BPUK Response to FCA Guidance consultation GC23/1
August 2023

We refer to the FCA's Guidance consultation GC23/1 || PS23/6 (Guidance on cryptoasset financial promotions): https://www.fca.org.uk/publication/guidance-consultation/gc23-1.pdf (the "FCA paper"). We appreciate the opportunity to provide feedback to this guidance for and on behalf of both Bitcoin Policy UK and certain Bitcoin companies operating currently in the United Kingdom, with whom we have consulted in preparing this response.

Preamble

The goal of good regulation, particularly in a context where retail consumers are involved, should be the prevention of customer harm. We include, in the definition of 'customer harm' when purchasing or investing in cryptoassets, the harm done by nefarious actors persuading retail investors to purchase spurious cryptoassets (exposing them to sudden and permanent drops in value) and/or the risk of financial losses when investing in such a fraudulent enterprise or scheme. Regulation should be proportionate to the risks, and strike a balance between the extent and nature of potential harm on the one hand, and the legitimate and good faith aims and goals of businesses and individuals engaged in commerce on the other. Good regulation should also be capable of being enforced and should not be seen to act in vain.

It is in this context that we have prepared our response. In doing so, we have discussed the FCA paper with several prominent Bitcoin companies operating in the United Kingdom and collated their feedback, in conjunction with our own views and advice.

As a general point, it is important for regulatory authorities fully to understand that Bitcoin is not merely a 'cryptoasset'. Bitcoin is also a network and a protocol, which is open source and free for any person with an internet connection to use and access, wherever in the world they are physically located. Anyone may participate in the network, or use it, and no regulatory body or law is able to prevent this. Bitcoin in this context is much more akin to SMTP (the email protocol) or TCP/IP, upon which the internet itself is built. Neither SMTP nor TCP/IP are, or ever could be, 'restricted mass market investments' or 'RMMIs'.

Bitcoin is, most simply, an uncensorable messaging protocol that does nothing more than allow users to broadcast information to other users, updating the network with details as to how much value has moved from one 'unspent transaction output' to another.

Advertisements to buy 'cryptocurrency', to the extent they fall within the financial promotions regime, should on balance be regulated, with a view to minimising customer harm. However, the nature of Bitcoin is such that it has no company behind it, no foundation, no pre-mine, and no controlling mind. As the FCA will be aware, it is at the time of writing the only 'cryptoasset' that the US Securities and Exchange Commission (the 'SEC') believes is neither a security[1] nor an investment contract. It is, furthermore, one of the few remaining cryptoassets to use the 'proof of work' algorithm, which imposes a real-world cost in terms of energy and equipment on those who create or 'mine' new Bitcoin and ensures that Bitcoin cannot be created from 'thin air', unlike the majority of other cryptoassets. There is a significant cost to the production of Bitcoin, and it is the proof of work algorithm that ensures the digital Bitcoin is tethered to the physical world via the energy expenditure that is essential to its production.

As such, we wish to put on record that our organisation believes the categorisation of Bitcoin as a 'restricted mass market investment' is gravely mistaken. In the financial context, aside from its nature as a network and a protocol, Bitcoin is most easily described as digital commodity money (unlike sterling, which is a 'liability' money, being a liability either of the Bank of England or of a commercial bank that has created it). Conversely, any child in the world can create a Bitcoin wallet at home using nothing more than a pair of dice or a coin[2] and with freely available internet software. With this wallet they can transact in Bitcoin with any other person in the world who has an internet connection. It is not possible to police such transactions and nor it is possible to prevent them - given that good law and good regulation should also be capable of being enforced, in this context we again urge the FCA to reconsider their categorisation of Bitcoin. It is absurd to label an asset that can potentially be created or received at home by any person and without the permission or assistance of any third party intermediary as a 'restricted mass market investment'.

To give some examples that illustrate this logical inconsistency:

(i) any person is able to mine Bitcoin at home using readily-available hardware, albeit at some cost[3];
(ii) products already exist on the market that function as dual purpose Bitcoin miners and home heaters, helping to offset the cost of heating with the mined Bitcoin[4], which can be accumulated, held or used by the owner of the product; and
(iii) free and open source protocols like Nostr have already fully integrated Bitcoin tips and payments into various clients (the term used to describe an app or 'user interface' that is used to

1 https://cryptoslate.com/sec-chair-gensler-confirms-everything-other-than-bitcoin-is-a-security-implications-and-analysis/
2 https://twitter.com/freddienew/status/1604065231701000193?s=20
3 https://compassmining.io/at-home-mining
4 https://heatbit.com/

interact with the Nostr protocol). Any person, anywhere (with no age limit) can create a Nostr profile and immediately send and receive Bitcoin in a permissionless way[5].

