

# **Prohibiting the sale to retail clients of investment products that reference cryptoassets**

**Consultation Paper**

CP19/22\*\*\*

July 2019

## How to respond

We are asking for comments on this Consultation Paper (CP) by **3 October 2019**.

You can send them to us using the form on our website at: [www.fca.org.uk/cp19-22-response-form](http://www.fca.org.uk/cp19-22-response-form)

**Or in writing to:**

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## Contents

<b>1</b>	Summary	3
<b>2</b>	The wider context	7
<b>3</b>	Our Policy Proposals	13
<b>Annex 1</b>		
	Questions in this paper	27
<b>Annex 2</b>		
	Cost benefit analysis	28
<b>Annex 3</b>		
	Compatibility statement	36
<b>Annex 4</b>		
	Abbreviations used in this paper	41
<b>Appendix 1</b>		
	Draft Handbook text	

# 1 Summary

## Why we are consulting

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- 1.1** Cryptoassets and the distributed ledger technology (DLT) that underpins them have attracted significant global attention.
- 1.2** As our [Guidance on Cryptoassets](#) explained, cryptoassets are often called 'tokens'. Different tokens offer varying legal rights and have different uses. In some cases, tokens will qualify as Specified Investments ('security tokens') as they provide similar legal rights or obligations to traditional securities like shares or bonds. Other tokens are unregulated and may operate, for example, as a medium of exchange and, to the extent they are accepted by others as payment, can be used to access goods or services.
- 1.3** While the UK cryptoasset market has grown, it remains small compared with some other jurisdictions, with limited trading volumes. Some mainstream financial services firms have taken limited steps into the market, and a small derivatives market has developed. At the same time, there is growing evidence that cryptoassets are causing harm to consumers.
- 1.4** As a result, the Government launched the Cryptoassets Taskforce ('the Taskforce'), consisting of HM Treasury, the FCA and the Bank of England in March 2018. The Taskforce's final report (the '[CATF Report](#)') was published in October 2018. It set out the UK's policy and regulatory approach to cryptoassets and made a number of commitments.
- 1.5** This consultation fulfils our commitment in the CATF Report to consult on a potential prohibition of the sale to retail consumers<sup>1</sup> of derivatives that reference certain types of cryptoassets. As the CATF Report found, we consider that retail consumers cannot reliably assess the value and risks of derivatives and exchange traded products that reference certain cryptoassets. This is due to the:
- nature of the underlying assets, which have no inherent value and so differ from other assets that have physical uses, promise future cash flows or are legally accepted as money
  - presence of market abuse and financial crime (including cyberthefts from cryptoasset platforms) in the secondary market for cryptoassets
  - extreme volatility in cryptoasset prices, and
  - inadequate understanding by retail consumers of cryptoassets and the lack of a clear investment need for investment products referencing them
- 1.6** We think these issues have and will cause retail consumers harm from potentially sudden and unexpected losses if they purchase these products. We are consulting on banning the sale, marketing and distribution of derivatives (ie contracts for difference, options and futures) and exchange traded notes (ETNs) that reference certain types

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1 References to retail consumers should be read as retail clients according to COBS 3.4

of cryptoassets to all retail consumers by firms in, or from, the UK.<sup>2</sup> We give our definitions of cryptoassets in Chapter 2.

## Who this applies to

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- 1.7** This consultation will be particularly relevant for:
- firms issuing or creating products referencing cryptoassets
  - firms distributing products referencing cryptoassets, including brokers and investment platforms, and financial advisers
  - firms marketing products referencing cryptoassets
  - operators of trading venues and platforms
  - retail consumers and consumer organisations

- 1.8** This is not a complete list, and it is likely that the consultation will be relevant to additional stakeholders, both regulated and unregulated.

## What we want to change

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- 1.9** This CP consults on rules to ban the sale, marketing and distribution of derivatives and ETNs that reference certain types of unregulated, transferable cryptoasset to all retail clients by firms in, or from, the UK.

- 1.10** We are not proposing to extend a ban to:
- professional or eligible counterparty clients
  - derivatives or ETNs that reference other tokens (see further definitions and discussion on scope in Chapter 3), or
  - collective investment undertakings (funds)

## Unintended consequences of our intervention

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- 1.11** We recognise that our proposals may encourage some retail consumers to 'invest' directly in unregulated tokens. We do not consider these forms of tokens to be appropriate investments for retail consumers, and will continue to warn consumers about them through our [ScamSmart](#) pages. The potential risk of retail consumers investing directly in unregulated tokens does not alter our proposals to ban those products within our regulatory remit which we assess as harmful to investors. We must act in line with our objectives and protect consumers from harmful regulated activities and investments within our perimeter.

- 1.12** The proposed scope of our ban could result in firms trying to avoid it, for example by offering derivatives and ETNs referencing other tokens, or encouraging retail clients to 'opt up' to professional client status or move their accounts to affiliated non-UK entities.

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<sup>2</sup> Our draft rules refer to 'cryptoasset derivative' and 'cryptoasset exchange traded note'

- 1.13** We will continue to monitor the risks that retail clients are inappropriately 'opted up'. We will work with international regulators to monitor the risks of firms seeking to move UK clients to entities outside the EU to circumvent our measures. We will also remind firms of their existing obligations, including the client's best interests rule, client categorisation rules, and product governance obligations. Where we see firms not complying with our rules, we will consider taking action using our supervisory and enforcement powers.
- 1.14** Our proposals may create a small risk that the value of existing holdings of investment products referencing cryptoassets is reduced, which could cause consumer loss. However, the CATF Report committed to exploring a ban, so this risk may already be reflected in the value of such products. If we proceed with a ban, we will allow an appropriate implementation period and engage with firms to ensure they treat customers fairly during the transition. We would also allow retail consumers with existing holdings to remain invested following a possible ban until they choose to disinvest, so would not require or expect firms to immediately close clients' positions.

## Outcome we are seeking

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- 1.15** We are seeking to reduce the harm to retail consumers caused by the sale of derivatives and ETNs referencing unregulated transferable cryptoassets. Based on our cost benefit analysis (CBA), we estimate a ban on their sale, marketing and distribution to retail consumers could reduce consumer losses by between £75m and £234.3m.

## How it links to our objectives

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- 1.16** This proposed ban is primarily focused on our operational objective to ensure appropriate consumer protection. It is also relevant to our market integrity objective. Chapter 3 sets out our detailed justification for our proposals.

## Equality and diversity considerations

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- 1.17** We have considered the potential equality and diversity issues from our proposals.
- 1.18** Based on our initial assessment, we do not consider that the proposals adversely impact any of the groups with protected characteristics under the Equality Act 2010. However, we welcome any feedback on any diversity implications from our proposals in response to this CP.

## Next steps

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- 1.19** We welcome feedback on our proposal by 3 October 2019. We will consider all feedback and, subject to the responses received, we will seek to publish a final policy statement and final Handbook rules as soon as possible after that, in early 2020.

**1.20** Use the online response form on our [website](#).

### **Implications of EU withdrawal**

**1.21** In March 2018, the UK Government and the EU reached agreement on the terms of an implementation (or transitional) period following the UK's withdrawal from the EU.

**1.22** The implementation period is intended to operate from the date that the UK leaves the EU until at least the end of December 2020. During this time, EU law would still apply in the UK, in accordance with the overall withdrawal agreement. This means that firms, funds and trading venues would continue to benefit from passporting between the UK and the European Economic Area (EEA) as they do today. Obligations derived from EU law would continue to apply and firms would have to continue to implement EU legislation that is still to come into effect before the end of December 2020.

**1.23** However, the implementation period forms part of the withdrawal agreement, which has not been ratified by the UK parliament. We continue to work to ensure the UK's legal and regulatory framework functions in all scenarios. These measures are likely to apply under Article 42 of the [Markets in Financial Instruments Regulation \(MiFIR\)](#) or the equivalent 'on-shored' MiFIR legislation in combination with FSMA.

## 2 The wider context

**2.1** This chapter describes the UK market for investment products referencing cryptoassets, our concerns about the actual and potential harms to investors in this market and our current domestic initiatives to address them. We also describe wider international regulatory actions on derivatives and other investment products referencing cryptoassets.

### Domestic developments

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**2.2** In October 2018, the Taskforce published the CATF Report outlining the UK's policy and regulatory approach to cryptoassets and DLT. The Report assessed the risks and potential benefits of cryptoassets, identified potential harms, and detailed the different activities that should be assessed and considered for potential regulation. The CATF Report committed to:

- mitigating the risks that cryptoassets pose to consumers and market integrity
- preventing the use of cryptoassets for illicit activity by bringing relevant firms into anti-money laundering (AML) and counter-terrorist financing (CTF) regulation
- guarding against potential, emerging threats to financial stability
- encouraging responsible development of legitimate DLT and cryptoasset-related activity in the UK

**2.3** HM Treasury committed to further work on cryptoassets, including for example:

- transposing the EU Fifth Anti-Money Laundering Directive (5AMLD) and broadening the scope of AML/CTF regulation
- consulting on cryptoassets currently outside the perimeter

**2.4** In the CATF Report we committed to consult on:

- a potential ban on the sale to retail consumers of derivatives referencing certain types of cryptoassets (for example, exchange tokens), including CFDs, options, futures and transferable securities. This CP is the response to this commitment.
- guidance clarifying what types of cryptoassets already fall within our current regulatory perimeter; we published a consultation on proposed [Guidance on Cryptoassets](#) in January 2019.

**2.5** Our Guidance on Cryptoassets CP focused on where activities relating to different types of cryptoassets do, or do not, come into our regulatory perimeter. We set out our views on where cryptoassets would be considered 'Specified Investments' under the Regulated Activities Order (RAO), 'Financial Instruments' under MiFID II, e-money under the E-Money Regulations (EMR), or if how they are used may be subject to the Payment Services Regulations (PSR).

**2.6** The Guidance on Cryptoassets CP described different types of cryptoassets and their common features. We use the same language in this CP:

- **Security tokens:** Tokens that meet the definition of a Specified Investment, like a share or a debt instrument, and fall within the regulatory perimeter. This will be determined by its intrinsic characteristics and the contractual rights and obligations the token-holder has, such as contractual entitlement to profit-share through dividends or ownership.
- **Exchange tokens:** Tokens that are not issued or backed by any central authority and are meant and designed to be used as a means of exchange. They are, usually, a decentralised tool for buying and selling goods and services without traditional intermediaries. Bitcoin is an example of such tokens. They do not currently fall within our regulatory perimeter.
- **Utility tokens:** These typically grant holders access to a current or prospective product or service, but do not give the same rights as those granted by Specified Investments. Utility tokens can also meet the definition of e-money in which case activities in relation to them may be within the regulatory perimeter.

