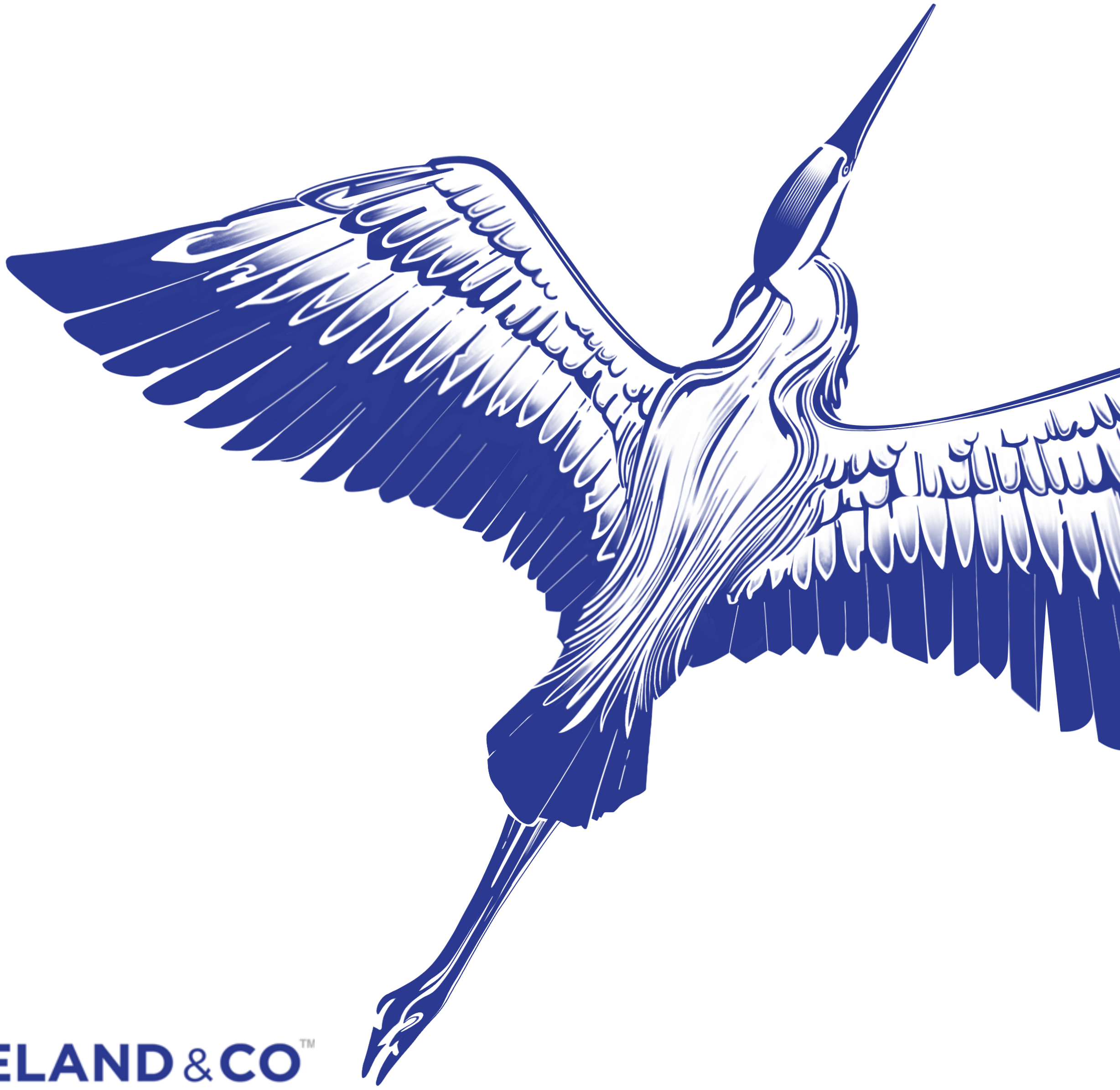

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UK CRYPTO-ASSETS AND DISTRIBUTED LEDGER TECHNOLOGY TASKFORCE REPORT

December 2018

The Taskforce (consisting of HM Treasury, the Financial Conduct Authority (the "**FCA**") and the Bank of England) (the "**Taskforce**") was launched by the Chancellor of the Exchequer in March 2018 and since then it has been working on developing its response to the regulatory challenges for use of crypto-assets[1] and underlying technology ("**DLT**", distributed ledger technology) on the UK market, summarised in the final report published in October 2018 (the "**Report**").

