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Treasury Committee

Regulating Crypto: Government Response to the Committee's Fifteenth Report

Seventh Special Report of Session 2022–23

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

Current Membership

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Rushanara Ali MP (*Labour, Bethnal Green and Bow*)

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Publication

Committee reports are published on the Committee's website at www.parliament.uk/treascom/ and in print by Order of the House.

Committee staff

The current staff of the Committee are Morenike Alamu (Committee Operations Officer), Bayley Hockham (on secondment from the Bank of England), Timothy Holmes (on secondment from HM Revenue & Customs), Dan Lee (Senior Economist), Adam McGee (Senior Media and Communications Officer), Adam Mellows-Facer (Clerk), Aruni Muthumala (Senior Economist), Dixsha Patel (on secondment from the Financial Conduct Authority), Dominic Stockbridge (Second Clerk), Adam Wales (Chief Policy Adviser), Maciej Wenerski (Committee Operations Manager), Richard Whisker (on secondment from the Bank of England), and Marcus Wilton (Senior Economist).

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You can follow the Committee on Twitter using @commonstreasury.

Seventh Special Report

The Treasury Committee published its Fifteenth Report of Session 2022–23, *Regulating Crypto* (HC 615), on 17 May 2023. On 14 July, we received a letter from the Economic Secretary to the Treasury containing the Government's response to that Report. The response has been appended to this Report.

Appendix: Response from the Economic Secretary to the Treasury

Letter from the Economic Secretary to the Treasury

Dear Harriett,

I am writing in response to the Treasury Committee's (the Committee) report of 17 May on *Regulating Crypto*. I would like to thank your Committee for its inquiry and recommendations, and welcome the opportunity to respond.

HM Treasury recognises many of the consumer risks described in the report, as well as the pressing need for robust and effective regulation. HM Treasury also welcomes the Committee's recommendation that the Government should take a "balanced approach to supporting the development of cryptoasset technologies". We believe that this is fully consistent with the Government's approach, which is aimed at creating the conditions for safe innovation and competition, while managing risks, especially those to consumers.

However, HM Treasury firmly disagrees with the Committee's recommendation to regulate "retail trading and investment activity in unbacked cryptoassets as gambling rather than as a financial service".

Such an approach would run completely counter to globally agreed recommendations from international organisations and standard-setting bodies, including the International Organization of Securities Commissions (IOSCO)[1] and the G20 Financial Stability Board (FSB)[2]. These recommendations are grounded in the principle of 'same activity, same risk, same regulatory outcome', meaning that any cryptoasset activity that performs a similar function, and poses similar risks, to those in the traditional financial system (for example, operating a trading platform or providing custody services) are subject to regulation that ensures equivalent outcomes.

The Committee's proposed approach would therefore risk creating misalignment with international standards and approaches from other major jurisdictions including the EU, and potentially create unclear and overlapping mandates between financial regulators and the Gambling Commission.

1 International Organization of Securities Commissions (IOSCO): Policy Recommendations for Crypto and Digital Asset Markets: Consultation Report: May 2023

2 Financial Stability Board (FSB): Regulation, Supervision and Oversight of Crypto-Asset Activities and Markets: Consultative report: 11 October 2022

A system of gambling regulation could also fail to appropriately mitigate many of the critical risks that were discussed in HM Treasury's recent consultation on cryptoasset regulation—including those associated with market manipulation, inadequate prudential arrangements, and deficiencies in core financial risk management practices.

A financial services regulatory framework is more appropriate for addressing the risks of unbacked cryptoassets and creating the conditions for safe innovation. This can – and will – come with a set of robust measures to mitigate consumer risks mentioned in the Committee's report, including the risks of "consumers getting misinformed".

The Government is already taking concrete action on this, through the introduction of a dedicated financial promotions regulatory regime for cryptoassets: legislation was laid before Parliament and debated last month, and will be in force by late 2023. Proposals included in HM Treasury's recent consultation also seek to ensure consumers have access to accurate information when making investment decisions. For example, through the introduction of a robust issuance disclosure regime.

HM Treasury has reflected on the Committee's suggestions in further detail in the appendix to this letter.

I look forward to continuing to work with the Committee as we deliver on our ambition to make the UK a leading jurisdiction for cryptoasset technology and investment, underpinned by clear and robust regulation.

ANDREW GRIFFITH MP

The Government's response to the Committee's recommendations

This appendix sets out the Government's response to each of the Committee's conclusions and recommendations. The Committee's text is in bold and italicised, and the Government's response is in plain text. Paragraph numbers refer to corresponding paragraphs in the Committee's report.