Considering these facts, it is logically inconsistent that Bitcoin has been categorised as a 'restricted mass market investment'. The nature of a 'restricted mass market investment' should not be such that any person is able to create it or receive it freely at home, without the assistance or intermediation of any third party. According to the definitions in the FCA's own handbook,[6] Bitcoin does not naturally appear to be any of a non-readily realisable security, a P2P agreement, a P2P portfolio, or a unit in a long term asset fund or indeed a non-standard investment in the same category as rare metals or forestry, and it is bizarre that the FCA proposes to regulate it as such. Gold is not a 'restricted mass market investment' and neither is Bitcoin.

Addressing the first limb of the definition alone, Bitcoin is in point of fact one of the most readily-realisable assets on the planet and is traded 24 hours a day, seven days a week, and can be exchanged for fiat or liability currency at any time of the day or night. Furthermore, as the SEC confirms, it is not and has never been a security.

As noted above, a 'restricted mass market investment' should not by its nature be capable of being created at home on a computer, or held or used in a permissionless way by any person, without interference or oversight, or received as a tip via a free and open protocol like Nostr. Given that these characteristics are fundamental to the open, free and permissionless way in which the Bitcoin protocol functions, that mining takes place, and that Bitcoin as a means of payment is used in the real world, we wish the record to show that we believe this categorisation is wrong and mistaken and it should be reviewed and revised. We note and refer to paragraph 1.32 of the FCA Policy Statement (PS23/6) "Financial Promotion Rules for Cryptoassets"[7] which states that "**many argued that the approach should be less restrictive and more bespoke, with marketing restrictions and positive frictions applying only to some types of cryptoassets. In particular, they argued that different cryptoassets have different risk profiles and called for a greater differentiation in our approach**". We add our support to this request for greater differentiation and distinction between different types of cryptoassets, and particularly with regard to Bitcoin and its unique nature.

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5 https://blog.bitfinex.com/education/nostrs-zaps-have-changed-the-social-media-game/#:~:text=Central%20to%20Nostr's%20user%20experience,on%20their%20Lightning%20Network%20nodes.

6 https://www.handbook.fca.org.uk/handbook/glossary/G3598r.html

7 https://www.fca.org.uk/publication/policy/ps23-6.pdf

Bitcoin, as noted above, may be described in many ways, but a ‘restricted mass market investment’ is not one of them. It is a digital bearer asset with no counterparty risk; it is a free and open source payment protocol with, via its Layer 2 protocols, a transaction throughput far in excess of Visa and Mastercard combined[8]; it is a permissionless money that no government can censor, debase or dilute, or with whose monetary policy a central bank can interfere. Beside all this, it is a secure, decentralised, public payments utility, that anyone can use and from which no one is excluded.[9]

We also note that the feedback received by the FCA showed that “**respondents had a net negative view on the proposed categorisation of cryptoassets**”. Despite the majority view from respondents being net negative, the FCA has nevertheless chosen to proceed with a categorization that we as an organisation believe is incorrect and in respect of which the proposed regulation will be at best counterproductive and at worst unenforceable.

We concede that the price of Bitcoin as measured in sterling is volatile, particularly over short periods, which is the only context in which the ‘RMMI’ definition could possibly make sense. However, the risk profile varies widely depending on the time period chosen for the analysis. Historically, Bitcoin’s price has undergone a series of blow off tops and subsequent corrections. At the time of writing, Bitcoin has a compound annual growth rate over the past 14 years of 249%, as compared to 5% for gold and 12% for the S&P over the same period[10]. Granted, promotions to invest in either gold or Bitcoin should be fair, clear, and not misleading, but including Bitcoin in the same bracket as other RMMI’s is not otherwise reflective of reality.

Bitcoin the asset is indeed volatile when its price is measured in sterling, and we agree that customers should be warned, educated and protected from the drawdowns in price that have historically occurred. But, given the nature of Bitcoin as described above, attempting to do so by miscategorising the asset as a ‘restricted mass market investment’ is not only a logical fallacy, but also very likely not to achieve the stated aims of the regulation.

