



DIGITAL CURRENCIES

Governance Group

REGULATORY APPROACH ON CRYPTOCURRENCIES AND STABLECOINS

*The Digital Currencies Governance Group's Position
Paper*

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EXECUTIVE SUMMARY

DCGG supports constructive consultative processes with industry and stakeholders for developing a regulatory approach to digital assets. DCGG notes that considerable progress has been made towards adopting appropriate regulatory frameworks in the UK. We also note that since the UK has now left the EU, there are opportunities for the country to attract both talent and capital to drive faster economic growth through welcoming innovation and competition, whilst mitigating risks to consumers and stability of the financial system.

Innovation in the digital currency/crypto assets space is moving at a fast pace. The growth and adoption of stablecoins on Distributed Ledger Technology (DLT) is likely to continue accelerating and to fundamentally transform the payments industry both domestically and internationally within the coming years. There will be substantial gains for those nation states and regulatory systems that adopt and provide the most successful regulatory systems and infrastructure. The United Kingdom is most well positioned to be the winner in this race.

Specifically, the opportunity as identified by our members is as follows:

To enable and encourage the issuance by FCA authorised e-money firms of fiat pegged stablecoin tokens in multiple fiat currencies on DLT, backed by reserves prudentially supervised by the Bank of England (PRA), with the option to hold at least some part of such reserves on the Bank of England ledger, whilst the balance of such reserves might be deployed providing credit and supporting growth in the economy. In order to achieve such a result, we advise the UK Government to promote the continued use and development of the existing FCA provisions on e-money but most importantly to add some important optional permissions and features as suggested below.

As a matter of law, it would appear that an FCA authorised firm with full e-money permissions is entitled to issue or provide services related to fiat pegged and asset backed stablecoins on a DLT. However, it is not explicitly clear in the current guidelines (PS19/22- 2019) whether this would be permitted by the FCA. For the avoidance of doubt, it should be made explicitly clear that it is permitted.

Furthermore, despite the UK being a major global centre for Foreign Exchange trading, it is evidently difficult for most FCA authorised e-money firms to find suitable custodians in the UK for fiat reserve deposits other than GBP. It is therefore our suggestion that the Bank of England

should provide custody facilities to FCA e-money firms to hold reserve assets including all major fiat currencies and gold. This is particularly important to stimulate the adoption and high liquidity of multiple fiat stablecoins such that they can be used to facilitate trade and securities settlement between major fiat currencies and other tokenised assets using smart contracts on DLT.

The benefits of this would be very substantial both to the participants and to the UK economy. For example, it would permit trading and settlement contracts for any underlying instrument to be legally structured such that settlement using any fiat currency stablecoin is to take place within the UK legal jurisdiction. This will help avoid the need for a foreign clearing house with the commensurate risks of central counter party credit, legal and political interference. Additionally, this would have evident benefits for supporting legal and settlement providers and to the UK exchequer.

An important step that can be taken relates to a new technology for ensuring AML/KYC compliance whilst preserving user privacy requirements consistent with GDPR. This technology known as Zero-Knowledge Proof (ZKP) is an advanced cryptographic technique that allows any piece of information such as user identity, tax and/or regulatory compliance, to be verified by a trusted counterparty such as a notary or lawyer. A short cryptographic proof is then provided which can then be re-verified at any time at very low cost without the verifier needing to maintain custody of the underlying information or documents.

Use of ZKP, when performed correctly, allows for meeting FATF AML/KYC/CTF compliance objectives and reducing the burden of proof under UK law. However, many international regulations, including US and EU rules are written in an unnecessarily prescriptive way that requires each intermediary in a payment transaction chain to have sight and custody of underlying documents. ZKP is a transformative technology that offers very substantial cost savings whilst enhancing both compliance and privacy. If the necessary legal and regulatory recognition were given to ZKP the benefits would accrue to all parties both existing financial intermediaries and new entrants. We strongly recommend the use of this technology within the UK and encourage adoption internationally.

