

Cryptoassets and stablecoin consultation
Payments and Fintech
HM Treasury
1 Horse Guards Road
SW1A 2HQ



Sent by email

19 March 2021

Response to UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence, dated January 2021

To Whom It May Concern,

Further to the above mentioned consultation, ISLA would like to submit the below responses for your consideration.

The information provided represents the consensus of the ISLA Digital Steering Group, which is available to all ISLA members and not considered confidential.

Yours sincerely,

David Shone

Director of Market Infrastructure & Technology

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About ISLA:

International Securities Lending Association (ISLA) is a leading industry association, representing the common interests of securities lending and financing market participants across Europe, Middle East and Africa. Its geographically diverse membership of over 160 firms, includes institutional investors, asset managers, custodial banks, prime brokers and service providers. Working closely with the global industry as well as regulators and policymakers, ISLA advocates the importance of securities lending to the broader financial services industry. ISLA supports the development of a safe and efficient framework for the industry, by playing a pivotal role in promoting market best practice, amongst other things. ISLA sponsors the Global Market Securities Lending Agreement (GMSLA) and the annual enforceability review in over 60 jurisdictions globally. Through member working groups, industry guidance, consultations and first-class events and education, ISLA helps to steer the direction of the industry and is one of its most influential voices on the European and global stage. <https://www.islaemea.org/>

Question Responses

Chapter 1: Cryptoassets and the current regulatory landscape

Box 1.A: Questions for respondents

1 Do you have views on continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed?

ISLA Response:

We consider it prudent to continue to use this classification methodology, particularly in light of the fact that there does not exist any international taxonomy at this point in time. It therefore makes sense that the regulatory bodies of the UK maintain a consistent method of describing the growing number of crypto-asset types at least internally to the UK. Where possible, the UK authorities should seek to influence the international community to agree upon definitions and taxonomy in the near term, so as to allow harmonisation of regulations globally. This is particularly important due to the fact that many DLT instances operate outside of traditional concepts of jurisdiction that would be found in custody and issuance arrangements today. If taxonomies can be aligned early, then this will mitigate against conflicting and fragmented regulation in the future.

We would add that whilst the FCA classification is useful in providing shorthand descriptors to facilitate discussion, it cannot be relied on to provide certainty in respect of the regulatory perimeter. In order to achieve the latter (which would be desirable), further guidance is required at the level of the detailed regulation.

We agree that classification by economic function or attribute of asset type allows for a robust future-proof methodology as well as ensuring the classification is largely agnostic to the underlying technology used.

Finally, it may be a consideration to also, in parallel, classify cryptoassets based on the nature of their protocol. Inherently due to the nature of these protocols, there is always a level of risk for network attacks (e.g., in a PoW protocol this is related to mining power, for example 51% attack). In our opinion this represents a real risk for the consumer and is potentially something that can be made more transparent in categorisation of the cryptoassets themselves, as the risk can be quantified. It is noted by some of our members that this approach lacks an element of future proofing, due to new protocols being introduced, hence the parallel consideration to inform an orthogonal purpose.

2 Do you have views on the proposed new regulated category of ‘stable tokens’?

ISLA Response:

Based on the reasons set out in the consultation, it makes sense to institute this new category as the sense is that these tokens will inherently be less volatile for consumers and investors. Financial institutions would also be able to use the taxonomy in this way to assist in collateral eligibility negotiations e.g., it can be envisioned in the future that a security lender may be prepared to accept stable tokens as collateral whilst refusing to accept exchange tokens in general due to their volatility and perceived lack of real-world source of value. As part of the definition, the UK authorities should look to define what counts as guaranteeing a “tether” to a real-world asset or the creation/destruction of tokens in circulation to maintain value.

it is important to distinguish between the different ways in which DLT may be deployed in financial markets and that we would expect some deployments to be neutral from a regulatory perspective. In particular, if records on a distributed ledger are simply used to evidence rights and obligations, in the same way as other systems of books and records, rather than creating any new asset or giving rise to a change in activity, we would expect that this should not trigger any regulatory consequences under the proposed regime.