Bitcoin will still be used, mined and transferred freely and peer to peer, irrespective of the new rules, while at the same time legitimate UK businesses such as exchanges will be materially harmed and potentially withdraw from the UK market completely as a result of the proposed restrictions, with a corresponding loss of jobs and inward investment into the UK. Additionally, restricting the legitimate business of honest commercial players in the industry, who will seek to

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8 https://bitpay.com/blog/what-is-the-lightning-network/#:~:text=How%20Many%20transactions%20per%20seconds,process%20tens%20of%20thousands%20TPS.

9 https://twitter.com/jackmallers/status/1653892056014786560?s=20

10 https://casebitcoin.com/charts

comply with the UK's regulation, will necessarily drive retail investors towards less scrupulous offshore participants who do not intend to comply with the regulation and against whom the FCA will not be able to enforce, thereby greatly increasing the risk of harming those customers that the FCA is ostensibly charged with protecting.

Specific Feedback from Relevant Firms

As noted above, we have consulted with a number of different firms operating in the UK when preparing this feedback. We wish to highlight two specific cases in particular (the firms have been designated Firm 1 and Firm 2 so as to preserve their anonymity). Their feedback is relevant to the whole of our submission, but some key points are summarised below.

Firm 1 was of the view that the new regulations would impose a significant compliance burden on UK businesses that offer relevant products and services to consumers. The cost of compliance would be significant, and would in addition prove a barrier to customer acquisition, leading to the loss of customers during the onboarding process - with potentially harmful consequences as outlined below.

As a result of these regulations, and particularly because of the frictions they will create in the onboarding funnels of legitimate and compliant UK businesses, UK consumers are likely to be driven to offshore providers that are not compliant with the FCA rules. This is because these offshore providers will be less likely to comply with the FCA requirements - we note that in theory the rules regarding advertisements are applicable notwithstanding the location of the relevant firm but also note that the likelihood of compliance by offshore firms, over which the FCA has no jurisdiction, is currently lower and will be likely to remain that way.

The FCA's regulations are obviously intended to protect consumers from the risks associated with cryptoassets. However, the unintended consequence of these regulations is that they could actually increase the risk of customer harm. This is because UK consumers will be driven to the unregulated providers as set out above as they either do not as entities have to comply with the same safety and security standards - or, even to the extent that they are theoretically subject to the rules, may take the decision not to comply owing to the impossibility of enforcement. A timely example of this behaviour was provided in 2022, where US citizens were able to trade assets on the FTX exchange, located outside the US and not subject to any regulation in that jurisdiction, with the consequential financial losses and customer harm resulting from the allegedly fraudulent conduct of those running FTX.

The FCA does not have the resources or jurisdiction effectively to enforce its regulations against offshore providers, and it is questionable whether firms whose COMI is in another jurisdiction will be willing to cooperate with the FCA's enforcement efforts.

As a result, the FCA's regulations are likely to have the unintended consequence of increasing the risk of customer harm. This is because UK consumers will likely be driven to such unregulated providers that either do not have to, or do not wish to, comply.

In summary, the FCA's regulations are:

- Excessively burdensome for UK businesses.
- Likely to drive UK consumers to offshore providers that are not compliant with the FCA rules (namely increasing the risk of regulatory arbitrage).
- Unlikely to be effectively enforced against offshore providers.
- Incorrect in their classification of Bitcoin as a ‘restricted mass market investment’.
- Likely to increase the risk of customer harm.

The FCA should reconsider the proposed regulations, and should focus on protecting consumers from the risks associated with cryptocurrencies without imposing an excessive burden on legitimate UK businesses that are likely to suffer a competitive disadvantage through their good faith efforts to comply.

The feedback received from **Firm 2** focused on the challenges posed by the new rules and the tight implementation timeline for cryptocurrency firms. The increased cost of compliance and the demanding four-month deadline may strain such companies, especially since they often lack the resources available to traditional finance firms. Implementing substantial technical changes, such as the 24-hour cooling-off period and mandatory risk warnings, within the proposed four-month timeframe could be difficult, potentially causing compliance issues for UK firms and in some cases preventing them from being able to continue to trade.