In summary, by explicitly permissioning e-money stable token issuance within the current e-money provisions and making available the Bank of England ledger as a fiat custodian with appropriate prudential supervision of reserves and supporting the recognition of new compliance and privacy technologies, such as ZKP, the UK would become the pre-eminent, safest and most sought after digital-assets regulatory jurisdiction worldwide.

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1. KEEPING INTACT CURRENT FCA CATEGORISATION INCLUDING STABLE TOKENS WITHIN THE EXISTING CATEGORY OF E-MONEY

We note that under guidance of the FCA, there is an existing categorisation between security tokens, e-money tokens, and unregulated tokens. We would strongly suggest keeping this provision while incorporating stable tokens within the existing category of e-money.

We would suggest maintaining an agile regulatory provision for digital assets by using the existing FCA provision on e-money and broaden its scope. In particular, by explicitly incorporating stable tokens within the current e-money provision, the UK would, with the appropriate prudential framework, become the strongest and safest digital assets regulatory jurisdiction worldwide. As explained in the introduction above, this success can be achieved by extending current e-money provision to comprehend stable tokens and by explicitly stating that a fully licensed UK e-money Institution (EMI) can be a stable coin issuer. Such an institution could deposit fiat (multiple fiat currencies) at the Bank of England for the scope of protecting consumers and stable token issuers. For this purpose, existing e-money provisions should explicitly encourage fully licensed e-money providers to deposit multiple types of fiat at the Bank of England as PRA.

We would therefore suggest that the UK Government regulates stable digital assets, such as stablecoins, within the e-money provision, while specifying a set of prudential, conduct, and consumer protection requirements that would allow innovation, economic growth and consumer protection. At the same time, there is a need to ensure that innovative technologies are implemented in a way that guarantees that all legal provisions rely on the most cutting-edge technology whilst ensuring they will stay future-proof and at pace with faster technological innovation.

We are of the opinion that new legislation must be avoided to prevent double regulation and that certain aspects of the existing e-money regime can easily be adopted by the digital asset regime, and a standalone crypto-asset focused regulation would, in our view, be an over-burdensome way to proceed.

E-money, including stable token, should feature tailored and proportionate requirements related to both digital operational resilience and market conduct (AML/KYC).

- *On digital operational resilience:* DCGG feels that it is an important aspect for ensuring consumer protection for crypto assets, and we recognise that there are a number of DLT-based solutions that significantly enhance the security and resilience both in the use of digital assets and the underlying infrastructure. As such, operating on a principle of encouraging technological solutions that would improve operational resilience is important for instilling confidence in both digital assets and the system. Thus, incorporating incentives for issuers to implement innovative solutions in the realm of operational resilience should be factored into the Government's objectives.
- *In terms of market conduct:* The Government can capitalise on deploying incentive-based regulation. The industry is constantly creating new innovative solutions to improve on the above-mentioned aspects, and Zero-Knowledge Proof (ZKP) is just one example of these solutions. ZKP is a cost-effective technology, which allows digital authentication without disclosing sensitive personal data. ZKP prevents the possibility of any information, either from the sender's or receiver's end, from being compromised, and it could serve as a part of the foundation of KYC regulation for digital assets.

2. FIAT-PEGGED AND BACKED STABLECOINS

We believe that there is a need to incorporate 'stable tokens' within current e-money regulation. The government could particularly focus on "*fiat-pegged and backed stablecoins*". Fiat-pegged stablecoins refer to a category whereby the value of the stablecoin is pegged, meaning that for each stablecoin there is an equivalent of fiat currency. For example, the value of one fiat-pegged stablecoin is pegged to one or more currencies in a fixed 1:1 ratio. Fiat-backed stablecoins stand for a category whereby the amount of the fiat currency or assets used for backing the stablecoin reflects the circulating supply of the stablecoin.

The focus on "*fiat-pegged and backed stablecoins*" would bring about huge economic benefits to the UK, including:

- *Multiple currencies* as reserve functions to guarantee as "collateral" for the stablecoin, meaning that one unit of a stablecoin can be redeemed for one unit of the asset that backs it.
- *Programmability settlement* offers the opportunity of executing payments automatically through the use of 'smart-contacts'. In other words, stablecoins can be swiftly adapted to changing conditions because of their code-based makeup, allowing for direct integration of innovative ideas into the user experience.

