GLOBAL
DIGITAL
FINANCE

5 April 2019

Re: GDF Response to the Guidance on Cryptoassets Consultation Paper (CP19/3*)

Background

Global Digital Finance (GDF) supports efforts by global standard setters, national authorities and regulators to consult and work with the nascent global digital and crypto asset industry.

As such, we are hereby providing input to the Financial Conduct Authority's request for feedback as part of the Guidance on Cryptoasset Consultation Paper CP19/3*[1] dated January 2019 in which the FCA has invited private sector entities and other experts to provide comments on the regulatory perimeter for specific cryptoassets.

The input has been drafted by members of the GDF Board of Directors, GDF Advisory Council, and members of the GDF Security Token and Stablecoin Working Groups.

About GDF

Global Digital Finance ("GDF") is a not-for-profit industry body that promotes the adoption of best practices for crypto and digital assets and digital finance technologies through the development of conduct standards, in a shared engagement forum with market participants, policymakers and regulators.

Established in March 2018, GDF has convened a broad range of industry participants, with 300+ global community members including some of the most influential digital asset and token companies, academics and professional services firms who support the industry.

Following 2 public consultations, in which we received hundreds of feedback comments from industry and policy makers alike, GDF successfully ratified

[1] https://www.fca.org.uk/publication/consultation/cp19-03.pdf

GDF

our Code of Conduct which today includes Overarching Principles, as well as the supporting Principles for Trading Platforms, Principles for Token Issuers, Principles for Funds and Fund Managers and Principles for Rating Websites, and a Taxonomy for Cryptoassets.

The GDF Code of Conduct is an industry-led initiative driving the creation of global best practices and sound governance policies, informed by close conversations with regulators and developed through open, inclusive working groups of industry participants, legal, regulatory and compliance experts, financial services incumbents and academia. Code principles undergo multiple stages of community peer review and open public consultation prior to ratification. The GDF Code will continue to expand and evolve in alignment with the crypto and digital asset industry.

In April 2019, we will launch a formal framework under which cryptoasset companies and professional services firms who support them can self-attest their adoption of the GDF Code of Conduct.

GDF also conducts policymaker, regulator and industry outreach to build a shared understanding of the risks and opportunities presented by digital assets and tokens. We convene quarterly Summits during which national and regional regulators and supranational policy makers participate as observers.

We appreciate the FCA's participation as observers in past GDF Summits and welcome the FCA's encouragement for this type of industry-led standard setting. Such ethical commitments by market participants instil confidence in the industry and heighten protection for consumers.

Response to Consultation Document

Q1: Do you agree that exchange tokens do not constitute specified investments and do not fall within the FCA's regulatory perimeter? If not, please explain why.

- We agree to what is set out in 3.38-3.40 and welcome in particular the following clarifications:
    - 3.38 *"Exchange tokens currently fall outside the regulatory perimeter. This means that the transferring, buying and selling of these tokens, including the commercial operation of cryptoasset exchanges for exchange tokens, are activities not currently regulated by the FCA."*
    - 3.39 *"For example, if you are an exchange, and all you do is facilitate transactions of Bitcoins, Ether, Litecoin or other exchange tokens between participants, you are not carrying on a regulated activity."*
    - 3.40 *"This is in line with our approach to other investment-like products that remain outside our regulatory perimeter, like assets that some might consider having speculative value (eg fine wine or art)."*

Q2: Do you agree with our assessment of how security tokens can be categorised as a specified investment or financial instrument? If not, please explain why.

- **Specified Investments and Transferable securities:**
    - We agree with your assessment of how security tokens can be categorised as a specified investment or financial instrument, however, we believe that more guidance is needed to address the gap between the definitions of "Specified Investments" under the RAO and "Transferable Securities" under MiFID II and how this applies to different types of tokens. For example, there is no guidance on when a specified investment would not be a transferable security under MiFID II.
- **Voting:**
    - The Guidance contains reference to voting on page 24 and notes that *"Tokens that give holders similar rights to shares, like voting rights, or access to a dividend of company profits or the distribution of capital upon liquidation, are likely to be security tokens. Tokens that represent ownership or control are also likely*

to be considered security tokens, as shares tend to represent ownership (through dividends and capital distribution) and control (through voting).”

- It would be useful if the FCA could clarify that *the ability to vote on future development or upgrade of, or change to, a blockchain protocol* - which is intrinsic to many blockchains and often a key distributed governance feature - does not trigger such protocol to become a security.