**2.7** Tokens may have mixed features that may overlap with the above categories, or change over time. For example, Ether can be used as a means of 'payment' (exchange token) on the Ethereum platform, and can also be used to run applications (utility token). XRP has similar features.

**2.8** We have undertaken other work on cryptoassets and related investment products, including:

- in April 2017, we published a Discussion Paper on distributed ledger technology seeking views on the potential benefits and challenges of the underlying technology behind Initial Coin Offerings (ICOs), which are a digital way of raising funds from the public. We published a Feedback Statement summarising responses and our views in December 2017.
- we have issued several warnings on cryptoassets and related investment products, including warnings on the risks of investing in ICOs, cryptocurrency contracts for differences (CFDs) and cryptoassets investments scams.
- in a statement in April 2018, we outlined that derivatives referencing cryptoassets are likely to be Specified Investments under the Regulated Activities Order (RAO) and are capable of being financial instruments under the Markets in Financial Instruments Directive II (MiFID II). We explained that if firms are conducting specified activities involving these products, they must be authorised and comply with relevant FCA and EU rules.
- in December 2018, we consulted on restricting CFD products sold to retail clients by firms in, or from, the UK. This included a proposal to introduce 2:1 leverage limits for CFDs and CFD-like products referencing cryptocurrencies. Cryptocurrencies under ESMA's definition are equivalent to exchange tokens under our taxonomy in our Guidance on Cryptoassets. Our measures were similar to the European Securities and Markets Authority's (ESMA) temporary product intervention measures restricting the sale of CFDs to retail consumers across the EU because of significant investor protection concerns. We have finalised these rules with PS19/18, but they may change following the outcome of this CP on a potential ban.
- in March 2019, we published the findings of two pieces of complementary research from third parties to gauge UK retail consumers' understanding of, and attitude towards, cryptoassets. It suggests that, although the scale of harm in the UK is smaller than we originally estimated, many UK consumers see cryptoassets as a

fast-track to easy wealth, while not fully understanding what they are buying. They often distrust mainstream media or official sources of information, undermining the effectiveness of our risk warnings about these products.

**2.9** We have actively reviewed and assessed reports of potential unauthorised activity involving cryptoassets. In 2019, our Unauthorised Business Department (UBD) has published 13 individual warnings about unauthorised firms involved in cryptoassets. As of June 2019, we also have 10 ongoing investigations into firms involved in cryptoassets.

**2.10** Our supervision work has also focused on CFDs referencing cryptoassets over the past 18 months. This found several concerns which these proposals aim to address, including that:

- firms were offering high leverage (before ESMA's temporary intervention measures – see below)
- prices offered by different providers show large variations in spreads between 'bid' and 'offer' prices, with even the best prices representing a relatively wide spread, which are a significant trading cost for customers
- some firms were charging excessive overnight funding costs and we observed considerable variations in charges, with even the more competitive rates significantly reducing client returns
- we found that cryptoasset CFDs were attracting large numbers of younger and inexperienced CFD investors, causing concerns that exposure to complex leveraged derivatives in such volatile assets was not appropriate for them

## European and international developments

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### European developments

**2.11** Following a request from the European Commission, in January 2019, both ESMA and the European Banking Authority (EBA) published advice to the European Commission, Council and Parliament on ICOs and cryptoassets. ESMA's Advice clarified the existing EU rules that apply to cryptoassets that qualify as financial instruments. It also gave ESMA's view on any gaps and issues in the EU financial regulatory framework for policymakers to consider.

**2.12** Before this work, ESMA also intervened in 2018 to impose temporary restrictions on selling, marketing and distributing CFDs to retail clients because of significant concerns about investor protection across the EU. While ESMA decided to impose leverage limits and other restrictions, rather than ban these products for retail clients, it stated in its first Decision Notice that:

CFDs with cryptocurrencies as an underlying raise separate and significant concerns. Cryptocurrencies are a relatively immature asset class that pose major risks for investors [due to the specific characteristics of cryptocurrencies] ... retail clients typically do not understand the risks involved when speculating on an extremely volatile and relatively immature asset class, which are exacerbated by trading on margin, as it requires clients to react in a very short time period.

**2.13** ESMA also published a report on DLT Applied to Securities Markets in February 2017 and issued warnings and statements during 2017 and 2018 about the risks of investing in cryptoassets. It cited significant investor protection risks from cryptoassets, including that they lack price transparency, display extreme volatility and are unsuitable for most purposes, including investment or retirement planning.

### International developments

**2.14** In a letter to G20 Finance Ministers and Central Bank Governors in March 2018, the Financial Stability Board (FSB) Chair Mark Carney noted that, as cryptoassets are currently small compared to the size of the overall financial system, they do not currently pose risks to global financial stability. The letter also explained that cryptoassets pose significant investor protection issues and financial crime risks, while recognising that the underlying technologies can potentially make the financial system and wider economy more efficient and inclusive.

**2.15** The FSB acknowledged that the cryptoasset market is evolving rapidly and requires continuous oversight. In 2018 it published reports, in July and October, outlining its monitoring framework of the potential risks affecting financial stability, regulatory approaches and communications.

**2.16** In its 2019 work program the Board of the International Organisation of Securities Commissions (IOSCO) identified cryptoassets among its 5 priorities. This is due to emerging concerns about trading, custody and settlement, accounting, valuation, and intermediation as well as investment funds' exposure to cryptoassets. In 2019, IOSCO will focus on how platforms that trade cryptoassets are regulated and will also examine regulation of investment funds with exposures to cryptoassets.

**2.17** Individual international regulators are also adopting or exploring new approaches to cryptoassets and related products. The table below summarises the most relevant developments on derivatives and other investment products referencing cryptoassets.

Country	Actions
USA	<ul style="list-style-type: none"> <li>• To date, the Securities and Exchanges Commission (SEC) has refused to approve applications to list exchange-traded products on US exchanges or mutual funds that invest in, or offer exposure to, cryptocurrencies.</li> <li>• Two Bitcoin futures contracts were self-certified by two US commodity derivative exchanges on 1 December 2017. Subsequently, one of the exchanges has <u>indicated</u> it will cease issuing new contracts beyond June 2019</li> <li>• Both the SEC and US Commodities and Futures Trading Commission (CFTC) have taken enforcement actions and imposed trading suspension in relation to unregistered or fraudulent ICOs and cryptoassets.</li> <li>• In September 2018, the Office of the New York State Attorney General published a report on cryptoasset trading platforms (<u>Virtual Markets Integrity Initiative Report</u>). It identified 3 main concerns: <ul style="list-style-type: none"> <li>(i) Trading platforms that perform a number of different and potentially conflicting roles create potentially significant conflicts of interest.</li> <li>(ii) Platforms have still not implemented effective controls to monitor the fairness and integrity of trading and price formation, and</li> <li>(iii) Protections for customer funds are often limited or misleading.</li> </ul> </li> </ul>

Country	Actions
Japan	<ul style="list-style-type: none"> <li>The Japanese Financial Services Agency (JFSA) published a draft report in December 2018 suggesting that crypto-referenced derivatives should be subject to registration requirements, similar to other derivatives transactions, and certain additional measures.</li> <li>These include minimum margin requirements (leverage limits), a suitability test and an appropriate explanation of risks to consumers.</li> </ul>
Hong Kong	<ul style="list-style-type: none"> <li>In November 2018, the Hong Kong Securities and Futures Commission (SFC) issued a statement that included a ban on retail investors accessing cryptoassets funds.</li> <li>The Hong Kong SFC noted that 'virtual assets' present various risks, including that they have no intrinsic value, their prices are short-term and volatile by nature, they are prone to cyber-attacks and do not operate under a set of recognised and transparent rules.</li> </ul>
China	<ul style="list-style-type: none"> <li>The People's Bank of China (PBoC) ordered the closure of all cryptocurrency exchanges and made all ICOs illegal in September 2017.</li> <li>In January 2018, PBoC ordered financial institutions to stop providing funding to any activity related to cryptocurrencies. Prior to this, Chinese-based exchanges Binance, OKex, Huobi were reportedly the top 3 crypto exchanges in the world with over \$1 billion in daily trading volume. Shortly after, the Chinese government blocked all overseas websites related to cryptocurrency trading and ICOs.</li> </ul>

## The harm we are trying to address

**2.18** Firms that sell, market and/or distribute derivatives and ETNs referencing certain cryptoassets in or from the UK to retail consumers could lead to the following harms:

- consumers being mis-sold or buying unsuitable products: Retail clients invest in products they are unable to value, and experience extreme volatility. This could result in sudden and large losses; and
- consumers' confidence and participation is threatened by unacceptable conduct such as market abuse, unreliable performance or by disorderly failure. market integrity, confidence and the orderly functioning of markets in derivatives and ETNs can be damaged by financial crime, market abuse and operational risk in the underlying cryptoasset market.

**2.19** In terms of the scale of the UK market, CFDs are the main derivative product that reference cryptoassets. Based on figures obtained from firms, between August to October 2017, there was c £3.4bn in retail client trading volume, representing 0.7% of total retail CFD trading volumes. This fell to £77m in the same three months in 2018. The decline in trading volumes is partly linked to the introduction of ESMA's temporary intervention measures restricting leverage to 2:1 from 1 August 2018, as well as a significant decline in the price of cryptoassets during this period.

**2.20** Two UK firms offer futures contracts on exchange tokens versus US Dollar. They reported having just over 13,000 retail clients trading these products monthly between June 2017 and December 2018.

**2.21** Leveraged derivatives increase the risk of loss, since leverage increases both the impact of price volatility and losses from product fees levied based on the underlying exposure.

- 2.22** Finally, two firms offer retail clients access to ETNs on exchange tokens that are listed on the Nordic Nasdaq. They reported c.11,000 clients with c.£97m invested as of the end of January 2019 and 30 December 2018 respectively.
- 2.23** Chapter 3 gives our full analysis on drivers of harm. Annex 2 assesses the costs and benefits of our proposals.

## 3 Our Policy Proposals

- 3.1** This Chapter discusses our proposals to permanently ban the sale, marketing and distribution of derivatives and ETNs referencing unregulated transferable cryptoassets to retail consumers by firms in, or from, the UK.

### Overview

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- 3.2** We are proposing to ban the sale, marketing and distribution to retail clients of derivatives and ETNs referencing unregulated transferable cryptoassets. We will refer to these products collectively as 'crypto-derivatives' in the remainder of this paper. These measures will be applied under Article 42 of MiFIR.
- 3.3** Where our measures go beyond the MiFIR power, we will use our rule-making power under FSMA. After the UK exits the EU we would expect to make the rules using a combination of our powers under the onshored version of MiFIR, and Financial Services and Markets Act 2000 (FSMA), as appropriate. When using these powers, we are required to meet a series of tests to help us to consider whether our intervention is proportionate to the harm we have identified. We set out our thinking below.

