

UK Regulators Grapple With Cryptocurrencies And ICOs

By **Sergey Kvitkin, Amar Mann and Amy Comer** (June 21, 2018, 2:49 PM EDT)

Not a day goes by without yet another news item or regulatory announcement on either side of the pond on blockchain, cryptocurrencies and initial coin offerings. In the U.K., we have seen a number consultations and inquiries launched by the regulators and the Parliament. The report of the first hearing held by the House of Commons Treasury Committee as part of its inquiry into digital currencies provides an entertaining and elucidating read.[1]

This article offers a snapshot of the current regulatory approaches taken by the main financial and fiscal regulatory bodies in the U.K. to cryptocurrencies and ICOs.

Financial Conduct Authority

The FCA is a main regulator of the U.K. financial markets whose strategic and operational objectives are to protect consumers and the integrity of the financial markets, and to promote effective competition.

Under the Financial Services and Markets Act 2000, no person may carry on regulated activity in the UK unless that person is an authorized person or an exempt person. Carrying on regulated activity without required authorization is a criminal offence. In addition, pursuant to the financial promotions rules, a person may not communicate, in the course of business, an invitation and inducement to engage in investment activity unless that person is authorized or the content of the communication has been approved by an FCA (or European Economic Area) authorized firm.

The current regulatory perimeter in the U.K. does not specifically include cryptocurrencies, ICO tokens or cryptocurrency exchanges on which they are initially offered or traded. According to the FCA's September 2017 consumer warning, most ICOs are not regulated by the FCA, especially where the issuers and the relevant exchanges are based overseas.

Whether an ICO would be regulated must be considered on a case-by-case basis and would depend on how the ICO is structured, and what features the issued tokens have.[2] Furthermore, if tokens are offered to the public in the UK and constitute "transferable securities" (as defined in the Markets in Financial Instruments



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Directive / MiFID II), their issuance may require publication of a prospectus. Such statements are certainly welcome by the practitioners, and further guidance is likely to follow, especially in view of the fact that the FCA has been reported to be probing into a number of currently unauthorised businesses that deal with cryptocurrencies.[3] However, unlike the U.S. Securities and Exchange Commission, to date the FCA has not taken any enforcement actions in respect of ICOs, token issuers or their professional advisers. It remains to be seen how it would act when faced with an actual or alleged case of noncompliance in the U.K.

In contrast with this seeming uncertainty, the FCA has stated that if a financial instrument has cryptocurrencies or tokens as the underlying reference asset, the activities of firms relating to these instruments (including any exchanges) may be subject to regulation under the FCA rules.[4] One example of such products that are regulated by the FCA is cryptocurrency-based contracts for difference, or CFDs. In November 2017, the FCA issued a warning to consumers about investments in cryptocurrency CFDs singling them out as extremely high-risk, speculative products, primarily because of the interaction of high volatility, leverage and market manipulation risks.[5] The FCA's chief executive has also gone on the record to compare buying bitcoin to gambling with the same level of risk.[6]

In April 2018, the FCA published a statement[7] confirming that firms conducting regulated activities in cryptocurrency derivatives will require authorization by the FCA and must comply with all applicable rules in the FCA's handbook and any relevant provisions in directly applicable European Union regulations. The derivative products in question include cryptocurrency futures, CFDs and cryptocurrency options. There are now a few exchanges and service providers in the U.K. holding the relevant authorizations, which shows that at least some of the industry participants are willing to play by the established rules.

The FCA has indicated that the door was still open for the government and Parliament to step in and bring cryptocurrencies and ICOs into the U.K. regulatory perimeter (similar to a number of jurisdictions such as Switzerland and, most recently, Gibraltar). The regulator intends to gather further evidence on market developments in ICOs and cryptocurrencies. Their findings will help to determine whether or not there is need for any regulatory action in this area.

Bank of England

In the bank's view, digital currencies do not currently pose a material risk to monetary or financial stability in the U.K.[8] They do not play a substantial role as money in society, and to the extent that they act as money, they do so in parallel with the traditional currencies.