- *Central Clearing Counterparty (CCP)*. The risk of settlement failures is diminished, because CCP isolates the effects of a significant failure of a market participant by providing clearing and settlement services for trades in foreign exchange, securities, options, and derivative contracts.
- *No need for a custodian or a clearing house*. The system runs on the blockchain, which ensures stablecoins transactions are recorded and verified transparently and instantly without the need of a custodian.
- *Settlement of transactions in any chosen legal jurisdiction* allows users of payment tokens to use fiat-pegged and fiat-backed stablecoins for settling transactions in their chosen legal jurisdiction. This kind of trade settlement cannot be done with e-money. This gives the opportunity to determine where the settlement takes place, and which is the preferred legal jurisdiction. Given that the system runs on the DLT, users can freely choose to be compliant with the UK jurisdiction.

We strongly support the view that the regulatory regime for stable tokens should address both the consumer protection requirements (i.e., persons holding stable tokens should be protected from the risk that stable tokens are not properly pegged or backed). If the UK takes the lead on developing this regulatory approach, there will be considerable benefits for the British economy for reasons we expand on below.

Additionally, for the purpose of regulatory clarity, existing e-money provision should explicitly state that there is no difference between e-money issuer and e-money token issuer so that a FCA authorised firm with full e-money permissions is entitled to issue or provide services related to fiat pegged and asset backed stablecoins on a DLT.

3. INNOVATION AND LENDING PLATFORMS

In our view, in order to avoid any possible tension, room for innovation should be allowed while being carefully balanced with protecting and maintaining market integrity. One relevant example is lending platforms on DLT.

As the situation stands, there are extremely successful global lending platforms (such as Celsius and Nexo) that allow lending and borrowing in digital assets. There are UK citizens that do participate in this lending and borrowing, but since this is not regulated in the UK itself, it all happens offshore. We see this sector as an area that the UK can capitalise on by creating a regulated space for the service. The fact that this is unregulated in the UK means that there aren't the protections available to ensure that consumers don't get exploited by these services. This could also have the side effect of lowering confidence in digital assets overall. Therefore, the e-money regulation should account for the lending platforms and their services to ensure

that the appropriate requirements are put in place. In particular, to reinforce the PRA of Bank of England by encouraging the issuance by FCA authorised e-money firms to hold at least some part of such reserves on the Bank of England ledger and by requesting these authorised firms to publish their balance sheets on the Blockchain.

4. THE UK AS A MODEL JURISDICTION FOR DIGITAL ASSETS

Our view is that the UK should seek to align its approach to financially sound jurisdictions, however we do not think the UK should wait for other jurisdictions to act in order for it to seek alignment. Our view is that the UK has the opportunity to be one of the first movers in establishing a regime that is designed to grasp the potential of reliable digital e-money, such as stablecoins, to unleash the potential of UK regulated digital assets. If the UK develops an appropriate regime, we see no reason why other jurisdictions would not look to emulate and align with it. The UK has the unique opportunity to be a pioneer in a sound digital asset regime and thus set a precedent on the global regulatory stage.

Provided with the opportunity to operate in a safe and welcoming regulatory environment in the UK, digital-asset businesses will help establish the country as a leading economic force in the digital asset space. As a consequence, various opportunities will arise, which will significantly boost the British economy. Thus, the UK will create numerous career prospects for skilled individuals to its market, as well as a number of digital finance-related jobs thanks to the promising industry.

5. CONSUMER PROTECTION

As with regard to risks and opportunities assessed by the Government, we would like to point out the following:

The ability of individuals and businesses to make and receive payments safely, smoothly and with confidence is critical to the UK's financial stability. The deployment of best practices that guarantee the safe use of stablecoins could make the UK a pioneer Government in the digital-asset space. In order for the UK to ensure that stablecoins are safe for consumers, the Regulator could require that the information concerning rights of redemption is public (e.g., daily publication of balance sheet on the blockchain). This will ensure that transactions stay fast and smooth whilst taking all necessary consumer protection measures.