- **Units in a collective Investment Scheme:**
  - The Guidance says on page 26 that *“A collective investment scheme means any arrangement, the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income arising from the investment or sums paid out of such profits or income. The participants do not have day-to-day control over the management of the investment and contributions of the participants, and profits from which payments are to be made, are pooled and/or the investment are managed as a whole by or on behalf of the operator of the scheme. Certain arrangements are excluded.”*
  - It also says *“A token that acts as a vehicle through which profits or income are shared or pooled, or where the investment is managed as a whole by a market participant, for instance the issuer of tokens, is likely to be a collective investment scheme. References to pooled investments, pooled contributions or pooled profits in a whitepaper could also be a factor in a token being considered a security.”*
  - Case Study 5 that notes that *“Firm IJ invests in fine art using the funds it receives and pools from investors and hires it out for use at corporate events for a fee. It issues tokens to investors in proportion to their contributions. These tokens also entitle the investors to receive a share of the fees generated by the art rental, and the profits it makes when it sells the art from time to time. The token holders have no dayto-day control over the art or the rental fees. The token holders’ contributions are pooled, so are the rental fees and profits from art sales, and the art is managed as a whole by IJ. The tokens that represent the participants’ share in the investment are therefore likely to constitute units in a collective investment scheme.”*

- Case study 5 is a very classic example of a CIS, i.e. an investment scheme that is collectively managed by a third party who acts as *"operator of the scheme"*.
- Often cryptoassets bear no similarities to an investment scheme. However, frequently a token represents the right to use a protocol that is being *developed by a team of developers*.
- For the avoidance of any doubt on this front, it would be useful if the FCA could explicitly clarify that the existence of a development team does not trigger the factor that "*the investment are managed as a whole by or on behalf of the operator of the scheme*".

- **CFDs, options, futures, exchange traded notes:**
  - The Guidance notes on P28 *"Firms and consumers can also gain exposure to exchange tokens through financial instruments which reference these tokens like CFDs, options, futures, exchange traded notes, units of collective investment schemes, or alternative investment funds. These instruments derive their value from referencing the cryptoasset, but they're not cryptoassets themselves."*
  - It adds that *"Products that reference tokens, like derivative instruments, are very likely to fall within the regulatory perimeter as Specified Investments (either as options, futures or contracts for difference under the RAO). These products are also capable of being financial instruments under MiFID II."*
  - Notwithstanding this clarification that they are "*very likely to fall within the regulatory perimeter as Specified Investments (either as options, futures or contracts for difference under the RAO)*", many platforms continue to offer these products (from onshore and offshore) on the basis that they do not believe this is a legal certainty ("*very likely*" rather than "*certainly*") and instead believe this is a complex legal question to be clarified either in law or regulation.
  - To avoid an unlevel playing field where different platforms obtain differing legal advice, it is recommended that the FCA insert a clarification as to when these products *"are certainly"* (rather than *"are very likely"*) regulated products.

- **Airdrops:**
    - Currently the Guidance does not touch upon airdrops. It may be useful to clarify that the regulatory analysis of airdrops should/ would follow the same criteria as set out in the Guidance. For example, that an airdrop in and of itself is not a placement or offering as no investment is involved. However, that it could qualify as a placement or offering if it attaches rights such as those described under Specified Investments.
- **Burning:**
    - Currently the Guidance does not touch upon burning of tokens. It may be useful to clarify that burning does not convert a token into a Specified Investment.
- **Securities Tokens:**
    - Currently the Guidance does not touch upon how securities token offerings (STOs) can be placed and executed in a compliant manner. For example, further consideration/guidance would be welcomed regarding secondary markets and custody in relation to securities tokens given the current misalignment of regulations built for traditional instruments.

Q3: Do you agree with our assessment of utility tokens? If not, please explain why.

- We agree with the definition of utility tokens in 3.51 that *"Utility tokens provide consumers with access to a current or prospective service or product and often grant rights similar to pre-payment vouchers. In some instances, they might have similarities with, or be the same as, rewards-based crowdfunding. Here, participants contribute funds to a project in exchange, usually, for some reward, for example access to products or services at a discount"*.
- We agree with your assessment that utility tokens should fall outside the regulatory perimeter where they do not exhibit features consistent with securities.
- We found the case studies helpful in giving examples of certain types of characteristics that of themselves point towards the particular asset being a utility token and therefore falling outside the regulatory perimeter.