On the other hand, in his March 2018 speech, the bank's governor highlighted the downside of digital currencies, including consumer and investor protection, money laundering, terrorism financing, tax evasion and the circumvention of capital controls and international sanctions.[9] These concerns are likely to continue attracting the attention of policymakers and regulators in the U.K. and globally. In particular, a proposed amendment to the Fourth Money Laundering Directive, or MLD5, is envisaged by the European Commission to bring virtual currency exchange platforms and custodian wallet providers within the scope of anti-money laundering regulations, including in respect of obligations to implement preventive measures and report suspicious transactions. However, implementation of MLD5 is not expected until mid-2019, and it is still uncertain how the U.K. will treat EU laws to be implemented after Brexit.

The bank's position is that instead of banning digital currencies and their associated activities outright, as done in a number of jurisdictions, it would be better to regulate elements of the digital currencies

ecosystem to combat illicit activities, promote market integrity and protect the safety and soundness of the financial system. This is because the underlying distributed ledger technology has the potential to catalyze innovations in payment systems that will help increase efficiency, reliability and flexibility of payments, as well as drive down transaction costs. DLT and other technologies underlying digital currencies can also have other wide-ranging applications with a potential to transform how people manage their interactions with public agencies, how businesses manage their supply chains, etc.

The bank is undertaking continued research into the implications of creating a central bank digital currency that would give open access to individuals and firms. However, given the shortcomings in the underlying technologies and the associated risks, the bank does not consider it as a near-term prospect.

Her Majesty's Revenue & Customs (HMRC)

In March 2014, the U.K tax office issued guidance on the tax treatment of income received from, and charges made in connection with, activities involving bitcoin and other cryptocurrencies.[10] The guidance is aimed at anyone making charges or otherwise receiving income from activities involving cryptocurrencies, including bitcoin miners, traders, exchanges, payment processors and other service providers.

Cryptocurrencies are generally outside the scope of U.K. value-added tax. However, VAT will be due in the normal way from suppliers of any goods or services sold in exchange for bitcoin or other cryptocurrency, calculated by reference to the sterling value of the relevant cryptocurrency at the point when the transaction took place.

With respect to other forms of taxation (such as corporation tax, income tax or capital gains tax), whether activities involving cryptocurrencies will be subject to tax depends on the activities and the parties involved. They will need to be looked at on a case-by-case basis taking into account the specific facts. In HMRC's view, no special tax rules for cryptocurrency-based transactions are currently required.

Conclusion

As of today, the U.K. regulators do not consider the issuing of, or trading in, cryptocurrencies themselves as regulated activities. However, trading in derivatives using cryptocurrencies and other digital assets will most certainly require FCA authorization (unless a valid exemption applies). It is also likely that new regulations and other forms of market intervention by the U.K. regulators and policymakers are likely in the near to mid-term. For U.K. businesses involved in ICOs or cryptocurrency-related activities, obtaining independent legal and tax advice would be business critical.

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[1] <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/digital-currencies/oral/82323.pdf>

[2] <https://www.fca.org.uk/news/statements/initial-coin-offerings>

[3] <https://www.ft.com/content/b9d2b246-6003-11e8-ad91-e01af256df68>

[4] <https://www.fca.org.uk/publication/feedback/fs17-04.pdf> (see section 3.8).

[5] <https://www.fca.org.uk/news/news-stories/consumer-warning-about-risks-investing-cryptocurrency-cfds>

[6] <http://www.bbc.com/news/business-42360553>

[7] <https://www.fca.org.uk/news/statements/cryptocurrency-derivatives>

[8] <https://www.bankofengland.co.uk/-/media/boe/files/digital-currencies/the-economics-of-digital-currencies>

[9] <https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/the-future-of-money-speech-by-mark-carney.pdf?la=en&hash=A51E1C8E90BDD3D071A8D6B4F8C1566E7AC91418>

[10] <https://www.gov.uk/government/publications/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies>