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HM Treasury – Future Financial Services Regulatory Regime for Cryptoassets

Email only – cryptoasset.consultation@hmtreasury.gov.uk

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Dear Cryptoasset Consultation Team,

Consultation response: Future Financial Services Regulatory Regime for Cryptoassets

On behalf of R3 and our members I am writing in response to the above noted consultation. Whilst not all areas of the consultation are relevant to our profession, cryptoasset regulation has fast become a priority topic for our membership. Given this, the following highlights the key areas which we would like to draw your attention to.

About R3

R3 is the trade association for the UK's insolvency, restructuring, advisory, and turnaround professionals. We represent licensed insolvency practitioners, lawyers, turnaround, and restructuring experts, those undertaking professional exams, and others in the profession.

We have 3,000 members working across the spectrum of the profession, from global legal and accountancy firms through to small, local practices. Our members have direct experience of insolvencies and their impact on individuals and businesses across the UK.

The insolvency, restructuring and turnaround profession is a vital part of the UK economy. The profession promotes economic regeneration, resolves financial distress for businesses and individuals, saves jobs, and creates the confidence and public trust which underpin trading, lending, and investment.

Our response is based on feedback received from across our membership, including a roundtable with R3 members and further input.

Issues with lack of regulatory framework

During our discussions with members, the lack of a regulatory framework was raised as a key issue for the cryptoassets landscape. Through this, we have identified three-core sub-themes.

Broad spectrum

A major challenge posed by cryptoassets is that they cover a broad spectrum of assets. Currently there are a wide range of insolvency regimes that are applicable to some but not all of these assets. An example of this is that a bank providing custody of cryptoassets might need a completely different regime than a multinational construction firm providing smart contracts.

Segregation of client money

The segregation of client money is an area of inconsistency which has the greatest potential to drive different outcomes for creditors and customers when it comes to regulation onshore and offshore. In

the UK, there are very few regulated crypto firms. The Financial Conduct Authority (FCA) regulations require proper ringfencing and reporting of assets along with regular reconciliations of client assets that are held on trust. However, a number of offshore British territories do not have these requirements. This means that when dealing with the collapse of a firm which operates in the UK and overseas territories, there is a lack of confidence that assets will be segregated appropriately.

Jurisdictional inconsistencies

An additional issue due to the lack of a regulatory framework is the inconsistencies between jurisdictions. To illustrate this issue, one of our members mentioned an active liquidation case where a British Virgin Islands based crypto investment platform argued they should be regulated in the British Virgin Islands (where there are much lighter regulations) rather than Gibraltar (where there are strong regulations) which was where most of its investors were based. It is clear that firms are doing their utmost to keep their activities under the radar, away from strong regulatory regimes.

Another example, which we provide in confidence, is of a well-known company which is reputationally 'clean' but, employs a corporate structure designed to avoid full compliance to national regulatory schemes. This company claims it is in fact a network of individual companies, each operating in a single jurisdiction, which shares the same name but no common ownership. This allows the network to comply with the minimum regulatory requirements of each jurisdiction, while ensuring that entities that are based in low regulation countries are not required to follow the more stringent regulations of a country like the UK. This makes it difficult to pursue the assets of the 'parent company' in the event of an insolvency because of the lack of transparency within the network. One of our members had communication with a lawyer representing the 'brand' but, during this communication, they found no corporate identifier and no jurisdictional identifier.

Both examples are clear in that there is a need for strong regulatory regime in the UK to ensure companies are not trying to bypass a stronger regulatory framework. Any future framework needs to have clear regulations on companies following UK rules if they operate in the UK, otherwise Insolvency Practitioners will continue to have a hard time returning assets to UK investors and consumers from companies operating in multiple jurisdictions.

Application of Part 24 of the Financial Services Market Act (FSMA)

The consultation paper mentions under the 'proposed cryptoassets regulatory regimes' that for insolvency and restructuring, part 24 of the FSMA will apply to all types of cryptoasset businesses mentioned in the consultation. We have found some issues with this.

The appropriateness of applying part 24 of the FSMA depends on what kind of cryptoasset business the scheme is being applied to. Furthermore, this part of the regime has not been properly tested on complex FinTech businesses that deal with fiat money (with cryptoassets being a step beyond fiat). An example of this is a case with a large FinTech firm with over 4 million users, the regime (part 24 of the FSMA) was extremely difficult to apply.

In practice, and if the FCA are going to regulate crypto platforms, some of the foundations of Part 24 would be valuable and sensible for cryptoasset insolvencies, but it needs tweaking to be more flexible in its application.