The FCA's approach to cryptocurrency regulation is arguably both selective and lacking clarity. While certain financial services-type regulations are extended to cryptoassets, a comprehensive and coherent domestic cryptocurrency regulation framework is still absent from the UK, and this set of regulations does not markedly improve the jurisdiction’s offering. This ambiguity in the regulatory landscape may hinder the UK's aspirations to become a cryptocurrency hub, as global firms with a UK presence face uncertainty in the jurisdiction, particularly when contrasted with the implementation of MiCA in the EU.

Although there are valid reasons to classify some cryptoassets as ‘restricted mass market investments’, given the proliferation of scam coins, the lack of differentiation by the FCA between different cryptoassets, particularly in the case Bitcoin, is concerning. Bitcoin's unique properties and clear value proposition set it apart from other assets, warranting special consideration in regulatory classification.

The feedback raises an essential question for cryptocurrency firms that are considering becoming regulated entities in the UK: ‘*Why undergo the rigorous process of compliance when unregulated firms can operate on a reverse-solicitation basis without adhering to UK regulations?*’ This disparity could prompt domestic companies to move offshore, undermining the UK's goal of becoming a prominent crypto-hub.

In conclusion, whilst the regulations themselves may not be inherently flawed, the FCA should approach their implementation more thoughtfully. Overly stringent requirements and tight deadlines could make it impractical for newer or smaller firms to comply, potentially driving innovation and UK customers away from our jurisdiction. A more measured and transparent approach is essential to strike a balance between regulatory compliance and fostering a thriving cryptocurrency industry within the UK.

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General observations in response

Financial promotion rules, aimed at protecting investors, are in principle a good thing

Marketing any financial asset to retail investors or the general public is something that should be subject to sensible rules to protect investors from inaccurate, or misleading advertising. This should apply equally to any financial product, whether insurance, bank accounts, financial products and other potential investments. Cryptoassets are in many ways no different. Without rules, consequences for breach, and a proactive regulator, unscrupulous persons and firms will abuse the system, marketing standards will be poor, the profit motive from companies will take over, and people will invest money based on spurious promises and misleading marketing.

Notwithstanding our comments regarding the miscategorization of Bitcoin, the financial promotions regime on the whole is a ‘good thing’ for consumers, and its application to cryptoasset promotions in particular is welcome. Aside from Bitcoin, the cryptoasset market is unfortunately heavily populated with bad actors who have consistently failed to act in good faith and have caused retail investors to lose large sums of money either by investments in ‘scam’ coins or via outright fraud.

However, based on the FCA’s Policy Statement PS23/6 *Financial promotion rules for crypto assets* (**PS23/6**) there are some concerning precedents which should be clarified in guidance.

People understand cryptoassets better than the FCA believes that they do

PS23/6 states: *For high-risk investments, even a good financial promotion may not be enough to adequately protect consumers. It may meet our requirements to be clear, fair and not misleading, but a consumer may still not understand when the underlying investment does not meet their needs.*

Customers should as a matter of principle have the ability to invest their money how they see fit. The FCA should take care not to let paternalism creep into their posture. Just because an asset is volatile, or because the FCA perceives it as “high risk”, does not mean that investors should not be allowed to hear about it. Investors may lose their capital in *any* investment. Shares in companies frequently “go to zero”, via the traditional methods of insolvency, liquidation or administration. The assumption in the above paragraph that people may not understand their own needs and an underlying investment (but that, implicitly, the FCA does understand their needs sufficiently to believe that an investment *does not* meet their needs), is concerning. The FCA should regulate the behaviour of entities providing services, and regulate market structure to ensure fair markets. It is manifestly *not* the job of the FCA to stop adult individuals from making their own decisions as to what assets are suitable for them.

"Cryptoassets" are not all the same.

The FCA continues to group all assets that are based on cryptography and blockchain technology in one unified block: "cryptoassets". This grouping treats assets that are wildly different as comparable, and allows 'examples' to be used which are not representative. This is a mistake, and the FCA does not do this in other asset classes. For instance the FCA does not treat all "financial instruments" as somehow equivalent, but recognises that bonds are different from stocks, and mini-bonds are different from index funds. We have set out in our preamble some of our thinking and logic where we highlight a number of the unique characteristics of Bitcoin that distinguish it, by way of example, from all other cryptoassets.

This was a point that was made by respondents in the CP22/2 consultation and it is disappointing that the FCA has not taken this into account in the drafting of the rules. We would sincerely hope that the FCA takes this further feedback into account in guidance.