### Why we are intervening

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- 3.4** We have considered the factors in Article 42 of MiFIR and Article 21 of the MiFIR Delegated Regulation. We consider we need to intervene in the sale, marketing and distribution of derivatives and ETNs referencing unregulated transferable cryptoassets to protect retail clients,<sup>3</sup> due to the:
- complexity of the underlying assets and the lack of transparency around their valuation, which directly affects retail consumers' ability to value the related investment product. Our analysis shows that retail consumers cannot reasonably assess the value and expected returns of crypto-derivatives because there are no reliable methods to establish a fair value or price for the underlying tokens. Such tokens have no inherent value, and so differ from other assets that have physical uses, promise future cash flows or are legally accepted as money. They are opaque, complex and unreliable as reference assets for investment products.<sup>4</sup>
  - retail consumers' lack of knowledge and understanding. Our analysis shows that retail consumers do not, in general, have sufficient understanding of the nature and risks of cryptoassets to make an informed decision to invest in these products.<sup>5</sup>
  - the particular product features, including leverage and volatility of the underlying assets. Our analysis shows that token prices are volatile which makes the value of retail consumers' investments extremely volatile. Volatility will be greater if a product is leveraged.<sup>6</sup>

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3 Article 42(2)(a)(i) of MiFIR.

4 Article 21 (2)(d), (e) and (l) of the MiFIR Delegated Regulation

5 Article 21 (2)(c), (d) and (l) of the MiFIR Delegated Regulation

6 Article 21 (2)(e) of the MiFIR Delegated Regulation

- disparity between consumers' expected return and the actual risk of loss. Our analysis shows that retail consumers may suffer sudden, large losses from their investments exacerbated by the widespread financial crime, market abuse and operational risks affecting the underlying market. This includes cyber thefts from exchanges and abusive trading practices (such as pump and dump schemes<sup>7</sup>), and potential 'hard fork' events (when a token splits in two<sup>8</sup>).<sup>9</sup>
- lack of transparency of, and potentially significant impact on returns from, costs and charges.<sup>10</sup> Retail consumers will be subject to additional risks, such as costs and charges that may be high and/or have a complex impact on the likely returns from a product over time, and the lack of a clear 'investment need' addressed by these products.<sup>11</sup>

**3.5** We do not consider that existing regulatory requirements, including product governance, appropriateness and disclosure requirements, can sufficiently address our concerns about the harm posed by these products. We do not consider that supervision or enforcement of existing requirements can better address our concerns and the risk of harm to consumers.<sup>12</sup>

**3.6** We consider our proposals to be proportionate to the seriousness of the risk of consumer harm, having considered the likely effect on investors and market participants.<sup>13</sup> The inherent risks of the product make it difficult for any retail consumers to make informed investment decisions, regardless of how these products are sold, marketed or distributed. We have seen evidence, which is outlined in the CBA, that this has led to poor client outcomes.<sup>14</sup>

**3.7** We will consult with national competent authorities (NCAs) in other Member States that might be significantly affected by our proposals during this consultation period. We have identified CFD firms regulated by the Cyprus Securities and Exchange Commission (CySEC) as most commonly selling products referencing cryptoassets on a cross-border in to the UK. We have sought data from CySEC to assess the impact of our measures. Our initial assessment, however, is that we do not expect our measures to have a discriminatory effect on services or activities provided from another Member State.<sup>15</sup> We will also comply with the notification requirements under MiFIR.<sup>16</sup> Overall, we consider the impact of our proposal on firms in other EEA jurisdictions who may sell these products into the UK will be low due to the relatively limited demand from UK retail consumers.

7 In general terms, such schemes involve participants taking a long position in a qualifying investment and then disseminating misleading positive information about the qualifying investment with a view to increasing its price. A definition can be found in the Market Abuse Regulation (MAR) Commission Delegated Regulation EU/2016/522, in Annex 2 Section 1, paragraph 4(c).

8 A hard fork splits the blockchain into two separate chains. Both chains inherit all previous transactions and, after the fork, each version will have its own unique transaction history. It can in some cases create a new cryptoasset.

9 Article 21 (2)(a), (b) and (v) of the MiFIR Delegated Regulation

10 Article 21 (2)(a)(b)(c)(e)(d)(f)(h) of the MiFIR Delegated Regulation

11 Article 21 (2)(c), (f), (g), (h) and (i) of the MiFIR Delegated Regulation

12 Article 42(2)(b)(i) of MiFIR.

13 Article 42(2)(c) of MiFIR.

14 Article 42(2)(c) of MiFIR.

15 Article 42(2)(d)(e) of MiFIR.

16 Article 42(3) of MiFIR

## Justification for our proposals

**3.8** This section sets out our analysis under each of the topics identified in paragraph 3.4 above.

### a) Valuation and price formation

**3.9** We have found that firms manufacturing, and consumers seeking to invest in, crypto-derivatives are unable to reliably value the underlying cryptoassets. This makes it impossible to reliably value the derivatives contracts or ETNs linked to them. Consumers therefore cannot make informed decisions about the value of their investment and face significant risk of harm as they cannot accurately assess their risk of loss, or possible rate of return.

**3.10** This lack of reliable models for valuations contrasts with other 'high risk' asset classes where values might be volatile, but credible valuations can be constructed based on assumptions about dividends/coupons, or use of materials in production or consumption. For exchange tokens, prices are driven by speculation about future supply and demand for the token, rather than by any underlying value. They promise no future cash flow and have no physical use.

**3.11** Despite this, exchange tokens would arguably have 'value' if they could be widely exchanged for other assets or goods. However, they fail to meet the tests of money (reliable store of value, wide acceptance and a unit of account) and are not legally recognised currencies, which the Bank of England has also stated.

**3.12** As Table 1 shows, without a more objective valuation basis, 2 analysts using the same pricing model arrived at Bitcoin valuations with a 400x difference. This helps demonstrate that value is difficult to calculate for exchange tokens. Even if the supply of one such exchange token is genuinely limited, the supply of others is potentially infinite and they are substitutable, implying that the value of any single such currency will fall to zero over time.

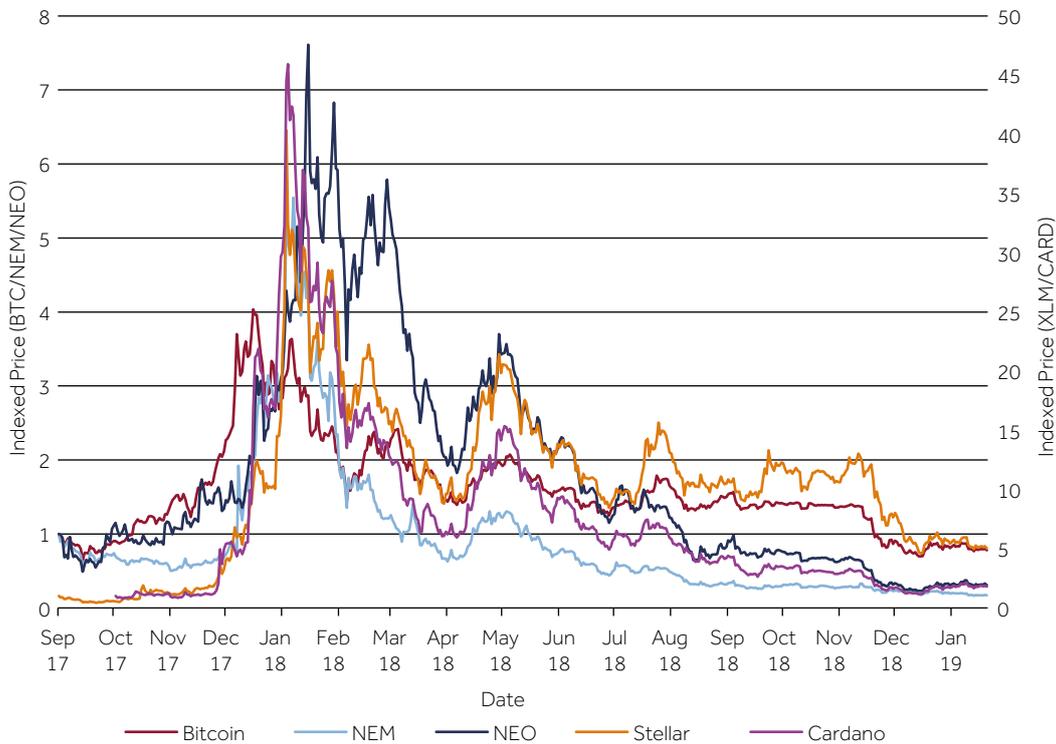
**Table 1: Valuation modelling of Bitcoin (£) in US Dollars (\$)**

Input	Jackman & Savouri	Coinsquare
Currency supply (M)	15,000,000	17,000,000
Velocity (V)	4	11
Value of purchases (P)	1,200,000,000	1,500,000,000,000
<b>Price (Y)</b>	<b>\$20 /£1</b>	<b>\$8,021 /£1</b>

**3.13** Many utility tokens are also designed to act as a medium of exchange or, where their 'utility' is not yet accessible, operate as such on the 'secondary markets' for tokens. For these tokens, we see a strong price correlation with exchange tokens (our analysis used Bitcoin as arguably the best-known exchange token). We have therefore seen similar valuation challenges for many utility tokens, and have assessed them alongside exchange tokens. We seek to capture both tokens in our rules under the term 'unregulated transferable cryptoassets'.

**3.14** We have examined a range of tokens to assess the correlation in price movements across cryptoassets (shown in the 3 price bubbles in Chart 4). The peaks and troughs of price of each token are highly correlated. This suggests that these markets are not driven by external factors such as usage or technological developments, but instead are driven by speculation, akin to gambling.

**Chart 1: Comparison of the price of Bitcoin against other tokens**



**3.15** To support our price formation analysis, we conducted a 'noise analysis' using the search trends of Bitcoin and Ether as a proxy for retail consumers' interest in cryptoassets. Chart 2 shows a strong correlation between the price rise of cryptoassets and the number of Google searches for these cryptoassets. Our analysis also suggests that tweets from 'influencers' on social media may also routinely affect sentiment and pricing.