We recognise the potential for some forms of cryptoassets and their underlying technologies to bring benefits to financial services and markets. The most convincing use case we have heard is the potential for cryptoasset technologies to improve the efficiency and reduce the cost of making payments, especially cross-border and in lower income countries with less developed financial sectors. An effective regulatory framework would support development of such technologies in the UK, while also mitigating some of the risks cryptoassets pose. We therefore welcome the Government publishing proposals for how it plans to regulate cryptoassets used in financial services. (Paragraph 30)

It has been more than four years since our predecessor Committee's Report called for greater regulation of the cryptoasset industry, and the FCA faces challenges in implementing existing and proposed crypto regulations. It is important that the Government and regulators strive to keep pace with developments, including by ensuring that the Financial Conduct Authority's authorisations gateway is open and effective, so that potential productive innovation in financial services is not unduly constrained. (Paragraph 31)

HM Treasury agrees with the Committee’s conclusion that certain cryptoassets and the underlying technology could lead to improved efficiencies in financial markets and payments. The Government also welcomes the Committee’s support for the publication of recent proposals for a UK regulatory framework which is aimed at supporting the development of these technologies in the UK.

Informed by the findings of the Committee’s last report, the Government has taken concrete action to address pressing risks in the sector and create the legislative foundations for future regulation as part of its phased approach. This includes the introduction of the UK’s cryptoasset anti-money laundering and counter-terrorist financing (AML-CTF) regime (effective since January 2020), and cryptoasset financial promotions legislation (debated in Parliament in early May 2023) which will ensure that cryptoasset promotions are clear, fair and not misleading. In addition, HM Treasury is taking forward legislation via the Financial Services and Markets Bill (FS&M Bill) to ensure that the legislative foundations are in place to regulate stablecoins and cryptoasset activities in the UK.[3] In doing so, the Government has sought to take an agile and proportionate approach to avoid stifling positive innovation.

With respect to the Financial Conduct Authority (FCA) gateway, the Government believes it is important for the UK to have a robust gateway to mitigate risks and maintain high standards and reputational integrity. As noted in HM Treasury’s Cryptoassets consultation, the Treasury is proposing a new authorisation regime under the Financial Services and Markets Act (FSMA) framework for persons who are carrying out certain activities involving cryptoassets.

HM Treasury and the FCA will work with industry to ensure crypto firms are made fully aware of the standards required for approval at the FSMA gateway. Further communications will be provided in due course to ensure standards for approval are clearly available to crypto firms operating in the UK. Once a future financial services regime is in place, subject to the outcome of the consultation, the FCA has committed to adopting a timely and proportionate authorisation process for complete and accurate applications. It will also endeavour to avoid duplicative information requests of businesses, taking into account the supervisory history of businesses during the authorisation process. In preparation for delivering an effective and efficient authorisation process the FCA has and continues to significantly increase its capacity in the Digital Assets Authorisation teams alongside continued FCA-wide recruitment of blockchain expertise.

While we support financial innovation where there are potential benefits, the extent of the benefits cryptoasset technologies may bring to financial services in the future —and the areas in which the technologies may have the most impact— remains unclear. In the meantime, the risks posed by cryptoassets to consumers and the environment are real and present. (Paragraph 36)

We recommend that the Government takes a balanced approach to supporting the development of cryptoasset technologies. It should seek to avoid expending public resources on supporting cryptoasset activities without a clear, beneficial use case, as appears to have been the case with the Royal Mint NFT. It is not the Government’s role to promote particular technological innovations for their own sake. (Paragraph 37)

3 The Financial Services and Markets Act received Royal Asset on 29 June 2023.

HM Treasury strongly agrees with the need for a balanced and technology-neutral approach towards supporting new innovation, including cryptoasset technologies. We believe that this recommendation is consistent with the current UK Government's approach, which is principally focused on regulating cryptoasset activity, clarifying tax treatment of cryptoasset activity, and participating in certain international organisations (such as the Financial Stability Board) to help shape and develop international standards and recommendations.

The Government recognises that the benefits and use cases of unbacked cryptoassets, and their underlying technologies, are uncertain and evolving quickly. Some businesses are actively exploring the use of the underlying blockchain technology, which has the potential to boost competition, cut costs, and increase efficiencies. HM Treasury therefore agrees that, to promote responsible innovation, there can be a role for the Government in establishing a clear framework for experimentation and competition and removing barriers which might prevent benefits from being realised.