A similar flaw could be found if the FCA considered all "financial instruments" as equivalent, thereby considering a government bond to be akin to a FTSE100 index fund to be akin to a share in a startup company to be akin to a speculative mini-bond to be akin to a complex derivative. Of course the FCA does not do this. It distinguishes between the different *types* of financial instruments, recognising that some types of instrument are at a threshold level suitable for marketing, and some may not be; some may be riskier than others; and so forth.

For instance an asset such as Bitcoin (a decentralised asset, with high transparency, high liquidity, no centralised control, global ownership, and with a cost to its production tied to the electricity and equipment cost in mining) is not the *same* as a 'token' launched by a group of humans, with a large 'pre-mine', with no intrinsic value and then rapidly 'rug-pulled' or 'exit-scammed'. Bitcoin may be volatile, and have large upswings and downswings in price, but it has not "gone to zero", has never been "hacked" and has a risk profile akin to many shares or commodities from a volatility perspective. At fourteen years, it has already outlived a number of companies that arose and failed in the 'zero interest rate policy' world that we have recently left behind. Putting Bitcoin in the same category as SQUID[11] would be akin to categorising a FTSE 100 index fund the same as a ponzi scheme just because they are both 'financial instruments'. One is not like the other.

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[11] https://www.coinbase.com/price/squid-game

Q1: Do you agree with our proposed guidance on the context of the cryptoasset financial promotions regime? Please explain your answer, highlighting any other issues that would be useful to consider.

Broadly, but subject to the caveats below.

The FCA notes in paragraph 2.3 that "*some cryptoasset investments already constitute a 'specified investment', for the purposes of the UK regulated activity regime, such as those which amount to a derivative or a unit in a Collective Investment Scheme (CIS).*" This is plainly true for self-described "security tokens", but these are a small proportion of cryptoassets. The FCA to date has been forward thinking, and the UK and Europe have been fortunate to avoid the "is it a 'security'' debate that dominates the United States. The FCA should be cognizant of this, and should not in guidance open the possibility of an equivalent "is it a Collective Investment Scheme" debate in the UK for cryptoassets and cryptoasset structures. If the FCA is going to "open this door" it should also be very clear that the large crypto assets such as Bitcoin are <u>not</u> "collective investment schemes' ' (which should be self-evident from our submission to date).

Regulate services and firms, not assets. One point which should be made is that the FCA regulates firms providing services. It does not regulate "assets" themselves. For instance "shares" are not "regulated", but certain activities or services relating to shares (dealing, custodying, etc.) are regulated *activities*. To take an absurd example, a private individual should be entirely able to pay for a billboard in Piccadilly that simply says "Buy Bitcoin". This person is not marketing a service, and this advert should not be subject to the financial promotion regime.

Q2: Do you agree with our proposed guidance on ensuring that cryptoasset financial promotions are fair, clear and not misleading? Please explain your answer, highlighting any other issues that would be useful to consider.

Broadly, but subject to the caveats below.

The FCA asserts the following in paragraph 28: "*the variety of cryptoassets and cryptoasset related models, and the potentially opaque nature of these investments that are marketed to consumers increases the risk that individuals do not fully understand the investments that are communicated to them*". This is a problem of the FCA's own making however, by categorising all 'cryptoassets' into the same bucket. It is a trite point, but were we to categorise <u>all</u> financial instruments in the same bucket (from complex structured products, to derivatives, to CFDs, to stocks), the same statement could be made: "*the variety of financial instruments and financial instrument related models, and the potentially opaque nature of these investments that are marketed to consumers increases the risk that individuals do not fully understand the investments that are communicated to them*". Not all "cryptoassets" are the same. To treat them as such, and thereby taint an entire type of asset by the worst of its kind, is a disservice to this emergent industry, and the millions of investors in the UK and globally who wish to responsibly own cryptoassets.

Q3: Do you agree with our proposed guidance for financial promotions of cryptoassets that claim a form of stability, or which claim their value is linked to a fiat currency? Please explain your answer, highlighting any other issues that would be useful to consider.

Broadly, but subject to the caveats below.

Where a firm utilises a third party 'stablecoin' for example USDT or USDC or similar, firms should be entitled to rely on public disclosures, or other evidence made public by the entities that operate or issue those coins. A firm may not be able to independently verify the backing of any coin without doing so, because the firm will not have access to the relevant information. This exemption should not apply if the stablecoin is issued by the firm, or by an affiliate of the firm.