We would also appreciate more clarity from the Government on who is going to be the main regulator in this space. There is some confusion on the regulation of cryptoassets because of different organisations leading on different areas of the digital asset landscape. For example, we understand

that The Bank of England (BoE) are going to regulate Central Bank Digital Currencies (CBDCs), another form of digital assets.

Special Administration

Special Administration Regimes (SARs) alter the administration process set out in the Insolvency Act 1986 (which sets out the standard objectives and powers of the administrator). SARs are found in sectors where it is in the public interest for administrators to have specific objectives and, powers over and above the duty seeking to maximise returns to creditors. Unless alternative objectives are in place as part of a SAR, any actions that do not put the interests of the creditors first and foremost would lead to regulatory penalties for an insolvency practitioner, which could lead to the loss of their licence to practice.

The consultation mentions that a SAR may be the most appropriate way to administer insolvent cryptoasset firms, but this depends on whether the crypto industry is sufficiently embedded within the wider economy and if the continuation of service trumps maximising returns to creditors.

Regulating Authority

There needs to be clarity over which regulatory body will supervise any new SAR. In its response to the recent consultation "Managing the failure of systemic Digital Settlement Asset (including stablecoin) firms", the Government indicated that it considers the BoE (rather than the FCA) should be the lead regulator in Digital Settlement Asset administrations. However, it is likely that these firms would be FCA regulated and, under the current proposal, the BoE is mandated to consult with the FCA before seeking a special administration order or directing special administrators.

It is important for the Government to consider the potential conflicts between the different objectives of various overlapping SARs, if a SAR was to be developed to deal with cryptoasset firms more widely.

Furthermore, the complex nature of cryptoasset firms would make it challenging to conform to many of the objectives of existing SARs. Challenges with Know Your Customer (KYC) and Anti-Money Laundering (AML) provisions would make it almost impossible to return funds to creditors within 7/14/28 days. Any supervising authority would need to understand the challenges office holders face when administering one of these companies.

Another problem with SARs is that certain jurisdictions, most notably the United States, do not recognise them and this can lead to problems as many cryptoasset firms have at least some US presence which can lead to them seeking some form of Chapter 11 protection.

SARs are useful tools, but efforts should be focused on developing robust custody and safeguarding systems. With these in place it would not be necessary to create a new SAR. The key is to ensure the law is fit for purpose. We believe that a new regime should be developed only if the new objectives it provides cannot be achieved through regulation and legislation.

Regulatory support

It is crucial that regulators understand that insolvencies involving crypto firms are inherently more complex and riskier to the insolvency practitioner than those involving FinTechs (which deal in fiat currencies). Funds disappear even faster than usual and, tracking them down is a very time consuming and expensive process that has no guarantee of success. Our members have had multiple cases where they have not been able to recover any cryptoassets at all from insolvent firms, despite knowing about the existence of such assets.

In the majority of cases, funds disappear offshore at which point it becomes almost impossible to retrieve them. As mentioned earlier, it is crucial that regulators take a hard line on firms adhering to the UK regulatory authority. We welcome the proposal in the consultation to include firms based overseas with UK customers in the regulatory framework.

In cases where funds can disappear very quickly the FCA, HMRC and the courts system will need to work closely together to grant asset freezes, injunctions and exercising a degree of flexibility to support the office holder. In a recent case one of our members found themselves needing to repay 70,000 individuals less than 10p each during the liquidation of a crypto exchange. With AML and KYC rules, this was an expensive process.

For the crypto industry to strengthen and succeed in the UK, then it is important that investors, creditors, and depositors feel secure in the knowledge that there is a strong and well-regulated system for them to get their money back. The insolvency profession underpins trust in the UK economy, and we do not believe this will be different in the digital asset space.

Engagement

A theme that was raised during our discussions, but not directly relevant to the consultation, is the engagement between the Treasury and FCA. We are calling for more proactive engagement between these two bodies on any regulatory work. We are also calling for more work to be done between the Treasury, FCA, the industry and the corporates in this space. This could be done through a series of roundtables, which would allow all voices affected by the cryptoasset regulation work to be heard. Approaching a regulatory framework in this manner will ensure that any regulatory framework is fit for purpose.

Conclusion

We hope these comments are helpful and that they will be considered in informing the next stage of this process. I would summarise by stressing that future developments in cyberasset regulation will not deal with the current problems faced by UK officeholders when seeking recognition in foreign jurisdictions where the Model Law is not available. If an insolvency is not recognised quickly, crypto assets will become even more difficult to locate leading to further costs being incurred. Due consideration should be given to this fact.

Contact

If you require any more information or would like to discuss the above in more detail, we would be delighted to facilitate this. Please contact R3's Public Affairs Manager, Kajal Kalia, on Kajal.Kalia@r3.org.uk.

Kind regards,

Caroline Sumner

R3 CEO