**Chart 2: Bitcoin (BTC) and Ether (ETH) Price and relative Google Mentions (GM)**



**3.16** During November and December 2017, a feedback loop appears to have emerged, temporarily creating exponential growth in the value of cryptoassets. This loop

appears to have been purely speculative (an 'investment mania' as the Financial Times called it), where price increases and reports of gains encouraged more retail participation.

**3.17** Cryptoasset valuations may not reliably take account of the potential risk of a hard fork event (where a single token splits into two), particularly if the process by which this could happen is opaque, difficult to understand or unpredictable, and undermines the original token value. Hard forks have led to significant price volatility, and in some cases sharp devaluations, both in the run up to a potential fork and once it has occurred (eg Bitcoin Cash hard fork in November 2018). This would directly impact the value of a derivative contract or ETN referencing that cryptoasset.

### **b) Risks from financial crime, market abuse and operational issues**

**3.18** The integrity and confidence in the cryptoasset market also affects retail clients holding crypto-derivatives. This is because their products' value is directly affected by any sudden devaluation or price dislocation in exchange or utility token prices.

**3.19** Market immaturity (including cryptoasset platforms' systems and controls), lack of transparency and absence of comprehensive market oversight in underlying cryptoasset markets means there are significant risks (see the VMII Report) from financial crime (including cyber-attacks), market abuse, and operational risks (as raised in the Financial Action Task Force Report).

**3.20** We have seen high volatility and price movements occurring after incidents of financial crime and market abuse. This includes the hacking of the Bitstamp exchange (January 2015). More than USD 950 million cryptoassets were stolen from cryptocurrency exchanges and infrastructure during 2018, which is 3.6 times higher than 2017. Sudden de-valuations of tokens caused by manipulative practices or thefts in turn leads to sudden losses in any product linked to its value.

**3.21** Recent Press reports from December 2018 indicate that individuals are orchestrating 'pump and dump' schemes for cryptoassets. This is done by synchronising the purchase of a selected cryptoasset (using messaging services such as Telegram) to push prices up before selling at a profit. Remaining consumers are left with a devalued and often illiquid cryptoasset. Actors with large holdings, especially in the more illiquid cryptoassets, may also use their dominant position to influence the price.

**3.22** The potential use of cryptoassets for money laundering is also a concern. Europol estimates that £3bn to £4bn is laundered using cryptoassets each year in Europe. This remains a small proportion of estimated total funds laundered in Europe, which stands at £100bn, but nevertheless remains a concern.

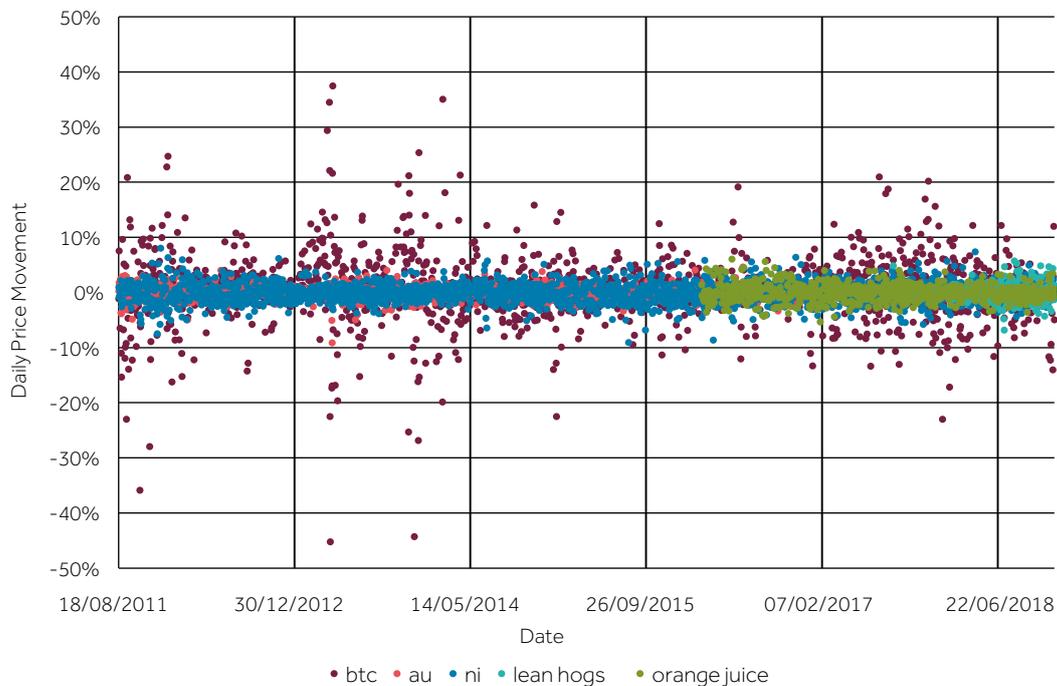
**3.23** The Treasury are introducing a domestic AML regime for certain cryptoassets activities by 10 January 2020 as part of implementing the Fifth Anti-Money Laundering Directive ('5AMLD'), which brings 'providers of exchange services between virtual currencies and fiat currencies, and custodian wallet providers into the scope of obliged entities'. While 5AMLD will help reduce money laundering risks associated with the anonymity of cryptoassets, it will not mitigate other financial crime risks such as abusive trading or cyber-thefts in relation to unregulated tokens.

### c) Extreme Volatility

**3.24** Extreme volatility and price dislocation in an underlying asset will affect the scale and speed of client losses from a derivative, for example, if consumers are unable to quickly close a long, open position in falling markets. Our CFD analysis has also shown that the frequency of trading increases with leverage and volatility, and amplifies aggregate losses due to trading costs. Volatility is also exacerbated by market abuse, especially in the forms of pump and dump schemes which drive up and then crash prices.

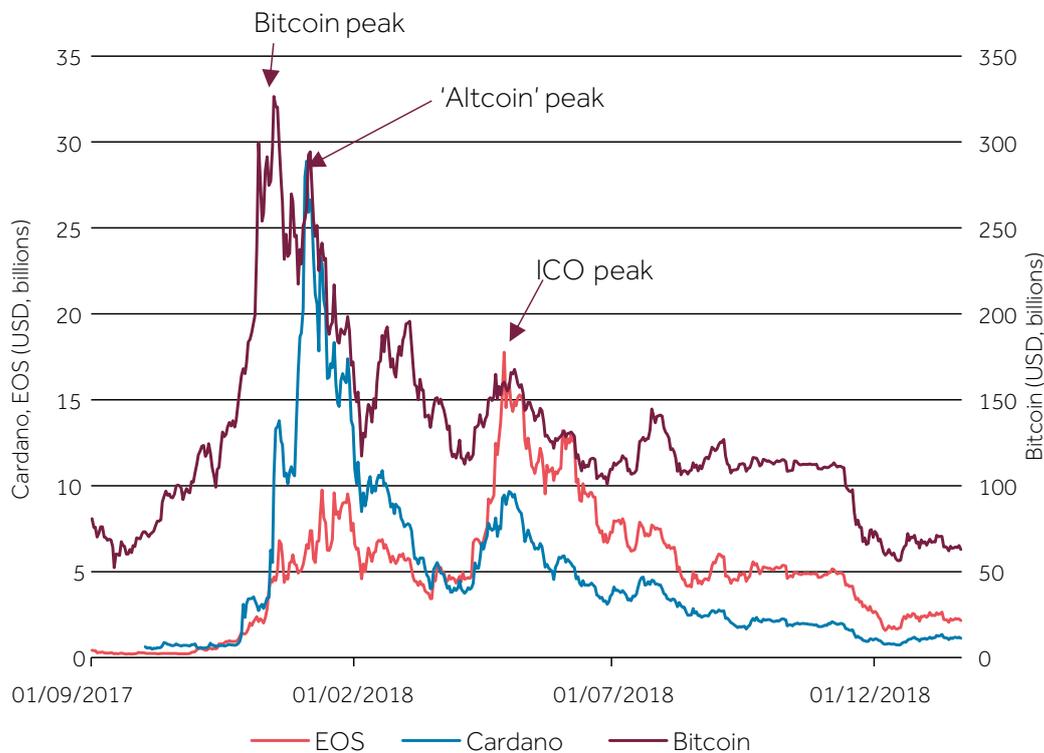
**3.25** We compared the volatility of Bitcoin with a sample of volatile commodities. We found that Bitcoin is on average 4 times more volatile than lean hogs and orange juice (relatively volatile commodities) and that the maximum daily price change is 10 times higher. In comparison to gold, Bitcoin’s mean and maximum price changes are 5 ½, and 7 ½ times higher, respectively. Volatility would be further exacerbated if a derivative is leveraged.

**Chart 3 – The day to day volatility of Bitcoin (BTC) compared to gold (AU), nickel (NI), lean hogs and orange juice**



**3.26** We explain above that the price of cryptoassets appears to be largely driven by speculation. Chart 4 shows 3 bubbles that we have identified through the price of 3 different cryptoassets: EOS, Cardano and Bitcoin.

**Chart 4: Comparison of market capitalisation changes in selected cryptoassets**

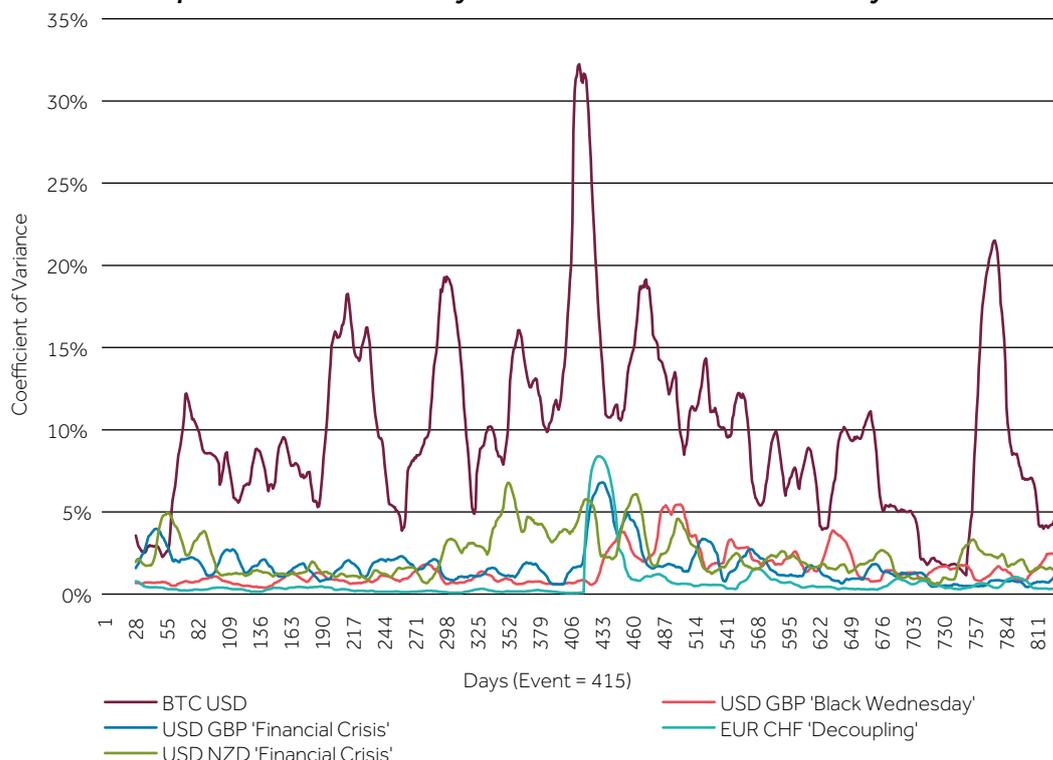


**3.27** Bitcoin also shows greater volatility than foreign currency pairs, and its volatility around its price peak was significantly greater than price movements during other exceptional market events for certain currencies. For example, British pound sterling (GBP) against US dollar (USD) on 'Black Wednesday', 16 September 1992, Swiss franc (CHF) versus the euro after its de-pegging by the Swiss National Bank on 15 January 2015, and USD/New Zealand dollar during the financial crisis from July 2008. We examined price changes 400 days before and after an exceptional pricing event.