At this stage, given the rising popularity of ESG investments and the growing importance of categorising existing securities and assets in relation to ESG concepts, the UK authorities should consider sub-categorising the existing token categories in a way that takes into account ESG concepts now. This may be difficult given the equally emergent nature of taxonomizing ESG concepts, but for instance a cryptoasset protocol based on proof of work is naturally more likely to consume more electricity to maintain itself than a proof of stake protocol.

For stablecoins backed by physical assets, close attention should be given to the stringent regulation of those issuing the stablecoins. It is essential the standards are maintained, and these entities are regulated, as issuance of non-backed assets within the cryptoasset ecosystem can result in sudden untethering and loss of stability within the stablecoin itself.

A larger concern lies not with the physical-backed stable token solutions, but instead those solutions which maintain stability via their protocol. These entities own and control their entire protocol, and have the ability to update and manipulate the logic of this protocol at any point, and will need to with updates and enhancements. Due to this there is an ever-present risk of bugs / flaws in the protocol, and hence these solutions not only require initial but ongoing oversight and audit. This risk affects the consumer and investor directly and cannot be entirely removed.

Chapter 2: Policy Approach

Box 2.A: Questions for respondents

3 Do you have views on the government’s proposed objectives and principles for cryptoassets regulation? Do you have views on which should be prioritised, or where there may be tension between them?

ISLA Response:

The proposed objectives seem sensible and in line with financial regulation to date.

It is important that the second principle (ensuring the approach is appropriate and focused on acute risks) is closely adhered to, in order to prevent stifling innovation, which could provide immense benefit to the industry, under costly and disproportionate regulation.

Box 2.B: Questions for respondents

4 Do you agree with the approach outlined, in which the regulatory perimeter, objectives and principles are set by government and HMT, with detailed rules to follow set by the UK’s independent regulators?

ISLA Response:

For the reasons set out in the consultation, around agility and ability to respond quickly to new developments and emerging risks, it is felt that this approach is sensible.

5 What are your views on the extent to which the UK’s approach should align to those in other jurisdictions?

ISLA Response:

Per the answer given to question 1, it is felt that cooperation and collaboration between international parties is key to the success of regulating this area of the market. By their nature DLTs can be partly or wholly outside one particular jurisdiction based on where the network nodes sit, where any tethered assets are custodied and where the owners of the tokens are. Added to this is the fact that many operate with private keys, which may be in cold storage, it can be difficult to determine who “owns” the cryptoasset at any given point in time.

Collaborating early in this space is thus important to ensure a level playing field for global financial institutions.

Chapter 3: Expanding the regulatory perimeter

Box 3.B: Questions for respondents

6 Do you agree with the government’s assessment of risks and opportunities?

ISLA Response:

Yes

7 Do you have views on the proposed initial scope of UK cryptoasset regulation as summarised above?

ISLA Response:

Whilst on the face of it, focusing on “payment” coins first then wider classes of cryptoasset makes sense from a retail consumer perspective, in conjunction with the assumption that, since the concept of paying with a token is conceptually easier to understand, payment token transactional volume will increase first, it makes sense this may not actually be the case in the wider financial market.

In 2020 96% of security loan volume in EMEA used non-cash assets as collateral, and efforts in the industry to date around using tokens has focused on tokenising securities to use as collateral in a more efficient way. Tethering to a pool of assets provides some legal protection for the collateral taker, in terms of ensuring that in the event of default the collateral taker knows that there are real world assets that they have a lien over and can sell to make good any loss due to default. It makes settlement and re-use of collateral simpler, faster, and more responsive to intraday market movements, ensuring liquidity even in times of stress.

Thus, we are of the view that actually the UK authorities should consider stable tokens of a wider scope earlier rather than later to increase the regulatory certainty in these operations.

8 Do you agree that this approach best balances the government’s stated objectives and principles?

ISLA Response:

Yes- the approach is measured and phased in a way that allows for agility to continued innovation.

Box 3.C: Questions for respondents

9 Do you agree that the activities and functions outlined above are sufficient to capture the activities that should fall within the scope of regulation?