The Report, consisting of 5 Chapters, provides an overview of crypto-assets and DLT, their nature, typology and current use, as well as an assessment of the risks and benefits of such assets/underlying technology. It also looks at the challenges they pose on the UK market and the path forward for UK regulation, with a focus in 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 AML risks across all crypto-assets.

Overall, the Report takes a more conservative view than the recent report on crypto-assets by the House of Commons Treasury Committee published in September 2018[2] which called for all crypto-asset activity in the UK to be regulated as a matter of urgency (including utility tokens and cryptocurrencies as amounting to existing regulatory investments in addition to crypto-assets).

KEY CONCEPTS, NATURE AND TYPOLOGY OF CRYPTOASSETS AND DLT

The main findings of the Taskforce in this area include the following:

- there is no commonly agreed definition of a crypto-asset;
- the market is constantly evolving, with new and different crypto-assets being developed all the time with around 2000 currently in existence;
- the Report outlines three different types of crypto-assets which have been identified by the Taskforce. These are (1) exchange tokens (like Bitcoin), (2) security tokens and (3) utility tokens. However, in order to determine whether a particular crypto-asset falls under any existing regulatory perimeter, it must be assessed on a case-by-case basis (for example, exchange and utility tokens generally do not fall under current regulation parameters, whereas the security tokens require further considerations with regards to the application of the current regulatory perimeter to them); and
- according to the Report, crypto-assets are typically used:
  - as a means of exchange e.g. to enable the buying and selling of goods and services, or to facilitate regulated payment services;
  - for investment e.g. with firms and consumers gaining direct exposure by holding and trading crypto-assets, or indirect exposure by holding and trading financial instruments that reference crypto-assets; and
  - to support capital raising and/or the creation of decentralised networks through Initial Coin Offerings ("**ICOs**");

Based on the work performed, the Taskforce has expressed several concerns, outlined in the Report, the main of which are:

- the complexity and opacity of many crypto-assets means it is difficult to determine whether they qualify as security tokens;
- there is not sufficient consistency of regulatory application given the variety and complexity of crypto-asset products intended to function as investments;
- there may be instances in which firms issue crypto-assets that have comparable features to investments but are structured in such a way that they fall outside the regulatory perimeter; and

[1] Crypto-assets can be described as cryptographically secured digital representation of value or contractual rights that uses some type of DLT and can be transferred, stored or traded electronically (like Bitcoin and Litecoin and those issued through the Initial Coin Offering (ICO) process, often referred to as 'tokens').

[2] https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/910/910.pdf

– that exchange tokens do not meet the traditional definition of a financial instrument.

DLT DEFINITION AND MAIN FEATURES

DLT is described in the Report as a type of technology that enables the sharing and updating of records in a distributed and decentralised way. Participants can securely propose, validate, and record updates to a synchronised ledger that is distributed across the participants. Depending on the access to the network, a DLT platform can either operate on a permission-less or a permissioned basis.

The Taskforce also describes the four main identified features of the technology, which are: data distribution, decentralisation of control, use of cryptography and programmability/automation (e.g. use of smart contracts).

IMPACT OF DLT AND THE TASKFORCE'S RESPONSE

The Report thoroughly describes the benefits, both actual and potential, which DLT can bring to the UK market, for example that it may:

- enhance resilience - decentralization of data maintenance can reduce the impact of data loss caused by an incident with any one participant. DLT can also eliminate, or reduce, central points of failure, so that if one participant in the network fails, others can continue processing;
- result in more efficient end-to-end settlement processes, as it can eliminate the need for costly and slow reconciliation processes between platforms;
- provide more efficient reporting, auditing and oversight;
- gain efficiency from automated contract tools (e.g. use of smart contracts); and
- potentially enable the tokenisation of existing assets, which can potentially bring new advantages to the firms and investors, such as efficiency improvements from smart contracts, enhanced resilience, lower barriers to investment, improved liquidity and tradability.

