UK Financial Conduct Authority Releases Final Guidance on Cryptoassets

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On July 31, 2019, the U.K. Financial Conduct Authority (FCA), the U.K.'s financial services conduct regulator, released its policy statement containing final guidance on the regulations applicable to cryptoassets (the Policy Statement) under the U.K. *Financial Services and Markets Act 2000* (the FSMA). The Policy Statement sets out how the FCA determines whether a particular cryptoasset is a "security", the scope of regulated financial services activities, and the permissions and obligations associated with carrying out regulated activities in relation to cryptoassets that are considered to be securities. The Policy Statement is relevant to anyone engaged in the issuance, creation, marketing, sale, holding or storing of cryptoassets in the U.K., and to others interested in the comparative approach to the regulation of cryptoassets taken by regulators outside Canada and the U.S. For regulatory developments within Canada and the U.S., view our bulletin "Canada & U.S.: Progress on Cryptocurrency Securities Regulation".

The FSMA requires any person carrying out a regulated activity to either obtain authorization from the FCA or obtain or rely on an exemption. While issuers of cryptoassets are not required to obtain special authorisation from the FCA in order to issue and distribute tokens/coins, they are subject to prospectus requirements that are similar to those in Canada unless they can rely on an exemption.

A separate regulatory regime applies to the use of cryptoassets by payment services regulated under the U.K. Payment Services Regulation 2017.

Types of Cryptoassets

The Policy Statement considers three broad categories of cryptoassets:

- Security tokens
- E-money
- Unregulated tokens.

The FCA's regulatory oversight extends only to the first two categories. Security tokens are treated in a manner similar to the approach adopted by the Canadian Securities Administrators (the CSA), as described further below.

E-money represents a special category of tokens defined as electronically stored monetary value represented by a claim on the electronic money issuer that is issued on receipt of funds for the purpose of making payment transactions and accepted by a person other than the electronic money issuer. E-money includes fiat balances in various types of online wallets or prepaid cards. The issuance of e-money is generally regulated under the FSMA's Electronic Money Regulations, but falls within the FCA's regulatory purview when carried out by credit institutions, credit unions, and municipal banks.

Unregulated tokens are all tokens that are not security tokens or e-money. These tokens can be centrally issued, decentralized, primarily used as a means of exchange, or grant access to a current or prospective product or service. They might be used in one or many networks or ecosystems. They can be 'privacy tokens', 'fungible utility tokens', 'non-fungible tokens', 'access tokens', *etc*. They can be fully transferable or have restricted transferability.

The Policy Statement addresses two categories of unregulated tokens: exchange tokens and utility tokens.
Exchange tokens are not typically used as a unit of account or a store of value. They are generally acquired for the purpose of speculation rather than exchange. The transferring, buying and selling of exchange tokens, including the commercial operation of cryptoasset exchanges for exchange tokens, are not activities that are regulated by the FCA.
Utility tokens provide consumers with access to a current or prospective service or product, and often grant rights similar to pre-payment vouchers. These tokens can usually be traded on the secondary markets and used for speculative investment purposes. Utility tokens generally also fall outside the scope of the FCA's regulation.

Stablecoins are tokens used to stabilize the volatility of cryptoassets. Stablecoins may be backed by financial assets, physical assets or other cryptoassets. Depending on the rights granted to holders, the nature of the underlying assets, and the surrounding arrangements, stablecoins may be treated as security tokens or e-money, but their classification under the FCA's taxonomy needs to be assessed on a case-by-case basis.

Security Tokens

In Canada, the CSA in Staff Notice 46-307 *Cryptocurrency Offerings* of August 24, 2017 noted that cryptoassets are generally assessed under a principled approach for the purpose of determining whether they meet the definition of a "security". The Canadian approach requires consideration of whether the token or coin involves:

- An investment of money
- In a common enterprise
- With the expectation of profit
- To come significantly from the efforts of others.

The CSA notes that, generally, tokens or coins offered pursuant to an initial token/coin offering are considered investment contracts, which is one of the categories in the definition of security.

The FCA's determination of whether a cryptoasset is a "security token" is carried out by reference to the categories of "specified investments" described in Part III of the *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001*, as amended on July 10, 2018. The most relevant types of specified investments are shares, debt instruments, warrants, certificates representing certain securities, units in collective investment schemes, and right to or interests in investments. Factors that indicate a cryptoasset is likely to be a "security token" include:

- The contractual rights and obligations the token-holder has by virtue of holding or owning that cryptoasset
- Any contractual entitlement to profit-share (like dividends), revenues, or other payment or benefit of any kind
- Any contractual entitlement to ownership in, or control of, the token issuer or other relevant person (like voting rights)
- The language used in relevant documentation, like token 'whitepapers', that suggests the tokens are intended to function as an investment
- Whether the token is transferable and tradeable on cryptoasset exchanges or any other type of exchange or market
- The existence of a direct flow of payment from the issuer or other relevant party to token holders

Similar to the Canadian approach, the FCA considers the substance of a cryptoasset, rather than its form.

The FCA may classify as "security tokens" both exchange tokens and utility tokens if they meet the criteria described above. In Canada, the CSA noted that a token delivered at a second or later step may be considered a "security", despite the fact that the token may have some utility. This may be because the token continues to have a number of the characteristics of an investment contract or because the token has other security-like attributes, such as a profit-sharing interest.

Prospectus Requirement

In the U.K., an issuer undertaking a non-exempt public offering of securities needs to provide investors with extensive disclosure under the prospectus requirement. The prospectus must contain information about the issuer, including historic financial information, the business carried out by the issuer, and the specific securities being offered. The prospectus requirement applies if a cryptoasset is a transferable security, and is offered to the public in the U.K. or is admitted for trading on a regulated market.

In Canada, token/coin distributions are usually carried out pursuant to a prospectus exemption. If a disclosure document is used, this could consist of a simple term sheet or a more detailed offering memorandum or similar document.

Exchange or trading platforms

The Policy Statement also notes that firms wishing to create infrastructure for the buying, selling and transferring of security tokens need special permissions from the FCA in order to carry out their activities. This applies not only to exchange and trading platforms, but also to firms that provide custody services, as well as to wallet providers.

Contact Us

BLG continues to monitor new developments with respect to the regulation of cryptoassets and trading platforms for cryptoassets in Canada and abroad. If you have any questions on how these developments affect your business, please contact one of the authors of this bulletin or any other member of BLG's Cryptocurrency and Blockchain Group. Our Cryptocurrency and Blockchain Group leverages BLG's expertise in legal areas, such as investment management, corporate finance, derivatives and fintech, to provide advisory and transactional support right from the start.

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