ISLA Response:

Yes

10 Do you agree that the government should primarily use existing payments regulations as the basis of the requirements for a new stable token regime, applying enhanced requirements where

appropriate on the basis of mitigating relevant risks? What other existing legislation and specific requirements should also be considered?

ISLA Response:

Yes- we see no value in re-inventing existing legislation, instead building upon it to capture the new risks posed by cryptoassets makes the most sense. However, the current perimeter of existing payments regulation is unclear in this context (see for example our comments on question 22 below in relation to “money” and “funds”). We would also note that given asset-referenced tokens may be used for both payments and speculative investment purposes, it may be necessary to consider investment regulation as well.

For stablecoins backed by physical assets, close attention should be given to the stringent regulation of those issuing the stablecoins. It is essential the standards are maintained, and these entities are regulated, as issuance of non-backed assets within the cryptoasset ecosystem can result in sudden untethering and loss of stability within the stablecoin itself.

A larger concern lies not with the physical-backed stable token solutions, but instead those solutions which maintain stability via their protocol. These entities own and control their entire protocol, and have the ability to update and manipulate the logic of this protocol at any point, and will need to with updates and enhancements. Due to this there is an ever-present risk of bugs / flaws in the protocol, and hence these solutions not only require initial but ongoing oversight and audit. This risk affects the consumer and investor directly and cannot be entirely removed.

11 Do you agree with the high-level requirements outlined? Do you consider that any additional requirements are needed?

ISLA Response:

Yes- the high-level requirements make sense. No further requirements are identified by us at the current time.

12 Do you have views on whether single-fiat tokens should be required to meet the requirements of e-money under the EMRs, with possible adaptation and additional requirements where needed?

ISLA Response:

Given their nature, almost by definition being a digital representation of the single fiat currency, it would make sense that these are treated as e-money.

13 Do you have views on whether exclusions to the authorisation regime are needed in relation to the stable token’s regime, in light of the government’s objectives? If so, which activities do you think should be excluded?

ISLA Response:

No exclusions to mention at the current time. We would emphasise that the scope of proposed regulation should consider and integrate with existing regulation (e.g. for tokenisation of existing

assets, as discussed in Chapter 4 of the consultation paper). The wider point to make here is that where regulation is fit for purpose and can be leveraged, that should be given due consideration.

14 What are your views on the appropriate classification and treatment of (unbacked) tokens that seek to maintain a stable value through the use of algorithms?

ISLA Response:

We would agree with the consultation paper that these are effectively unbacked exchange tokens, that do not provide the safety of linkage to an asset of known value. Issuers of these tokens own the protocols and are thus effectively able to control the “supply” of tokens in a way that makes them akin to a central bank. It does not seem prudent to offer that level of monetary control to an organisation not of a central bank status, without extremely high levels of regulation around access to the protocol itself.

15 Do you agree Part 5 of the Banking Act should apply to systems that facilitate the transfer of new types of stable tokens?

ISLA Response:

Yes

16 Do you have views on potentially extending Bank of England regulation of wider service providers in the stable token chain, where systemic?

ISLA Response:

This would appear prudent. Since the financial crisis of 2008 it has been clear that regulation of systemic players (those firms “too big to fail”) in the industry is core to ensuring the continuing confidence in the market. With increasing investment in the crypto asset classes and infrastructure it would make sense to treat that market in the same regard. Already price movements in popular exchange tokens, such as BTC, influence virtually all other coins and crypto asset classes. Extrapolate that to any protocol or chain which underpins large swathes of infrastructure. A good example here would be Ethereum which is emerging as one of the systemic players in sustaining De-fi applications. Regulation of such systemic players to prevent failure and knock-on shock to the crypto asset pantheon is important. At this moment it is uncertain as to whether such a failure would even be prevented from impacting CBDCs.

17 Do you agree that Part 5 of FSBRA 2013 should apply to payment systems facilitating the transfer of new types of stable tokens?