We believe that DLT can be considered much safer than traditional payment systems and therefore does not require the same regulatory approach. In comparison to traditional payment systems, DLT offers a number of benefits such as less counterparty risk, lower settlement fees,

simplified operational processes, safe access to lending platforms and a higher level of transparency.

Regarding the supervision of reserves for stablecoins, we suggest that authorised e-money issuers should be allowed to seek Prudential Supervision from the BoE for their reserves as a way to engender confidence in the backing of the e-money tokens as explained in the introduction to this paper. We would like to emphasise that a hypothetical problem with stablecoin issuer withholding reserves can be resolved on the DLT. Stablecoin issuers offer the assurance to their token holders that they maintain adequate reserves in diversified assets including fiat money such that they can meet requests for redemption of the tokens in all reasonable circumstances. This is achieved by simply regularly publishing information which guarantees the possibility of redemption of funds. For example, a solution is to offer stablecoin issuers to publish their balance sheet on the DLT every 24 hours. If supervision of the reserves occurred as in this example, then regulators and issuers would be able to react more quickly to potential risks as they arise. The greater transparency that is offered by this option should also factor into the consideration of the amount required to be held in reserve by the issuer. Reassurance to consumers would indeed be obtained by asking that a trustworthy part, such as the Bank of England, would hold the fiat collaterals on their ledger.

6. FINANCIAL STABILITY

As with regard to the UK Government's concern that disruption or outage within the stablecoin chain could lead to consumers being unable to access their money and make payments, we are aware that this possibility exists. There are ways in which any blockchain can be disrupted or attacked. For this reason, stablecoin issuers should analyse specific risks related to their business and put in place any necessary means to mitigate and ensure continuity to protect consumers. HMT should also be aware that some chains and stablecoins are structurally superior to others hence the need for transparency in order to guarantee consumers protection.

We strongly believe that there is a need to address volatility and consumer protection. The risk of volatility can be mitigated by allowing stablecoins to be backed and pegged by fiat, assets or collateral, and that this information to be visible for the Regulator as well as for the consumers who can easily access the balance sheet of the stablecoin issuers every 24 hours. The Regulator could demand that stablecoin issuers who comply with UK standards must publish this information several times a week in a cost-effective and smooth manner for both parties, that is on the blockchain.

As with regard to the concerns of the UK Government of consumers not understanding the product or service they are being offered, we strongly advise for the Government to create an informed digital-asset investment certificate that the consumer could be asked to present when accessing certain activities related to digital assets and be exempted as informed investors.

7. INTEROPERABILITY AND LENDING

We would strongly urge the UK to ensure appropriate management of reserves and redeemability that is vital for protection of consumers who will use stable tokens. Furthermore, we think that there are two other aspects of crypto asset markets which the UK Government should consider:

- *Interoperability with payment infrastructure*

It is advised for the Government to suggest the prudential requirement of the Bank of England maintaining a ledger for multiple fiat currencies by explicitly mentioning, in the e-money regulation, the possibility for the Bank of England to be a trustworthy party that would guarantee that multiple currencies and assets are safely deposited. For example, in the case of a UK licenced EMI lending stable tokens, the Bank of England could safely store multiple currencies by safeguarding the EMI as well as UK consumers.

- *Role of stablecoin issuers in consumer lending*

Another aspect that we feel should be considered in a crypto-assets regulation that we have not seen mentioned so far, concerns the topic of lending by crypto platforms. This is a growing market practice for both stable token issuers managing their collateral and dedicated lending platforms using digital assets as collateral. The UK has an opportunity to offer legal certainty and attract such providers, rather than risk UK citizens accessing them outside the country and without the consumer protections of their home jurisdiction. When a fully licensed e-money institution engages in lending activities, it could be monitored by the Bank of England who would act as prudential supervisor (in practice, the EMI would prove its redemption by regularly publishing balance sheets on the blockchain).