Q4: Do you agree with our proposed guidance for financial promotions of cryptoassets that claim to be backed by a commodity or an asset? Please explain your answer, highlighting any other issues that would be useful to consider.

Broadly, but subject to the caveats as raised in Q3.

Q5: Do you agree with our proposed guidance for financial promotions of complex yield models or arrangements? Please explain your answer, highlighting any other issues that would be useful to consider.

No. Despite both having "% yield", "staking" and "borrowing and lending", should not be considered as analogous and the FCA should split these into separate sections.

We note that staking yields are not relevant to Bitcoin or to the way in which its protocol operates, but nevertheless include these comments for the sake of completeness. A staking model where a firm simply takes a specific cryptoasset (e.g. Ether) and stakes it in accordance with the protocol rules applying to that asset (e.g. Ethereum), and passes the pro rata protocol staking reward back to customer (including net of any fee), should be considered as a relatively simple product. In staking, the customer is fundamentally taking "protocol risk" (and fraud risk on the service provider). Rates of return for staking are often publicly ascertainable and transparent, because they are based on open protocols, and not private closed companies. As a separate point, we would be supportive - when the regulatory perimeter is extended to cryptoasset service providers - for this to be subject to regulatory obligations for instance an obligation to maintain at least 1:1 "staked" asset on the relevant protocol, clear disclosures of fees, obligations on the staking service provider to comply with protocol rules, obligations to publish binding rules relating to how the service provider will 'vote' any staked assets, and so forth.

A "yield account" created via a "borrowing and lending" model - e.g. Celsius, Blockfi, Voyager, etc. - is simply an unregulated 'banking' model, where yield is generated by 're-hypothecating' and then lending out deposited customer assets. This model has been shown to be fragile, and the companies that operated in this space have been shown to be untrustworthy or at minimum to have poor internal governance structures. In yield account / borrowing and lending models the customer is taking multiple and unknown credit, market, liquidity, conduct, and other risks (one of the reasons why banking and deposit taking is so highly regulated around the world). There is a good argument for these models (i.e. "Celsius" models where customers can earn "interest" in their "interest accounts" for depositing their assets) to be either restricted entirely (banned) for retail or at minimum made to be Non-Mass Market Investments (NMMIs) similar to speculative mini-bonds. See *Discussion questions on complex yield models/arrangements* below.

Q6: Do you agree with our proposed guidance for financial promotions on social media? Please explain your answer, highlighting any other issues that would be useful to consider.

Broadly, subject to the caveats below.

The FCA should make it clear in guidance that a firm marketing itself as a company, is not necessarily carrying out a 'financial promotion', and therefore not all social media activity by a company will be 'financial promotion'. For example Coinbase (used solely because they are a well known brand in the space) may have an active Twitter account which is viewable by persons in the UK. This does not mean that Coinbase tweets are *all* financial promotions. Only tweets that are demonstrably financial promotions should be subject to the guidance.

Q7: Do you agree with our proposed guidance on due diligence before a financial promotion is communicated? Please explain your answer, highlighting any other issues that would be useful to consider.

Broadly, subject to the caveats below.

In paragraph 59 the FCA references certain bullets that "*a firm may need to consider*". Some of these are either illogical or excessive and should be amended:

- *"Ensuring the cryptoasset is not linked to fraudulent activity, scams, money laundering or other financial crime."* This is plainly impossible for any firm to "ensure", with regard to any money or asset. Sterling, dollars, gold, stocks, bonds, debit cards, cheques, banks, etc. are all "linked to fraudulent activity, scams, money laundering or other financial crime" by virtue of them being used for such purposes or by persons perpetrating the relevant crimes. Cryptoassets are likely no different. Firms will have their own anti-money laundering obligations, and other regulatory obligations, all of which will be encouraged by responsible companies operating in any industry, however this drafting goes too far. We would suggest that this bullet point is amended to read: "*conducting due diligence to satisfy itself that the cryptoasset is not itself reasonably likely to be a fraud or scam*".

- *"Understanding the operational or technological risks. This may require a firm to take reasonable steps to check the technological and operational risks associated with the cryptoasset, such as risks related to the blockchain platform it uses and understand its vulnerability to hacks or code exploits."* This standard is overly high for any service provider. To expect all cryptoasset service providers to understand all of the code or "take reasonable steps to check " for every blockchain, and the vulnerabilities to hacks or code exploits for every asset or smart contract, is excessive. These matters - hacking and code exploits - should form part of standard risk disclosures to customers.