ISLA Response:

Yes

18 Do you have views on location and legal entity requirements?

ISLA Response:

As mentioned, the issues around jurisdiction need to be solved at an international level. Even if a UK based entity contracts through another UK based entity to access a node, the actual assets that are tokenised on the network could be sat in an entirely other jurisdiction. Imagine the complexity of a UK based borrower, accessing a node in London, borrowing tokens issued by a Brazilian based firm, on a ledger whose central issuing server is based in Japan, where the tokens represent a Global Depositary Receipt on a Russian underlying, custodied in a French custodian. This is clearly a contrived example but illustrates the fact that the ability to control cross-border crypto activity will be a legal minefield, not necessarily solved by simply enforcing contracting node access with a UK entity.

Fundamentally for any address holding the token which is not registered to a specific exchange/entity, which comprises the majority of addresses, it will not be possible to derive the location of the addresses of such assets. Of course, in the case of the physical-backed cryptoassets, the location of the tethered assets can be leveraged, but without registration of blockchain addresses which hold the tokens, this information will not be retrievable.

Chapter 4 Call for evidence on investment and wholesale uses

Box 4.A: Questions for respondents

19 Are there any areas of existing regulation where clarification or amendments are needed to support the use of security tokens?

ISLA Response:

It will be important to address the current lack of clarity as to whether certain securities issued through a DLT-based system would be capable of meeting the requirements of UK corporate law (for example, under the Companies Act and/or Uncertificated Securities Regulations). See also points noted under question 22 below.

The biggest obstacle is the essential role of a CSD in a market where CSDs are currently not generally engaging with security tokens. The UK should consider whether the CSD rules are fit for purpose in a DLT environment and the extent to which the role of a CSD continues to be necessary and whether other market players could contribute to any of the functionality that is traditionally provided by a CSD.

Box 4.B: Questions for respondents

20 What, specifically, are the potential benefits of the adoption of DLT by FMIs? What could be the benefits for trading, clearing and settlement?

ISLA Response:

DLTs themselves allow for multiple nodes in a network keeping multiple copies of the ledger at each node, ensuring agreement between entries, and removing the need for an external ledger. The assumption is that the question implies that the DLT in question is a blockchain which has additional properties of note: they are cryptographically secure, append-only and updated by consensus.

Generically, these properties remove the need for a trusted third party due to the multiple copies, grant immutability to the series of transactions that have occurred, enforce security (node access is through ownership of a private key) and reduces to infinitesimal the probability of “bad actors” through a proof of work or proof of stake protocol that ensures the effort to defraud the network is more than any potential payoff.

Specifically, therefore if we take each of these aspects in turn:

Multiple ledger copies at each node at the same time

- *Removes the need to reconcile between parties on the same network reducing overheads and operational costs both in performing reconciliations, but also in other processes dependent on agreement of ledger positions: billing, collateral and margin calls, credit risk etc.*
- *Precise positional knowledge allows for more precise collateralisation, and if tokenised digitally even fractional collateralisation is possible, enhancing intra-day liquidity by freeing up assets that would previously be used to “over” collateralise a position*
- *Instant Agent Lender disclosure- knowledge of legal counterparts at execution recorded instantly in the ledger*

- *Traders will be able to execute and have instant representations of the same trade in their respective nodes without any booking model differences, preventing downstream issues*
- *Smart contracts can ensure that trades only occur when a party genuinely has securities to trade/or will do- prevents naked short selling in relevant markets, reduces likelihood and instances of return failures*

Immutability

- *Adds integrity to the positions and balances on the ledger*
- *Provides a perfect audit trail for internal auditors, transaction investigation etc.*
- *Provides a perfect copy of transactional activity for regulatory reporting, or client reporting purposes*

Security

- *Could reduce the need for onerous operational checks on customer identity during the lifetime of a customer relationship- if the customer has the key, they own the position*
- *Combined with other digital validation techniques could allow for a faster, more thorough, and continuously updated KYC process*

Add to the above, the concept of tokenisation of assets, allowing transfer of ownership without movement of assets in traditional CSDs means that settlement can move to instant real-time transfer of ownership.

