis for individuals discussed in Section IX.i.

    - For corporation tax purposes, HMRC does not consider any cryptoassets to be money or currency. They are therefore not subject to, for example, the foreign currency rules.
- **VAT**
    - Supplies in the course of a trade priced in cryptoassets will be liable to VAT in the normal way as for supplies in any other currency.
    - Exchanges of cryptoassets for traditional currencies are financial transactions and will generally be exempt from VAT.
- **Stamp taxes**
    - Transfers of cryptoassets would need to meet the definition of 'stock or marketable securities' or of 'chargeable securities' for stamp duty or stamp duty reserve tax to apply. Generally, cryptoassets do not meet these definitions, so neither tax will apply on such transfers.

According to Coindesk

- For capital gains, the first GBP 12,570 of profit is tax free for everyone. If you pay a higher rate of income tax, you'll pay a flat fee of 20% on gains thereafter. If you pay a basic-rate income tax, capital gains taxes depend on how much you've earned. To work out how much you need to pay, take your total taxable gains and deduct your tax-free allowance of GBP 12,300. You'll pay 10% on gains within the basic income tax bracket, and 20% tax on figures greater than that.

STABLECOINS

The government has indicated that it intends to bring certain stablecoins "into the regulatory perimeter" where stablecoins are used as a means of payment.

Following a consultation in January 2021, the government has revealed its approach towards stablecoins in 2022 in this consultation response. In it, the government addressed that a UK regulatory framework needs to be flexible enough to adapt to rapid innovation, while also agreeing that "systemically important entities" should be subject to Bank of England regulations.

According to the UK Government

- With respect to stablecoin used as a means of payment specifically, the government proposes that the regulation should capture all stablecoins that reference fiat currencies,

including a single currency stablecoin or stablecoin based on a basket of currencies. This takes on board arguments made about the diversity of models and uses of stablecoins, and the government's priority to regulate those that have the capacity to potentially develop into a widespread means of payment. In light of stakeholder feedback and the desire for more commonly understood methodology, the government has also decided to adopt the terminology of 'stablecoin'

According to JD Supra

- To bring stablecoins used as payment within the regulatory perimeter, changes to several pieces of legislation will be made. These are the Electronic Money Regulations 2011, the Payment Services Regulations 2017, the Banking Act 2009, and the Financial Services (Banking Reform) Act 2013. The FCA will have powers to regulate issuers of stablecoins for payments as well as other entities providing related services, including wallet providers and firms providing custody services. The requirements will ensure convertibility into fiat currency, at par and on demand. As with other entities providing payment services and e-money issuance, stablecoin-based payment service entities will need to be established in the U.K. to provide these services in the U.K.
- Notably, consumers will have a legal claim to redeem the value of the token against either the stablecoin issuer or, where appropriate, the third party facing the consumer. The government appreciates that often a stablecoin issuer may not offer holders a legal claim, leaving a customer with no redemption rights or with rights against a third party. However, for consumer protection, the government will not permit no legal claim to be available.
- Firms undertaking activities in relation to stablecoins for payment would become subject to numerous regulatory requirements, including authorization, prudential requirements, rules for ensuring the quality and safekeeping of reserve assets, orderly failure and insolvency requirements for issuers and service providers, systems and controls, risk management and governance, conduct requirements, financial crime requirements, outsourcing, operational resilience and security requirements.

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