With this in mind, the Government is also planning to set up Financial Market Infrastructure (FMI) sandboxes, which will enable firms to experiment with DLT and other technologies in providing the infrastructure services that underpin financial markets, potentially making markets more efficient, resilient and transparent. The first FMI Sandbox will be implemented this year, and will be run and administered by the FCA and Bank of England, which both operate independent of Government.

With respect to a Royal Mint NFT, the Royal Mint is not proceeding with the launch of an NFT at this time but will keep this proposal under review. It should also be noted that no taxpayer money has been directly used to fund the project. The Royal Mint operates as a commercial business and any cost associated with developing the project was met entirely out of the Royal Mint's own revenues.

Regardless of the regulatory regime, their price volatility and absence of intrinsic value means that unbacked cryptoassets will inevitably pose significant risks to consumers. Furthermore, consumer speculation in unbacked cryptoassets more closely resembles gambling than it does a financial service. We are concerned that regulating retail trading and investment activity in unbacked cryptoassets as a financial service will create a 'halo' effect that leads consumers to believe that this activity is safer than it is, or protected when it is not. (Paragraph 51)

We strongly recommend that the Government regulates retail trading and investment activity in unbacked cryptoassets as gambling rather than as a financial service, consistent with its stated principle of 'same risk, same regulatory outcome'. (Paragraph 52)

HM Treasury recognises that there are significant risks and consumer harms associated with today's cryptoasset markets. As noted in response to earlier recommendations, that is why decisive action has been taken through the introduction of AML-CTF regime for cryptoassets, new legislation to regulate cryptoasset promotions and legislating as part of the Financial Services and Markets Bill to enable the regulation of stablecoins and cryptoassets within the financial service framework.

On 1 February 2023 HMT also published a comprehensive consultation with wide-ranging proposals to further mitigate cryptoasset risks, including a draft framework for issuance disclosures, market abuse and core cryptoasset activities such as operating a cryptoasset trading platform and custodying cryptoassets. This also includes robust measures to ensure consumers understand the, often high, risks involved when making investment decisions to mitigate the 'halo effect' risk described in the Committee's report.

Taken together, this would create an extensive and powerful set of tools and measures for the FCA to mitigate consumer risks and ensure that individual investors are much better informed when it comes to trading decisions in all types of cryptoassets.

With this in mind, the Government firmly disagrees with the Committee's recommendation that "the Government regulates retail trading and investment activity in unbacked cryptoassets as gambling rather than as a financial service".

The recent failure of FTX has informed the UK's proposed approach towards protecting UK consumers. Initial findings and statements regarding the causes of this event point towards (i) the commingling of customer and firm assets, (ii) a lack of transaction documentation, (iii) inadequate information controls and cybersecurity, (iv) unmanaged conflicts of interest between the main trading platform and the proprietary trading arm (v) lack of financial and risk management capabilities (vi) deficiencies in corporate governance and (vii) excessive leverage.

A system of gambling regulation, in isolation, would be unlikely to address these risk factors. It would also not be equipped to deal with insider dealing, market manipulation, predatory short selling and many other behaviours which can manifest themselves in both cryptoasset markets as well as traditional financial services markets.

The Gambling Commission has a strong track record of safeguarding consumers and the wider public by ensuring gambling is safe and fair. However, overseeing financial risks, which are akin to those which exist within financial markets, is not within the mandate or field of expertise of the Gambling Commission.

The cryptoasset industry is highly globalised and often borderless in nature. UK consumers currently can access products and services provided by overseas firms or applications and protocols without a clear geographic nexus. If the UK were to unilaterally adopt a system which is out of step with approaches taken globally, this could push cryptoasset activity offshore, reducing the UK's opportunity to make it safer and capitalise on the potential benefits, while leaving consumers exposed to residual risks.

The Committee's recommendation would also not be consistent with the recommendations of the FSB and international standard-setting bodies, including the BCBS[4], CPMI[5] and IOSCO. The UK adopting a regulatory framework that is consistent with international standards and guidance will help provide clarity for consumers and firms, and guard against fragmentation and regulatory arbitrage.

As such, HM Treasury agrees with the Committee on the pressing need for robust and timely regulation. However, the recommendation to rely on gambling regulation would

4 The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks.

5 The Committee on Payments and Market Infrastructures (CPMI) is an international standard setter that promotes, monitors and makes recommendations about the safety and efficiency of payment, clearing, settlement and related arrangements, thereby supporting financial stability and the wider economy.

represent a fundamental departure from the Government's intended approach which reflects recommendations from global standard-setting bodies and has been carefully designed and calibrated with input from domestic regulators and international peers.