There is currently a lack of clarity as to the application of certain areas of existing financial regulation in the context of DLT-based systems, including the boundaries of applicable regulatory frameworks. In providing clarifications it will be important that regulators have regard to the distinct ways in which DLT may be deployed (as referred to above). For example, the following definitions can be difficult to interpret in the context of records on a distributed ledger: the definition of “transferable securities” under MiFID II, the definition of “cash” under the Financial Collateral Regulations, the definition of a “transfer order” under the Settlement Finality Regulations, the meaning of “money” within the definition of “payment system” under s. 182 of the Banking Act 2009 and the meaning of “funds” within the definition of “payment service provider” under s. 41 Financial Services (Banking Reform) Act 2013

21 What are the potential drawbacks of DLT for wholesale markets and FMIs?

ISLA Response:

If firms start to use DLT to settle trades near real-time then this could ironically cause a squeeze on intra-day liquidity, depending on the type of DLT deployed. Today firms may have days or weeks to fund a transaction, at this point it could be a matter of seconds, or indeed the funding would need to be in place prior to execution. This has its own logistical, mathematical, and technical issues to resolve. Any firm doing this form of trading will not be able to rely on over-night funding batches for instance and will have to ensure their treasury infrastructure is also upgraded to prevent this becoming a weak link in the efficiency chain.

An interesting aspect to physical-backed cryptoassets is related to the risk of transfer. In cryptoassets if a token is sent to an incorrect address, this transaction is permanent and irreversible. In turn, this introduces a fundamental risk that may block untethering of a cryptoasset where the control of the cryptoasset may be permanently lost due to an error in transfer at some stage (e.g., ~20% of bitcoin is estimated currently unrecoverable due to this exact risk).

It is worth re-iterating again that the benefits and drawbacks mentioned in this and the previous question will ultimately depend on the type of DLT employed.

22 Is UK regulation or legislation fit for purpose in terms of the adoption of DLT in wholesale markets and FMIs in the UK? How can FMI regulation/legislation be optimised for DLT?

ISLA Response:

It is recommended that the UK look to implement some minimum standards as set out in the consultation paper, and most likely enforce them with regulation. This is to ensure the integrity, security, and proper management of this new technology in a way that does not harm customers of the DLT owners.

Given the multijurisdictional nature of DLT platforms, it would also be helpful to have a common conflicts of law rule, adopted internationally, to determine which legal system will determine the proprietary effects of assets which are held solely through a distributed ledger.

In some cases, the use of DLT in financial markets will result in a reallocation of risks and responsibilities between parties. Regulators should consider whether it would be appropriate in any circumstances to reallocate regulatory responsibilities to reflect that.

There is currently a lack of clarity as to the application of certain areas of existing financial regulation in the context of DLT-based systems, including the boundaries of applicable regulatory frameworks. In providing clarifications it will be important that regulators have regard to the distinct ways in which DLT may be deployed (as referred to above). For example, the following definitions can be difficult to interpret in the context of records on a distributed ledger: the definition of “transferable securities” under MiFID II, the definition of “cash” under the Financial Collateral Regulations, the definition of a “transfer order” under the Settlement Finality Regulations, the meaning of “money” within the definition of “payment system” under s. 182 of the Banking Act 2009 and the meaning of “funds” within the definition of “payment service provider” under s. 41 Financial Services (Banking Reform) Act 2013.

In order for firms to feel confident to invest it is crucial that the UK provides transparency on its approach and moves quickly to reduce regulatory uncertainty. The UK should move forward with:

- 1) changing rules that are a clear obstacle to digitisation,*
- 2) reviewing markets rules where further changes may be required*
- 3) creating a framework within which firms can test DLT products with exemptions to rules*
- 4) providing guidance on the interpretation of existing rules in a DLT context and*
- 5) taking an agile and flexible approach to the application of markets rules to accommodate new technologies.*

23 What are the wider industry incentives or obstacles to the adoption of DLT in wholesale markets and FMI in the UK?

ISLA Response:

A group of trade associations, namely ISDA, ISLA and ICMA, are progressing two initiatives which lay the industry foundations for standardised smart contracts: a Common Domain Model (CDM), encoding transactional data and lifecycle event functions in a standardised way; and a Clause Library & Taxonomy (CLT), cataloguing the standard business outcomes from legal master agreements.

These initiatives form the building blocks that the industry will need to build standard smart contracts representing analogue products that exist today, as well as improving business processes to ensure these products truly become “smart”. Adoption of these standards should allow firms to “plug and play” across the growing number of DLT platforms.