**3.28** When comparing the coefficient variation<sup>17</sup> of Bitcoin around its peak to exceptional volatility events occurring in FX pairs (Chart 5), the latter are still well below the trend volatility for Bitcoin /USD (BTC/USD).

<sup>17</sup> The coefficient of variation (CV) is a measure of relative variability. It is the ratio of the standard deviation to the mean (average) and is used as a measure of probability distribution or frequency distribution.

**Chart 5: Comparison of the volatility of Bitcoin and selected currency crises**



**3.29** We have observed short periods of high volatility in other assets, including equities, but this normally occurs only over a short period. Cryptoassets appear atypical compared with other assets as they show more extreme volatility over a longer duration. We also compared the volatility of Bitcoin with a sample of utility tokens, which shows that most utility tokens experience even higher volatility than Bitcoin. For example, between September 2017 to February 2019, the daily mean price change for Bitcoin was 3.3%, whereas for Cardano (a utility token) it was 5.9%. The highest daily price movement for Cardano was 58% compared to 23% for Bitcoin.

**3.30** A lack of liquidity may also exacerbate volatility. Table 2 shows the spread between the maximum and minimum highest traded prices on Bitcoin across a selection of exchanges from 10 to 24 December 2017, when Bitcoin reached its historical price peak. Unlike other assets, the price of Bitcoin diverged across different venues, with high variance.<sup>18</sup> Such wide price dispersion on an interchangeable asset indicates that cryptoassets markets are inefficient and illiquid. This means a derivative or ETN cannot be assured of a reasonably reliable reference price.

**Table 2: Differences in bitcoin prices across exchanges, 10/12/17 to 23/12/17 (Source: Bitcoincharts.com)**

Date	10/12	11/12	12/12	13/12	14/12	15/12	16/12
Spread (\$)	2,665.12	1,567.89	892.97	850	1,179.00	1,704.65	2,034.98
Date	17/12	18/12	19/12	20/12	21/12	22/12	23/12
Spread (\$)	2,068.69	1,771.21	2,083.96	1,518.83	1,827.99	3,248.0	3,131.63

<sup>18</sup> Academic studies show prices of listed equity shares traded across multiple venues converge towards a mean (see eg Buckle et al, 'The impact of multilateral trading facilities on price discovery', 11 July 2018). In decentralised currency (FX) markets, we observe hundreds of slightly different prices across venues, but within very small price increments

## d) UK consumers' understanding of cryptoassets

- 3.31** Limited understanding among UK consumers of the underlying cryptoasset market, as well as the complex nature of derivatives, can further exacerbate the above risks and make crypto-derivatives unsuitable for retail consumers.
- 3.32** We issued a consumer warning about the risk of investing in CFDs referencing cryptoassets in November 2017. Despite this, FCA-commissioned research suggests that UK consumers perceive cryptoassets as a shortcut to easy money, while also over-estimating their knowledge of cryptoassets and the underlying technology. 'Fear of missing out' and influence from social media were given as common reasons for investing. UK consumers investing in crypto-derivatives therefore risk substantial losses due to their lack of understanding of the inherent product risks.

## e) Other risks

- 3.33** Our work on CFDs showed that trading costs significantly affect returns, especially where clients trade frequently. Higher costs will increase the likelihood of negative returns over time. We see that some derivatives and ETNs referencing exchange tokens have relatively high costs and charges. From our supervisory work, we have seen much higher spreads and /or financing costs for CFDs on cryptoassets compared with CFDs on more traditional underlying assets. Meanwhile, 8 ETNs listed on the Nordic Nasdaq market places have ongoing costs of 2.5% per annum (see Key information documents).
- 3.34** Relatively high fees reflect the degree of market risk and costs associated with the firms' proprietary hedging or purchasing of cryptoassets to support clients' exposures provided by these products. It will, however, further reduce the likelihood of retail consumers achieving positive returns over time, especially if they trade frequently.
- 3.35** A further risk is that allowing a retail crypto-derivative market to grow creates a perception among retail consumers that these are suitable or appropriate investments. In our view, these products do not meet a legitimate investment need and are not widely used for hedging purposes. Instead, retail consumers use them for purely speculative purposes. This risk may be increased by investors' limited understanding of cryptoassets. Our research found that consumer perceptions were equally split between whether they view investment relating to cryptoassets as akin to a 'bet' or an investment ('Cryptoassets: Ownership and attitudes in the UK').

**Q1: Do you agree with our analysis of the key risks and harm posed by these products? Is there any additional evidence or factors that we should consider?**

## Scope: what we are covering

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- 3.36** We propose to prohibit the sale, marketing and distribution to retail clients of all derivatives referencing unregulated cryptoassets that allow transferability (ie can be widely exchanged on cryptoasset platforms or other forum). We intend the scope

of derivatives to cover CFDs,<sup>19</sup> futures<sup>20</sup> and options<sup>21</sup> as defined in the Regulated Activities Order (RAO). 'Referencing' tokens should be taken to include derivatives that use an index or benchmark price for tokens within the contract, as well as those using a single price from a cryptoasset trading platform.

- 3.37** While CFDs are currently offered most widely, we have seen limited offerings of futures contracts on tokens. We believe such product offerings could grow, and that futures contracts based on tokens represent the same risks of harm to retail consumers as CFDs. We are not currently aware of options on cryptoassets offered in the UK. However, we propose that the ban applies to these products pre-emptively as, if they became available, they would present similar risks to cryptoasset-referenced CFDs and futures. Retail consumers will be unable to value options properly due to the lack of reliable valuation methodologies for underlying tokens.
- 3.38** We also propose to include ETNs. ETNs are structured products whose returns track the performance of a specific asset, index or other benchmark. In some cases, an ETN may be a debt instrument where an issuer uses a special purpose vehicle (SPV) to purchase underlying assets to the value of amounts invested by clients, and then issues notes whose redemption value reflects the value of assets purchased (less fees). We believe they pose similar risks to derivatives on tokens, and we have seen poor outcomes from the limited products currently available on EU trading venues. So, we are proposing to ban their sale to retail clients
- 3.39** We intend to capture products referencing tokens that are (i) not Specified Investments or e-money, (ii) are capable of being traded on or transferred through any platform or other forum, and (iii) is not limited to being transferred to its issuer or a network operator in exchange for a good or service.
- 3.40** We propose definitions as part of our draft Handbook instrument in Appendix 1 and welcome feedback as to whether this achieves our intention. We also outline our CBA for these proposals in Annex 2.
- 3.41** A ban would apply to products sold, distributed or marketed in or from the UK to retail clients. This would include banning sales to UK retail clients by other firms within the EEA, including where retail clients seek products via reverse solicitation. It would also prevent UK brokers or platforms marketing and distributing products available in other jurisdictions to UK retail clients. However, retail clients could still seek products from a third country firm via reverse solicitation.

**Q2: Do you agree with our proposal to prohibit the sale, marketing and distribution of CFDs, futures, options and ETNs referencing relevant cryptoassets to retail consumers?**

**Q3: Do you have any comments on the draft Handbook rules and definitions we propose to achieve our policy intention?**

19 A cash-settled derivative contract in which the parties to the contract seek to secure a profit or avoid a loss by agreeing to exchange the difference in price between the value of the cryptoasset CFD contract at its outset and at its termination. References to CFDs in this CP include references to CFDs, spread bets, and rolling spot forex contracts that qualify as MiFID financial instruments.

20 A derivative contract in which each party agrees to exchange cryptoasset at a future date and at a price agreed by both parties.

21 A contract which grants the beneficiary the right to acquire or dispose of cryptoassets.

**Q4: Do you have any comments on our CBA for these proposals as detailed in Annex 2?**

## Scope: What we are not covering

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### Exclusions in relation to tokens

- 3.42** We propose to exclude tokens that are unregulated but are not widely transferable. This would exclude, for example, tokens used on a private network where they can only be redeemed with the issuer and cannot be exchanged between third parties via platforms. We believe such tokens would, in any case, be an unlikely asset to base a derivative contract or investment product on.
- 3.43** Our proposed ban is not intended to cover derivatives that reference e-money tokens. This is because the E-Money Regulations would apply with its full suite of capital and safeguarding requirements (including for example redemption rights).
- 3.44** We do not intend to capture derivatives that reference security tokens. Such tokens are Specified Investments and do not pose the same risks as exchange and comparable utility tokens. They offer contractual rights or obligations (eg an entitlement to profit share), and so have a basis for their valuation. Security tokens that are transferable securities and offered to the public over a certain size may also be subject to the Prospectus Directive (or the Prospectus Regulation from 21 July 2019) and be listed on a regulated market, triggering additional regulatory obligations.
- 3.45** We are not aware of any derivatives on security tokens being offered in the UK. If firms were to consider offering these products in future, they would need to carefully consider their regulatory obligations, in particular on product governance.

**Q5: Do you agree with excluding derivatives on security tokens and tokens that meet the definition of e-money? If not, please explain why.**

### Exclusions in relation to funds

- 3.46** The CATF Report (page 43) stated that the FCA 'will not authorise or approve the listing of a transferable security or a fund that references exchange tokens (for example, exchange-traded funds) unless it has confidence in the integrity of the underlying market and that other regulatory criteria for funds authorisation are met.'
- 3.47** Mainstream authorised retail funds, namely Undertakings for Collective Investments in Transferable Securities (UCITS) schemes and non-UCITS retail schemes (NURS), cannot currently invest in unregulated cryptoassets directly, or in derivatives and ETNs referencing them. This is due to restrictions on the types of 'eligible' assets such funds can invest in.<sup>22</sup> That situation might change over time if the cryptoasset market evolves such that eligibility standards can be met.