- We welcome in particular the clarifications that:
    - 3.3. *"We appreciate that people may purchase cryptoassets for speculative purposes, anticipating that their value will increase. We also appreciate that there are a number of factors that may increase their value, including speculative trading on secondary markets (usually cryptoasset exchanges). This is similar to the purchase of a number of goods, the value of which the investor expects to increase over time (residential or commercial property, wines, cars, artwork etc)"*,
    - 3.4. *"However, the fact that a cryptoasset is acquired for value (in exchange for a certain number of cryptoassets or for payment in fiat currency) does not necessarily make it a Specified Investment under the RAO, nor a Financial Instrument under MiFID"*, and
    - 3.52 *"Much like exchange tokens, utility tokens can usually be traded on the secondary markets and be used for speculative investment purposes. This does not mean these tokens constitute Specified Investments."*
- We also note that 4.1.3 says that *"My network is/aims to be fully decentralised and I will not have any control over the network anymore. Does this have an impact on whether the tokens could be regulated or not? No. The nature of the network does not determine whether a token is a security or not. A security token is determined by its intrinsic characteristics and the rights it confers on holders, as detailed in the Guidance chapter. However, the more decentralised the network the less likely it is that the token will confer enforceable rights against any particular entity, meaning it may not confer the same or equivalent rights as Specified Investments."*
- We suggest that the FCA add to the above language to the effect that the *movement of a blockchain protocol from test-net to main-net is not a determinative factor* under UK law in the assessment as to whether the token qualifies as a Specified Investment, and that instead the factors set out in the Guidance, including the standing definitions of Specific Investments, are determinative.

Q4: Do you agree with our assessment that exchange tokens could be used to facilitate regulated payments?

- Yes, we agree that exchange tokens could be used to facilitate regulated payments but our interpretation of the example included in para 3.57 ***Sandbox case study 1*** is that the exchange token is not a

regulated “payment instrument” or facilitating regulated activity itself. The services only fall within money transmission/regulated payment services on account of the cross-border fiat payments (irrespective of whether an exchange token is involved in the funds flow).

Q5: Are there other use cases of cryptoassets being used to facilitate payments where further Guidance could be beneficial? If so, please state what they are.

Q6: Do you agree with our assessment of stablecoins in respect of the perimeter?

- Yes we agree.
- While the Guidance includes some cases studies of sandbox treatment, clarity as to how/subject to which licenses GBP fiat tokens can be issued in a compliant fashion would be welcomed as it would create a more level playing field.
- We would also welcome further Guidance as to the likely regulatory treatment of other categories of stablecoins including -
    - **Non-fiat asset backed tokens** (both cryptoassets or non-crypto assets forming collateral)
    - **Non-asset backed tokens** e.g. algorithm backed and hybrids (i.e. combining collateralisation / non collateralisation).
- GDF has initiated a working group in regards to Stablecoins and these various categories have come up in the discussions.

Q7: Do all the sections above cover the main types of business models and tokens that are being developed in the market?

- Yes it covers the main types of tokens and activities.
- We would note that the GDF taxonomy that can be accessed here used the terminology “consumer token” to include not only utility tokens but also tokens that confer:
    - **Consumer Ownership Rights:** Tokens can themselves be a natively digital consumer good, such as a tokenised collectible like a badge for online gameplay or a unique digital collectible that does not exist in the physical world, such as a virtual pet; or they can represent ownership of an analog (i.e. not digital or on

the blockchain) good, such as a traditional baseball card. In these cases, the token can confer ownership in the corresponding good and/or represent the good.

- **Consumer Coupon Rights:** Tokens that provide a partial or complete discount on particular goods, services, or content, in the physical world or in the virtual world, e.g. file storage on a given token-powered network or electricity provided to retail customers.

- **Consumer Activity Rights:** Tokens that involve rights or obligations related to an individual user's activities on a token-powered network. With regard to consumer activity rights, we contemplate at least two current subcategories:

  - **Reward:** Tokens that serve as a form of reward or payment for performed activities. In the cases of online platforms, the tokens earned can also be used to access features or get benefits on the platform. In the case of physical systems, the tokens may act like "frequent flyer miles" to be redeemed for services or goods.

  - **License:** Tokens that serve as a means to access or perform certain activities related to a blockchain or online service. Analogies in the analog world may include a software license, taxi medallions for New York City taxis, or occupational licensing and certifications for certain vocations. In the virtual world, this could include a token which allows access to a content-driven website. License rights may also include relationships similar to those we are all familiar with, such as a membership to a wholesale club, or the right to participate in a book club of the month.

- Given, however, that the rights set out above that such consumer tokens embed are not relevant to the FCA's regulatory remit, it may not be necessary for the FCA to change its terminology to capture such consumer rights.

Q8: Are there other significant tokens or models that we haven't considered?

- Recently there is an emergence of *Initial Exchange Offerings (IEOs)*. From a regulatory perspective they could be viewed as very similar to ICOs and consequently could appear to fall in the same legal categories set out in the Guidance. However, given the appearance of this new

term-of-art, we hereby flag it for completeness in case the FCA wishes to study IEOs in more detail or include them in the Guidance.

- Furthermore, some crypto exchanges have issued tokens that can be used e.g. for settling trading fees on the platform or for participating in lotteries for IEOs. These tokens appear not to be Specified Investments and instead appear to be utility tokens per analogy to Case study 8. If our assessment is not correct in this regard, we recommend the FCA to insert a clarification in the Guidance.