- *"Understanding the environmental, social and governance risks associated with the cryptoasset."* A firm should not be required to consider ESG ``risks'' associated with an asset. It is however entirely reasonable for a firm to have to carefully consider whether any purported "ESG benefits" are warranted. We would suggest that this bullet point is amended to read: "*conducting due diligence to satisfy itself that any claims relating to environmental, social, or governance benefits made by or in respect of the cryptoasset in the relevant financial promotion are factual*".

For large, well-known, crypto assets such as Bitcoin or Ethereum, there would be benefits to having "standardised" or agreed upon disclosures so that these can be used by all market participants. This would also ensure that consumers get consistent information from market participants. We would propose that this be in an industry-generated format, via a forum in which the FCA is involved.

Q8: Do you agree with our proposed guidance on disclosing legal and beneficial ownership of cryptoassets? Please explain your answer, highlighting any other issues that would be useful to consider.

Broadly, subject to the caveats below.

The obligation to disclose legal and beneficial ownership of crypto assets should only apply in circumstances where rehypothecation applies or where beneficial ownership may 'not be what it appears'. For example in "Celsius" style models where customers' assets were shown to be "in their account" but had been rehypothecated and "lent out" by Celsius to generate yield.

This disclosure obligation should not apply to traditional custodial models relating to crypto assets. If this were to be applied to all cryptoasset firms, then this should be applied equally to all investment firms and traditional finance (for example where 'legal' ownership of shares and bonds usually rests with custodian entities, whilst beneficial ownership rests with customers). It would not be in customer interests to believe that a custodial cryptoasset structure is somehow "different" because the cryptoasset company is forced to disclose this where a traditional broker is not. In plain terms, if Coinbase is deemed to have "legal ownership" of cryptoassets because they control the private keys, they should no more have to "disclose" this in financial promotions than Hargreaves Lansdown have to "disclose" in their promotions that Hargreaves Lansdown owns the legal interest in stocks and funds in customer accounts.

Q9: Do you agree with our proposed guidance on disclosing the firm's regulated status? Please explain your answer, highlighting any other issues that would be useful to consider.

No.

It is a disservice to the firms that have gone through this process not to permit them to make this clear to consumers. It is also a disservice to consumers, who *should* be able to use MLR registration as a proxy for "reputable". In the view of the FCA there is clearly a difference between firms that they have registered under the MLR process and those that they have not (for example, in this context, whether they are able to approve financial promotions relating to crypto assets).

‘Registration’ with the FCA under the MLRs is akin to an ‘authorisation’ process. Firms undergo a rigorous application process, often taking 6-12 months, with their models being carefully reviewed by the FCA. The FCA also routinely declines to ‘register’ firms. The fact that firms are not able to operate in or from the UK without being MLR registered, and that this registration is discretionary by the FCA (i.e. it is not a simple ‘registration’ but an application and approval process), means that at minimum this is a quasi-authorisation.

Q10: Are there any other topics you believe our guidance should cover?

Yes. See the matters raised above, in particular:

- Brand marketing
- The “assets” themselves being unregulated
- “Learning materials” should be carved out

<u>Discussion questions on complex yield models/arrangements</u>

Q1: What are the benefits and opportunities of cryptoasset borrowing, lending and staking models/arrangements for consumers?

Staking, and borrowing/lending, should be considered very separately, and should not be lumped together even if “*the way these arrangements are advertised through financial promotions can be very similar*”.

Staking allows a holder of an eligible cryptoasset (on a blockchain protocol that supports staking, such as Ethereum, Solana, Cosmos, and others) to earn a *protocol based* yield on their asset. This is a useful activity for a holder of an asset to be able to do. They could do this *themselves* natively on the protocol, however many people would rather an intermediary did this for them. This should not be prohibited, however there should be clear disclosures on the risks, and (in future) regulatory obligations on ‘staking service providers’ to ensure good conduct.

‘Yield accounts’ derived from Borrowing/Lending (e.g. Celsius, Voyager, Blockfi, etc.) is simply unregulated banking, and should be treated as such from a regulatory perspective. Notwithstanding the allegations of fraud or criminal activity, even if these businesses were run ethically they are still exceptionally dangerous for ‘depositors’, as the recent insolvencies of most (if not all) major participants in this subsection of the industry has shown. This would be akin to an unregulated bank, with no FSCS coverage and no prudential oversight, taking deposits, offering interest rates, and lending these out to high risk borrowers. It is unclear to this respondent how a firm could adequately disclose the risks of such a product in a financial promotion so as to make that financial promotion compliant.