However, notwithstanding the abovementioned benefits, the Taskforce still see certain challenges in using DLT, which are of technological, operational and legal natures. For example, the main legal challenges are enforceability of smart contracts, as well as application of new Data Protection regulation to a DLT.

The Report also suggests that the following approach will be taken with regards to DLT development:

- the authorities will continue to take a technologically-neutral approach to regulation;
- the Taskforce continues to explore whether there are any unintended consequences of regulation to the innovations of new technologies, including DLT;
- the authorities will continue to encourage and enable experimentation and innovation; and
- the FCA will continue to test the usage of DLT technology, whilst government will continue to invest in research projects.

IMPACT OF CRYPTO-ASSETS: POTENTIAL BENEFITS AND RISKS OF CRYPTOASSETS

Notwithstanding the main concerns around crypto-assets expressed by the Taskforce in its Report, it still highlights the potential benefits of their use depending on the type of crypto-asset. For example:

- as a means of exchange – the crypto-assets have a potential to increase the efficiency of international transfers;
- for investment – they may widen access to new investment opportunities; and
- as a capital raising tool - through streamlining the capital raising process.

The Taskforce has identified a range of risks associated with crypto-assets, including:

- risks of financial crime, including opportunities for crypto-assets to be used for illicit activity and cyber threats;
- risks to consumers, who may buy unsuitable products, face large losses, be exposed to fraudulent activity, struggle to access market services, and be exposed to the failings of service providers;
- risks to market integrity, which may lead to consumer losses or damage confidence in the market; and
- potential implications for financial stability, which may arise if the market grows and crypto-assets are more widely used.

TASKFORCE RESPONSE

In order to mitigate the aforesaid risks, the Taskforce will take the following further actions:

- deal with the challenges that crypto-assets pose to consumers and market integrity (e.g. an envisaged ban on retail sale of the derivatives transactions referencing exchange tokens);
- prevent the use of crypto-assets for illicit activity by "going significantly beyond" the EU Fifth Anti-Money Laundering Directive in the UK;
- guard against threats to financial stability that could emerge in the future; and
- encourage responsible development of legitimate DLT and crypto-asset-related activity in the UK.

NEXT STEPS

As we briefly mentioned in our article published on 13 November 2018, Chapter 5 of the Report sets out a table on the next steps which the members of the Taskforce plan to take.

By the end of 2018 the Report states that:

- the FCA aims to consult on perimeter guidance on security tokens which will clarify the current regulatory position in relation to security tokens; and
- the FCA also aims to consult on a potential prohibition of the sale to retail consumers of all derivatives referencing exchange tokens (e.g. bitcoin).

By early 2019 the Report states that:

- the UK government intends to issue a consultation in early 2019 to explore whether (and how) exchange tokens and related firms (such as exchanges and wallet providers) could be regulated effectively. The Report specifically refers to a coordinated international approach being essential, which will be a new approach to take as Bitcoin exchanges have not been subject to regulation to date;
- the UK government plans to issue a consultation in early 2019 to explore initial coin offerings, where tokens are issued that have comparable features to specified investments. Critically, the UK government "*stands ready to redefine and expand the perimeter if required*";
- as the EU Fifth Anti-Money Laundering Directive provisions on crypto-assets will be implemented in 2019, the UK government intends to go beyond the directive, and will consult in early 2019 on applying anti-money laundering requirements to other persons involved in the crypto business; and
- although tax is outside the Taskforce's remit, there is a note that HM Treasury is working closely with HMRC and that HMRC will further update their guidance on the tax treatment of crypto-assets by early 2019.

The Taskforce will convene every six months to consider developments and review the UK's approach.

To view the full Report, please click here.

For more information on crypto-assets or DLT, Cleveland & Co external in-house counsel, your specialist outsourced legal team are here to help.

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