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<sup>22</sup> UCITS schemes can invest in derivatives referencing an index if the index meets certain quality criteria, and similarly for an asset-backed security (ABS) – which would have to meet valuation and liquidity criteria to be eligible. At present, it is very unlikely an index or ABS referencing cryptoassets could meet those criteria.

**3.48** Qualified investor schemes (QIS) and unauthorised alternative investment funds (AIFs) could potentially invest in derivatives referencing unregulated tokens. Unauthorised AIFs could also invest in the tokens themselves if permitted by their investment mandate. However, QIS and unauthorised AIFs are subject to rules that restrict promotion of non-mainstream pooled investments to certified high net worth or sophisticated retail clients. We view the combination of existing restrictions on the promotion of unauthorised AIFs, the diversification of risk in a pooled fund structure and existing regulatory obligations on AIF managers, as sufficient to protect the limited subset of retail clients who can access them.

**3.49** So, we are not currently proposing any intervention for investment funds. We will continue to monitor developments and may reconsider if we see evidence of harm emerging.

**Q6: Do you agree with our proposed approach to funds? If not, please explain why.**

### Exclusion of non-retail clients

**3.50** The inherent risks of valuation, financial crime, market abuse and volatility affecting crypto-derivatives could pose similar harm to wholesale investors. However, we are not proposing to extend an intervention to professional clients or eligible counterparties (see our client categorisation rules in COBS 3).

**3.51** This is partly because the level of participation by institutional investors or wholesale firms in cryptoassets and crypto-derivatives is very limited. These clients may, in general, have greater understanding of the risks, and greater capacity to absorb potential investment losses.

**3.52** Firms providing these products must, however, carefully consider and assess whether the clients meet the relevant criteria to be treated as professional clients or eligible counterparties.

**Q7: Do you agree with our proposed scope to exclude non-retail consumers from the prohibition? If not, please explain why.**

### Other options that we have considered

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**3.53** We have considered other regulatory responses as an alternative to a ban on sales to retail clients, from less 'interventionist' options (eg 'do nothing' or provide further consumer warnings) to stronger remedies (eg prohibitions on marketing or sale to any client).

**3.54** We believe that any remedy other than a ban on the sale to retail clients would fall short of adequately reducing the harms to consumers and risks we have identified. We will continue to review crypto-derivatives and will reconsider our position if the fundamentals of the market change.

## Do nothing

- 3.55** A '**do nothing approach**' does not address the fundamental product flaws or address the significant harm to consumers posed by these products. Existing disclosure obligations and appropriateness tests are unlikely to be effective in conveying the risks to retail clients. Continuing to allow the offer of these products by firms with FCA authorisation may also give retail investors a false sense of security by contrast to the unregulated nature of the underlying.

## Disclosure remedies

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- 3.56** We considered potential disclosure remedies, including:

- **Further FCA warnings** to emphasise the risks of these products and our view that they are not appropriate or suitable for retail consumers.
- **Firm risk warnings or other disclosures** to indicate the key features and risks of these products, and high likelihood of losses.

- 3.57** We consider disclosure remedies are unlikely to adequately change consumer behaviour. Our consumer research suggests consumers are unlikely to follow advice from authoritative sources. Many will continue to be influenced by social media and a desire to seek quick, high returns. Consumer risk warnings cannot address the fundamental flaws in a crypto-derivative product. Consumers are also prone to optimism bias when investing in speculative products such as these. This could be made worse by firms' marketing and other media sources over-emphasising the potential for profit in trading crypto-derivatives.

- 3.58** The continued offer of these products by firms with FCA authorisation may also perpetuate a false sense of safety.

## Product or sales restrictions

- 3.59** We considered options that would reduce likely participation or levels of trading, including:

- Applying **leverage limits** to all margined products (eg including futures) or prohibiting leveraged exposure (eg limited to 1:1 exposure). This may reduce retail client participation if they need to post more funds to speculate in CFDs or futures, or reduce the notional exposure which may limit aggregate losses.
- Imposing a **minimum denomination/lot size** for all products to reduce mass-retail client access by creating an effective 'wealth bar', limiting the risk of harm in terms of numbers of clients affected.
- Only allowing **advised sales** requiring a recommendation from a qualified financial adviser based on our existing rules on suitability.

- 3.60** We do not view these remedies as appropriate or sufficient to address the harm to retail consumers. Even without leverage, the volatility observed in token prices is excessive enough to present significant harms to consumers. Imposing leverage limits, minimum investment sizes or advised-only sales on these products does not address these inherent valuation issues and risks from financial crime and market abuse in the underlying. It also implies that such products may be suitable for retail clients and meet an investment need, which we do not believe to be the case. Minimum investment

amounts could prompt some consumers to invest more rather than less in products referencing cryptoassets.

- 3.61** Additional fees charged by advisors could lead to worse outcomes, as we previously found for CFD distributors offering advisory or discretionary managed models. It is difficult to see how advisors could legitimately recommend a retail client to invest in these products given the existing client's best interest and suitability rules.

### Marketing ban or a temporary prohibition

- 3.62** **Restricting the marketing to sophisticated or high-net worth retail clients** would prevent 'mass marketing', however would not mitigate the risks we have identified. Consumers acting as a result of social media influencers rather than firm marketing are unlikely to be deterred by this measure.

- 3.63** Although a **temporary prohibition** would address the immediate risk, under MiFIR powers we can only intervene for a 3-month period. We consider a short-term policy response to be inappropriate to the identified risks.

### Combination of alternative options

- 3.64** We believe that each of the proposed alternative options, in themselves, do not lead to a sufficient reduction in the harms found. We have seen some reduction in retail client activity and losses as a result of leverage limits on CFDs, for example. However, we do see any additional measures as sufficient to address the valuation issues for tokens and risks from other features of the underlying cryptoasset markets. A **combination** of measures, instead of a ban, would not lead to an adequate level of retail consumer protection in our view.

- 3.65** In conclusion, we believe a ban for retail clients is the most proportionate response to the inherent product risks and the inappropriate offering of retail products with a direct, intrinsic link to individual cryptoasset values.

**Q8:** Do you agree with our conclusion that alternative options would not sufficiently address the harm? If you disagree, please indicate any preferred option(s) and how it would better address the harms we have identified in a proportionate manner.

## Annex 1

### Questions in this paper

- Q1:** Do you agree with our analysis of the key risks and harm posed by these products? Is there any additional evidence or factors that we should consider?
- Q2:** Do you agree with our proposal to prohibit the sale, marketing and distribution of CFDs, futures, options and ETNs referencing relevant cryptoassets to retail consumers?
- Q3:** Do you have any comments on the draft Handbook rules and definitions we propose to achieve our policy intention?
- Q4:** Do you have any comments on our CBA for these proposals as detailed in Annex 2?
- Q5:** Do you agree with excluding derivatives on security tokens and tokens that meet the definition of e-money? If not, please explain why.
- Q6:** Do you agree with our proposed approach to funds? If not, please explain why.
- Q7:** Do you agree with our proposed scope to exclude non-retail consumers from the prohibition? If not, please explain why.
- Q8:** Do you agree with our conclusion that alternative options would not sufficiently address the harm? If you disagree, please indicate any preferred option(s) and how it would better address the harms we have identified in a proportionate manner.

## Annex 2

# Cost benefit analysis

1. This analysis presents estimates of the material impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide qualitative estimates of outcomes.
2. We have conducted this cost benefit analysis (CBA) to assess the proportionality of our proposed intervention and its likely effects on retail consumers and market participants, consistent with our obligations under Article 42(2) of MiFIR. MiFIR does not specifically require a CBA.
3. As mentioned in the CP, we rely on our rule-making powers under FSMA in addition to the powers under Article 42 MIFIR. We are required under FSMA to undertake a CBA for any proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'. We have therefore undertaken a CBA for that purpose as well.

## Market failure analysis and the proposed remedies

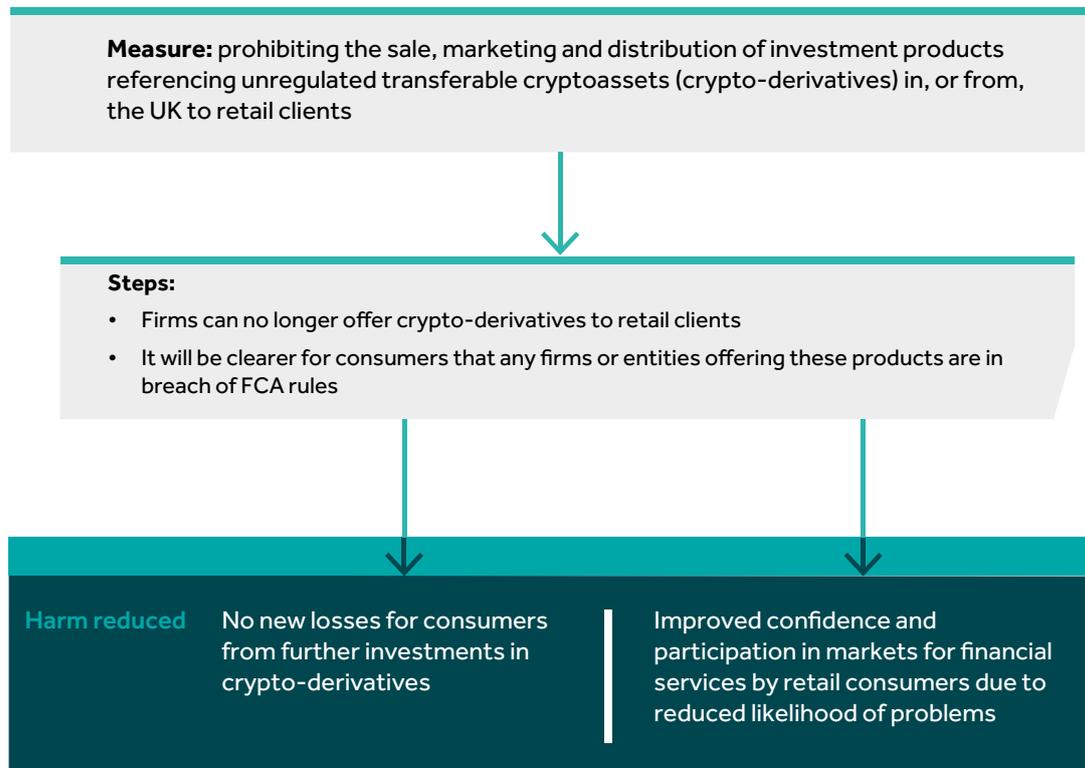
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4. As explained in Chapter 2, investment products referencing unregulated transferable cryptoassets ('crypto-derivatives') are characterised by:
  - information asymmetries which prevent retail consumers from making well informed decisions
  - significant operational risk and widespread misconduct including cyber risk, financial crime and market abuse linked to their sale, marketing and distribution
5. This CP aims to address our significant concerns about the risks to retail consumers in relation to the sale, marketing and distribution of crypto-derivatives and provide an appropriate level of investor protection. We propose a prohibition on the sale, marketing and distribution of crypto-derivatives by firms to retail consumers in, or from, the UK.