We note in GC23-1 paragraph 2.23 the FCA notes: "*The recent collapse of high-profile crypto borrowing and lending firms (eg Celsius, Voyager, BlockFi) highlighted the risks from these business models (eg lack of clarity of beneficial ownership of cryptoassets and high risk collateralised lending) and the harms to consumers who may lose all or most of their cryptoassets and become unsecured creditors in the insolvency process.*" We wholeheartedly agree, but would add an important qualification - these firms collapsed because of either fraud or mismanagement at the level of their human controllers, not because of flaws in the underlying assets that they managed. To state otherwise would be to do the same as alleging that Lehman Brothers collapsed because of the nature of the dollar, rather than because of the excessive risk appetite of its executives.

The ability to earn interest on assets - traditional assets or crypto assets - by depositing them with an entity who then uses them for its own purposes (i.e. "banking"!) is genuinely useful for customers, in the same way as being able to earn interest on cash held in accounts. However given the inherent risks, this should be provided only by well-regulated, well-capitalised, entities and subject to clear rules. It is hoped that future regulation will allow duly regulated entities to provide these services in a safe, secure, manner.

As a side note, it seems clear that the vast majority of the population do not understand how traditional fiat banking itself works, or the risks associated with banks. These risks are so great that banking is the most highly regulated of all financial services, and so great that the government establishes FSCS protection to protect retail depositor funds. The risk of "bank runs" is very real, as we have seen recently in the United States. Any bank today, no matter how financially sound (for a bank), will fail almost instantly if all depositors on the same day decided to move their money to another bank. As Henry Ford quipped about the U.S. banking system "*It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning*"; ours in the UK is no different. To expect the general public to therefore be able to actually understand the risks of "unregulated crypto banking" i.e. "borrowing and lending yield accounts" is nonsensical.

Borrowing and lending itself *as a product* - i.e. a person wishes to borrow crypto or fiat from another person, on a secured or unsecured basis - is different. For instance firms may be willing to lend fiat money against crypto collateral. There is no a priori reason why this should be more dangerous than any other borrowing relationship the person may choose to enter into. The FCA may choose to regulate the activity, but it's reasonable to expect that the borrower intuitively understands the relationship. This is very different to "lending structures" that are structured to look like "savings accounts" where you "deposit assets" and "earn interest".

Q2: Which type of cryptoasset borrowing, lending and staking models/arrangements provide the greatest benefit to consumers?

Both models can provide benefits but they are different. These are not equivalent models which should be "chosen" between.

Q3: What are the risks associated with cryptoasset borrowing, lending and staking models/arrangements for consumers?

See above for details.

Q4: Which types of cryptoasset borrowing, lending and staking models/arrangements present the greatest risks to consumers?

"Yield accounts" powered by borrowing/lending, carried out by unregulated entities.

Q5: If you are a firm that provides cryptoasset borrowing, lending or staking models/arrangements to retail investors please provide information on: a. The different types of cryptoasset borrowing, lending and staking models/arrangements you offer to consumers and the form of related financial promotions. b. What data your firm collects to calculate advertised rates of return? c. What modelling your firm undertakes to calculate advertised rates of return? d. What steps your firm takes to assess and mitigate the risks to consumers associated with these models/arrangements?

N/A.

Q6: Please provide any data, including details of the source and time period for the data, you have or are aware of related to: a. The number of UK consumers who invest in cryptoasset borrowing, lending and staking models/arrangements and the average amount invested. b. The number of firms who provide cryptoasset borrowing, lending and staking models/ arrangements to UK consumers. c. Gains or losses experienced by UK consumers in relation to cryptoasset borrowing, lending and staking models/arrangements.

N/A.

Recommendation: split out staking, and borrowing/lending, as two entirely separate models.

Q7: Are there any other issues we should take account of when considering our approach when developing regulatory requirements for cryptoasset borrowing, lending and staking models/arrangements?

Yes. Staking, and “yield accounts generated by borrowing/lending”, and “borrowing” and “lending” as separate products, should all be considered separately. The product and risks of each are very different.

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