8. SAFETY OF PAYMENTS ON DLT

It is our view that the technology behind DLT is first and foremost what makes payments by way of digital assets inherently safer and with greatly diminished risks than payments made by traditional electronic means. The technology should be the driver in this respect, and regulation should not front run it. If this would be the case, then a regulation that does not take the technology into consideration could severely hamper the inherent safety of digital-asset payments. The blockchain is the most transparent way to accomplish and record transactions. On the blockchain, transaction recording and verification is immediate and permanent due to the DLT. When a transaction is recorded in the blockchain, transaction data such as price, asset, and ownership is verified, replicated and stored instantly. In this sense, we would urge to avoid the creation of new legislation by acknowledging the potential of existing e-money such as

stable tokens who can give an added value due to speed, immutability and record of their transactions.

The FCA states that it is necessary to meet standards of KYC/AML (p. 49, FCA Guidance, 2019). We strongly believe that innovative and cost-effective technologies such as Zero-Knowledge Proof (ZKP) should be taken into consideration as they do not impose burdens on all the participants in the settlement process. The UK could be the leader in introducing ZKP on the international stage - verification is done by a trusted counterparty in the UK such as a qualified UK lawyer/accountant registered in the UK.

9. U.K. MULTILATERAL TRADING FACILITY

DLT replaces the need for complex market infrastructure. Each FMI is a link in a chain that creates risk if it is the weak link and increases cost. For example, a DLT exchange delivers value instantaneously without the need for separate clearing and settlement or custody. By using DLT, significant insolvency events such as what happened with Lehman Brothers in 2007 could be prevented. The DLT can overcome transaction accounting and transaction verification, which could reduce fraud and improve transaction efficiency.

In line with this, it is worth mentioning that DLT exchange infrastructure needs to be appropriately regulated for the UK to efficiently operate in this field. We consider that the UK should invest efforts in making it more practical to launch a Multilateral Trading Facility (MTF). Due to the current long and complex process of FCA authorisation, only one company called Archax has decided to initiate the process to be regulated in the UK - the process took three years, and it is not yet in operation. This example proves that MTFs struggle to timely and financially operate on the UK market. Exploring both the adoption of new technologies as well as the regulatory risk for FMIS must be addressed by the UK Regulator in an agile and proactive manner.

To summarise, existing provisions on e-money should be amended in order to ensure that it is more practical to launch a Multilateral Trading Facility in the UK.

CONCLUSION

Since leaving the EU, the UK has the opportunity to seize the innovations of DLT finance and become a model jurisdiction in the deployment of such technologies. Welcoming innovation and competition whilst mitigating risks to consumers and stability of the financial system, will make the UK the most eminent, safest and most sought-after digital assets regulatory jurisdiction worldwide.

This objective can be smoothly achieved by enabling and encouraging the issuance by FCA authorised e-money firms of fiat pegged stablecoin tokens in multiple fiat currencies on DLT, backed by reserves prudentially supervised by the Bank of England (PRA) with the option to hold at least some part of such reserves on the Bank of England ledger. The balance of such reserves might be deployed providing credit and supporting growth in the economy by explicitly stating that authorised firms with full e-money permissions are entitled to issue or provide services related to fiat pegged and asset backed stablecoins on a DLT. This goal can also be achieved by encouraging the Bank of England to provide custody facilities to FCA e-money firms to hold reserve assets including all major fiat currencies and gold.

As representatives of the major players of the digital-asset scene worldwide, we at DCGG rest at your disposal for any further detailed information and technical suggestions on how to practically develop the propositions made in this text. As a closing remark, we would like to suggest the UK Regulator to approach the topic of digital assets holistically by taking into consideration all aspects mentioned above and to grasp the unique leadership chance that the UK could seize by implementing this new regulation. The above suggestions would greatly contribute to creating jobs, facilitating economic growth, and enabling major technological innovation in the sphere of digital finance. These major benefits can help the UK achieve a leadership status in the digital finance world.