### Methodology and rationale

6. As part of our market failure analysis we requested data from seven firms that make up a large proportion of the CFD, futures and ETN market in the UK during the collection period. The data collection period covered a 19-month period from June 2017 to December 2018. This period captures important stages in the price evolution of cryptoassets (including periods of price increases and decreases as well as periods of relatively low volatility). When requesting data from firms we asked them to provide data for all products referencing cryptoassets that they offered to retail clients.
7. The diagram below summarises the rationale of our proposal.

**Figure 1: Causal pathway of our proposals and their expected benefits**



8. The sections below assess costs and expected benefits due to the proposal.

## Cost decomposition

### Costs to firms

9. We do not expect significant one-off implementation costs due to our proposal. However, firms may incur some one-off costs (for example, removing marketing materials).
10. We do not expect firms to incur any ongoing costs, although our proposal to ban crypto-derivatives will lead to a loss of revenue from fees and charges of around £75m per annum across all products, based on revenues from June 2017 to December 2018. More specifically, we estimate firms will forgo revenues of £68.5m per annum in relation to CFDs, £2.3m for futures, and £5.7m for ETNs. Loss of revenues to firms will, however, form part of the benefits to retail consumers, as any profits foregone from charges would be losses avoided by retail consumers (benefits are discussed more fully below).

### Costs for consumers

11. Some individual consumers may miss out on profits if they would have invested in a crypto-derivative product or ETN and achieved positive returns. As we analyse further below, while there have been short-term periods of (high) net profits from some products, in particular for a small number of retail clients investing in ETNs through UK firms, we do not consider a positive outcome over time is likely to be sustained. As set out in our policy analysis above, we do not consider retail consumers can reliably value and predict likely returns from any product referencing cryptoassets.

12. Although the exceptional volatility and price bubble in Bitcoin in late 2017 resulted in a minority of retail clients realising substantial returns, there have also been significant, widespread losses in other periods.
13. We observed profits experienced by clients in ETNs between November 2017 and February 2018 of £116m. We do not consider this is a reliable indicator of likely future returns as, for example, in the second half of 2018 most retail clients experienced losses in the same ETNs. We also observe the number of individual retail accounts making a profit to be relatively small, with a much greater number incurring losses over time per account.
14. With regards to CFDs and futures, we observed much smaller profits despite the Bitcoin price bubble – and as a result net aggregate losses occurred across the 18-month period we examined. While, as for the ETN, it is impossible to predict future outcomes over a given time period in which prices are volatile (especially as investors can take ‘short’ positions in CFDs to benefit from price falls), there is clearly a significant risk of future losses (see below).
15. By adopting a prohibition, retail consumers who previously used crypto-derivatives to hedge positions in the underlying cryptoasset market would also no longer be able to use these products for this purpose. This may result in future losses by consumers holding unregulated cryptoassets that they may otherwise have hedged and offset using crypto-derivatives.

### Benefits we expect to see

16. Retail clients experienced losses of around £234.3m per annum by purchasing derivative products that reference cryptoassets, distributed as follows:

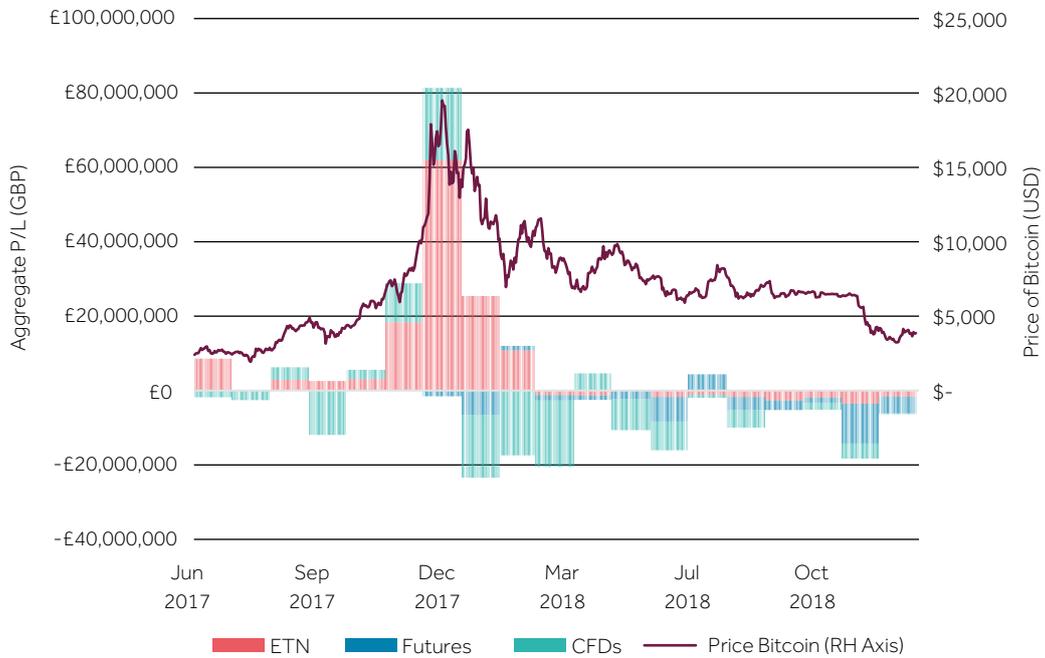
**Table 1: Aggregate profits, losses and fees by product type**

Product type	Net aggregate profit (Jun 2017- Dec 2018)	Total Losses (Jun 2017- Dec 2018)	Total Losses (per annum)	Fees (per annum)
CFDs	(£55m)	(£245m)	(£155m)	£68.5m
Futures	(£36.5m)	(£87.3m)	(£55.1m)	£2.3m
ETNs	£117m	(£38.3m)	(£24.2m)	£5.7m
<b>Total</b>	<b>£25.5m</b>	<b>(£370.6m)</b>	<b>(£234.3m)</b>	<b>£75m</b>

17. We recognise some clients realised profits over the period we examined. However, we consider the significant variance in client outcomes is consistent with our policy analysis. That is, the value of these products in the short run is highly unpredictable and prone to extreme volatility due to the nature of the underlying assets.
18. We do not believe that the profits experienced from November 2017 to March 2018 suggest likely future consumer benefit. If we exclude the four months covering the Bitcoin price bubble, by only considering all products’ performance after the bubble, from March 2018 to December 2018, we have observed consistent aggregate losses, including £16.8m losses in the ETN.
19. In line with our concerns around the effect of ‘hard fork’ events, we saw losses totalling £18.2m in November 2018, coinciding with the Bitcoin Cash hard fork. These losses were realised across CFDs, futures and ETNs on which we collected data. This was the second largest aggregate loss after March 2018 (-£20.5m). We expect our proposal to

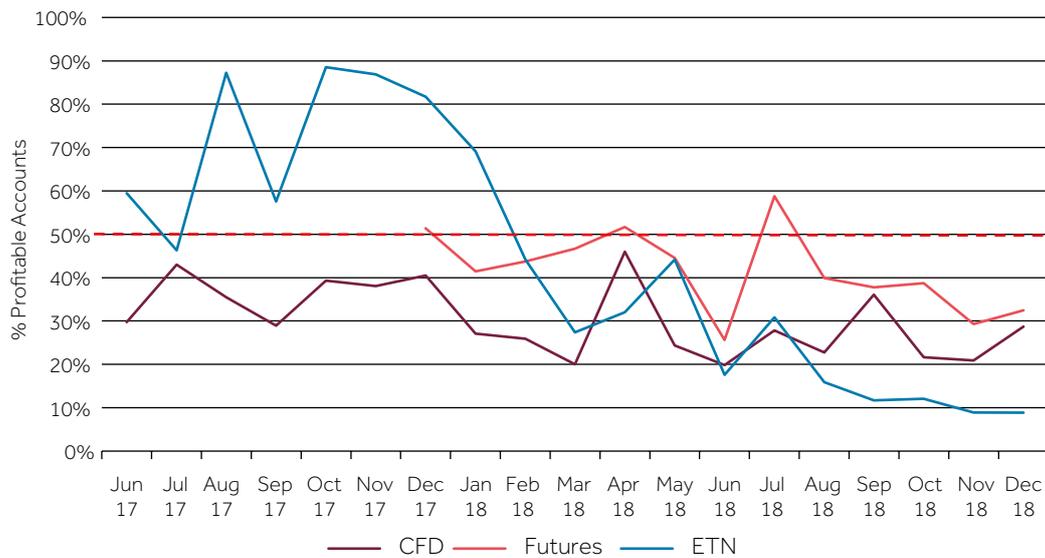
stop this harm occurring by preventing new retail investments in crypto-derivatives (Chart 1).

**Chart 1: The aggregate profits and losses in each instrument**



20. We have observed poor client outcomes for most individual retail client accounts, with 67% losing money by investing in these products across the full 18-month period. For the calendar year of 2018 (12 months), this figure increases to 72%. Since the start of 2018 we have seen worse client outcomes, with a substantial deterioration in the number of profitable accounts trading cryptoasset ETNs (Chart 2).