- One token model which the Guidance does not address is the 'variable token' by which we mean tokens which start out their life as one 'category' of token but by virtue of the utility of the token and change in characteristics it then falls into another 'category'. For example, there may be tokens which are initially used as fundraising tools in an equity-like form thereby being classes as securities token but then once the 'ecosystem' is built, may only be used for the purposes of running the platform or as a means of exchange within the closed proprietary platform, representing exchange or payment tokens.

    - This creates the biggest legal uncertainty as to when digital assets come in and out of the regulatory perimeter and we would welcome further guidance from the FCA as to how this will be addressed, whether notification systems should be put in place, what digital asset issuers would be required to monitor, do or implement in order to ensure regulatory compliance.

Q9: Are there other key market participants that are a part of the cryptoasset market value chain?

- The Guidance on Cryptoassets Consultation Paper does not refer to all of the parties involved in creating tokens.

- GDF created the following list of actors that may be useful as a point of cross reference for the FCA. This list must be read in conjunction with Question 10 where we give further input as to which should not be mapped into financial regulation:

- **Exchange/ transfer:**
  - Centralized Matching-Engine Based Crypto Exchanges [2]
  - Centralized Directory / Marketplace Based Crypto Exchanges [3]
  - Decentralized Crypto Exchanges
  - Crypto OTC Desks
  - Crypto ATMs
- **Custody/safekeeping:**
  - Crypto Custodian Wallets
  - Crypto Non-custodial Wallets (online)
  - Crypto Non-custodial Wallet (offline – e.g. hardware / paper)
- **Payment/ lending:**
  - Crypto Payment Gateways
  - Crypto Payment Apps
  - Crypto Point of Sale Terminals [4]
  - Crypto-only E-Commerce Portals [5]
  - Crypto Credit / Debit Cards
  - Crypto Lending Apps
- **Investment/ trading:**
  - Crypto Derivatives Trading
  - Crypto Brokers
  - Crypto Funds
  - Crypto Investment Apps
  - Crypto Investment Advisors
- **Token issuance/ sale:**
  - Coin Issuers
  - Firms / advisors supporting coin issuance
- **Other:**
  - Smart contract developers
  - Miners and transaction processors

[2] A centralised exchange with a electronic matching system that matches buy and sell orders.
[3] A directory or market place that provides a venue for buyers and sellers to agree a trade of virtual assets (e.g. localbitcoins.com).
[4] PoS terminals to allow real world retail outlets to accept cryptocurrency as a means of payment (e.g. Pundi X).
[5] E-Commerce web sites that accept cryptocurrency as a means of payment for listed items.

Q10: Are there activities that market participants carry on in the cryptoasset market that do not map neatly into traditional securities?

- Several of the **activities above do *not* map** neatly into traditional financial regulation:
    - We would highlight in particular different forms of **custody** and refer the FCA in this regard to the published GDF paper that can be accessed here. In this paper we distinguish between **four current types of custody.**
    - We would also highlight in this regard the fact that in our view **non-custodial wallets cannot be easily captured** within the remit of AML or other regulation given that:
        - There is no technological way to prevent users from creating a payment address;
        - There is no technological way to restrict P2P virtual asset transfers between end-users;
        - Given that transfers to a wallet address cannot be prevented once the wallet address is created, enforcing requirements such as rejecting incoming transfers that lack originator/beneficiary information may not be possible;
        - Some wallets (e.g. those that use BIP32 for hierarchical deterministic wallets[6]) create new addresses automatically in order to protect privacy (e.g. for large players like market makers or exchanges who do not want their positions or trading sizes to be known);
        - Currently there is no register of who owns what payment addresses, but even if there was, it seems unlikely that it would be possible to ensure that everyone who creates a payment address duly registers it. In this respect, although we recognise certain "blacklisted" addresses are becoming known through sources such as the Office of Foreign Assets Control ("OFAC") in the United States and third party service providers, this cannot serve as a day-to-day source of CDD information.

[6] Hierarchical Deterministic (or HD) Wallets are a tree structure where a wallet owner can create multiple wallets in multiple currencies containing multiple addresses, all from the same master key. See https://medium.com/bitcraft/hd-wallets-explained-from-high-level-to-nuts-and-bolts-9a41545f5b0 .

- Furthermore, the below ***do not map neatly into or should not map into*** financial regulation.
    - **Exchange/ transfer:**
        - Decentralized Crypto Exchanges
    - **Payment/ lending:**
        - Crypto Point of Sale Terminals
        - Crypto-only E-Commerce Portals
    - **Other:**
        - Smart contract developers
        - Miners and transaction processors
- For elaboration on players that should not map into financial regulation, see also ***Section A of the October 9, 2018 letter to FATF***.[7]

[7] https://www.gdf.io/wp-content/uploads/2018/10/GDF-Letter-to-FATF-dated-October-9-2018.pdf