One major obstacle to the larger FMI in the industry will be organisational inertia, in part due to the sheer amount of recent regulation that has resulted in significant industry spend on technology in the near past. For instance, adoption of either the initiatives above, or new technology such as DLT, can be hard to financially stomach if a firm has just spent significant capital on meeting the regulations of SFTR. Whilst most would agree with the strategic benefit, finding the cash reserves to invest in a new technology, especially since it is unsure which DLTs will become the large players could be a hard sell.

Additionally, whilst it is growing, the knowledge and skillset around DLT remains a scarce resource, with the ability to apply it to business problems even rarer.

Finally, it can prove difficult to reach consensus from market participants in agreeing a set of standards, though trade associations have proven they can facilitate this, particularly with SFTR. Consensus can be particularly challenging when different participants (lenders, borrowers, vendors etc.) of the industry are tempted to operate to their own agendas.

24 If market coordination is required to deliver the benefits of DLT, what form could it take?

ISLA Response:

It should be the role of trade associations to bring their members together to mutualise strategic market issues with implementing DLT such as they may be. This was done within securities lending for SFTR, ISLA leading the market in defining best practices, and continues with the above-mentioned initiatives around the CDM and the CLT.

25 Would common standards, for example on interoperability, transparency/confidentiality, security or governance, help drive the uptake of DLT/new technology in financial markets? Where would common standards be most beneficial?

ISLA Response:

Yes, common standards would help. As already seen with the CDM initiative, such standards do indeed foster interoperability. The industry is looking to compete within the financial product sector, not on digital infrastructure. Thus, it is important that there are levels of standardisation across DLT providers that mean FMIs can “plug and play” as and when they like, as the technology evolves, and it becomes clearer which features and set ups are more beneficial to them.

26 What should the UK government and regulators be doing to help facilitate the adoption of DLT/new technology across financial markets/FMIs?

ISLA Response:

Initiatives such as the Bank of England’s Wholesale WG on Data Collection are useful to foster regulatory compliant standards and provide the impetus for solution generation. Something similar should be considered in this area.

Any regulatory framework that is to be imposed should be announced and acted on in the near term so that a) firms have certainty in the space as to what can be achieved and what cannot be i.e. which product ventures are profitable and which are to be avoided, and b) DLT providers can converge on compliance, an incentive to take up, since a firm may currently be hesitant in case a particular DLT ends up on the wrong side of compliance standards in the future.

Another point to consider here is the concept of a CBDC: there is a case to be made whereby the introduction of a wholesale CBDC can be an enabler of widespread adoption of DLT across financial markets.

Box 4.C: Questions for respondents

27 Do you see value in the government capturing tokens typically used by retail consumers as a form of speculative investment under the regulatory perimeter in the future?

ISLA Response:

Retail consumers are not represented by this organisation.

28 Do you have any views on how the government should bring these tokens into the regulatory perimeter in the future?

ISLA Response:

Retail consumers are not represented by this organisation.

29 What are the risks and opportunities you see in relation to DeFi?

ISLA Response:

Risks include:

- *Proliferation of different protocols make the space a little un-navigable to the average firm. As noted elsewhere, without coalescence of some standards firms could each choose*

differing protocols and the efficiency benefits of the technology could be lost as firms try to communicate between two different protocols and networks

- *Lack of required knowledge and skillset for adoption/application to business problems or opportunities as noted above*
- *DeFi is a high level of automation and thus needs controlling carefully as set out in the consultation paper. Automating something which intentionally or otherwise turns out to be “bad” in some way could be catastrophic*
- *As with all forms of security, the rise of quantum computational capabilities could in the near future negate the security offered by DeFi products and DLT.*
- *Loss of private keys through error, mishap or disaster could result in large pools of unclaimed assets, leading to a problem that is almost inverse to that of Lehman in the last crisis- the assets will be segregated but proof of who owns them is not available.*
-

30 Do you have any evidence of risks to consumers when using tokens as a form of speculative investment or through DeFi that may be of interest to the government and UK authorities?

ISLA Response:

No evidence to provide at this time.