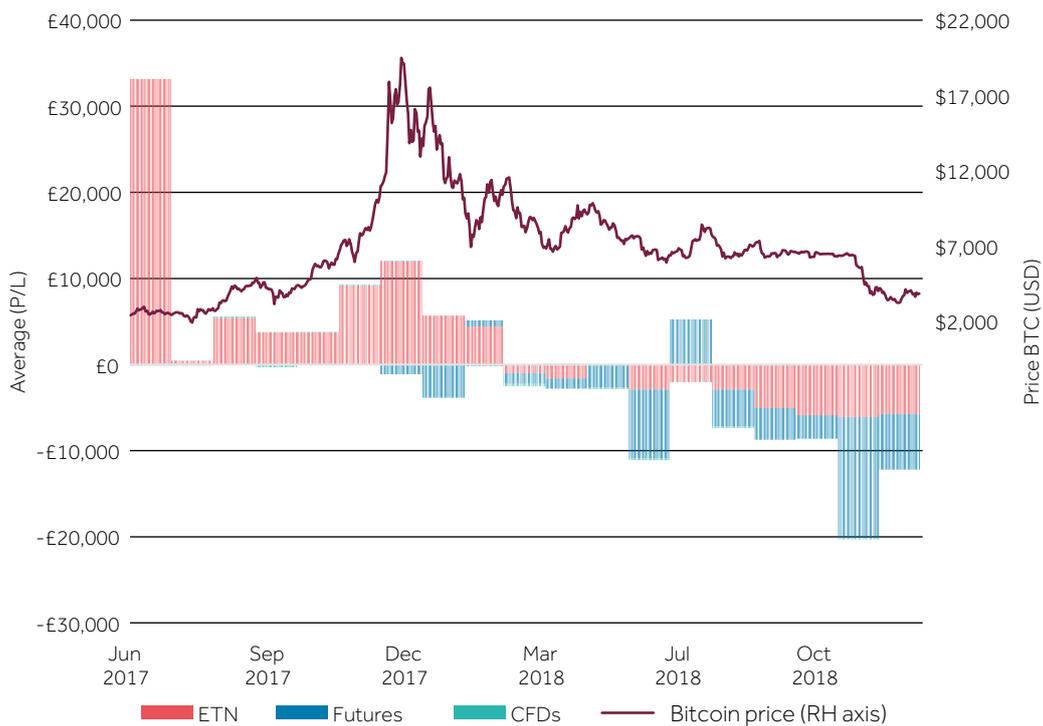
**Chart 2: The percentage of profit making accounts in each instrument**



**Further analysis of ETN outcomes versus other products**

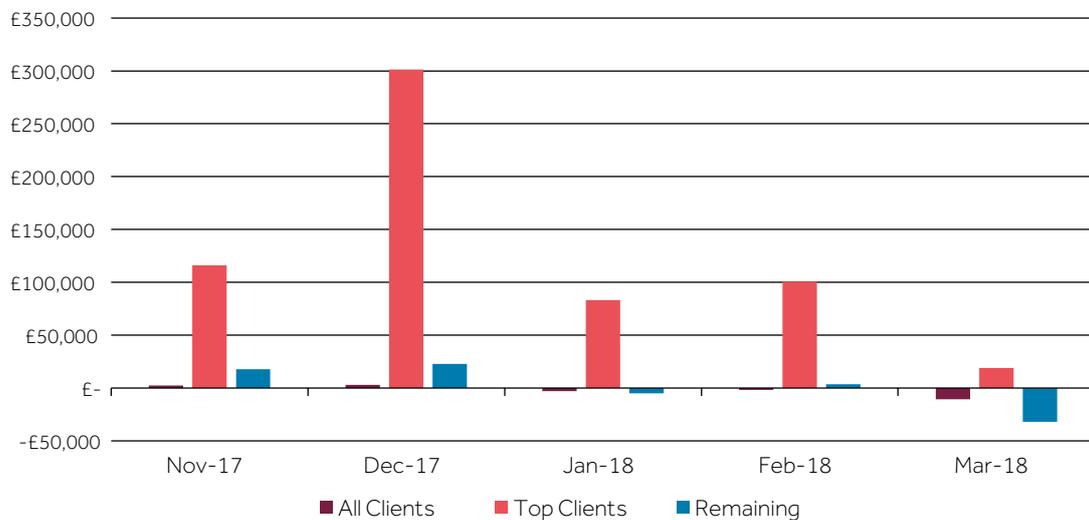
21. We observed large consumer gains through the ETN from June 2017 through February 2018 as the price of cryptoassets increased. This may suggest a large number of early buy-and-hold investors in the Bitcoin ETN (which was available from 2015) and a small number of clients investing very large amounts in the run up to the bubble. This can be seen in June 2017 where there is a large average profit per consumer which is not in line with the wider trends in this market (Chart 3).

**Chart 3: The average aggregate profits and losses per active account in each instrument type**



22. We have also further examined the distribution of outcomes in the ETN products. We see disproportionate outcomes amongst the top 10 retail clients each month by firm, indicating a high concentration of profits among a small group of consumers. For example, in the five months from November 2017 to March 2018, 2 per cent of retail clients accounted for 55 per cent of total client profits, gaining a total of £49.5m. In one month, February 2018, 3 per cent of the most profitable clients accounted for 70 per cent of total client profits, with the realised profits of this group totalling £8m. In December 2017, at the peak of the bubble, the 20 most profitable clients across two firms made an average profit of £300,000 (Chart 4).

**Chart 4: Distribution of average profits among the top 20 most profitable retail clients in ETNs and remaining retail clients**



23. While the structure of the product and length of holding may have some bearing on performance in terms of the drag of costs and charges over time, we consider the ETN products continue to pose a high risk of harm by offering exposure to cryptoassets. In the second half of last year, for example, the ETNs saw higher losses per account than for CFDs, with loss-making accounts averaging a £6,000 loss per client in some months. As noted above, we also observed a higher number of loss making accounts with 84 per cent to 91 per cent of retail accounts losing money between August and December 2018, when compared with CFD accounts.

**Future outcomes**

- 24. Across different historical periods client outcomes vary considerably. As discussed above, it is also extremely difficult to predict future price changes in cryptoassets in any particular time-limited period.
- 25. However, we consider the challenge to reliably value these products, the lack of any inherent value to the underlying assets, and other issues in the market will make future losses more likely for most retail consumers than future sustained profits. A ban will mean that retail clients do not lose transaction costs from trading and holding derivatives or ETNs on cryptoassets. We have estimated this to be £75m per annum, based on typical costs and charges experienced from June 2017 to end 2018.
- 26. We also consider our intervention will likely benefit the majority of retail consumers investing in such products. This is because most individual accounts lost money across the period we considered, suggesting any profits tend to be concentrated among few investors. Given the size of some investors' returns, there is also a possibility that some of those retail clients may be eligible to 'opt up' to elective professional clients, who will not be subject to our prohibition, should they wish to continue trading.

### **Impact on non-UK based EEA firms**

- 27.** As noted above in para 3.41, the proposed scope of our measures would align with Article 42 of MiFIR and so our proposed ban would equally apply to non-UK EEA firms when selling to a retail client located in the UK. We identified Cyprus as the predominant EEA member state from which firms offer crypto-derivatives into the UK on a MiFID service passport.
- 28.** We sought data from CySEC to establish the impact on CySEC-authorized firms, although the measures would apply in exactly the same way as for UK firms. Based on this data, we concluded that Cyprus investment firms are likely to forgo annual costs and charges revenues of around €9.5m from ceasing sales to UK clients if we proceeded to ban these products. There would be a corresponding benefit to UK retail consumers as they would no longer incur costs and charges, and they would also benefit to the extent they avoid additional trading losses in relation to CFDs sold by Cyprus-based firms. We did not obtain data on outcomes for UK clients trading with Cypriot firms, but expect these to be consistent with our analysis for UK firms.

### **Unintended consequences**

- 29.** Our proposal may drive retail customers to invest directly in unregulated tokens.
- 30.** Our proposals could have a negative impact on the pricing of existing open positions which could cause losses to retail consumers wanting to sell or exit their positions.

### **Conclusions**

- 31.** Given the unpredictable and volatile nature of cryptoassets, and the lack of inherent value in the underlying assets, we consider our intervention will likely benefit the majority of retail consumers investing in derivatives and ETN products referencing cryptoassets. We note that most individual accounts (67%) lost money across the period we considered for all products.
- 32.** We recognise that the inherent unpredictability of outcomes in these products in the short run may mean that some clients forgo future profits, in particular as shown by the ETN performance. However, we consider that due to the unpredictable, volatile nature of the underlying cryptoasset and the lack of inherent value in the underlying assets, as outlined in the CP above, a majority of retail clients are likely to suffer a loss over the long-term should they invest in these products. The potential for consumer harm from sudden and significant losses across a large proportion of retail clients investing in such products outweighs the possible effect of a smaller group of clients missing out on future profits as a result of volatility in a time-limited period. This is supported by the fact that part of the historical profits were driven by a price bubble and some of those profitable retail clients are likely to be eligible to 'opt up' to be elective professional clients, who will not be subject to our prohibition.
- 33.** Overall, we do not expect firms to incur any ongoing costs from implementing our proposals, and will face minimal costs from withdrawing products and ceasing marketing activities. Our proposals would, however, lead to a loss of revenue for UK firms from fees and charges of around €75m per annum across all products.
- 34.** We consider that our proposals will ultimately benefit a majority of consumers by protecting them from future losses. Based on the 19-month period of data we collected, we estimate an upper range benefit of £234.3m, representing an annualised

figure of total losses experienced by retail consumers across the three product types available in the UK (see Table 1 above). Notwithstanding investment returns, retail consumers are likely to benefit from avoiding future costs and charges of up to £75m. We estimate therefore potential benefits to be in a range from £75m to £234.3m. We recognise that it is difficult to predict future performance in a particular time-limited period. However, the evidence of the risk of high losses is consistent with our analysis of the underlying assets.

- 35.** As such, we believe our proposal is proportionate and justified to deliver our consumer protection and market integrity objectives.

## Annex 3

# Compatibility statement

### Compliance with legal requirements

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1. As noted in the CP, we are relying upon our powers under Article 42 of MiFIR to make our product interventions, and to the extent that those interventions are not within the scope of MiFIR we rely upon our rule-making powers under FSMA.
2. When consulting on new rules made under FSMA, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules is (a) compatible with its general duty, under s. 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, and (b) its general duty under s. 1B(5) (a) FSMA to have regard to the regulatory principles in s. 3B FSMA. The FCA is also required by s. 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.
3. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this consultation. It includes an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the FSMA.
4. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (s. 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.
5. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s. 1JA FSMA about aspects of the economic policy of Her Majesty's Government to which we should have regard in connection with our general duties.
6. This Annex includes our assessment of the equality and diversity implications of these proposals.
7. Under the Legislative and Regulatory Reform Act 2006 (LRRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRRA.

## The FCA's objectives and regulatory principles: Compatibility statement

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8. Our proposals contribute to the FCA's operational objective of consumer protection.
9. Our consumer protection objective is to secure an appropriate degree of protection for consumers. In considering what degree of protection may be appropriate we are required to have regard regulatory principles set out in s. 3B FSMA.

### The differing degrees of risk involved in different kinds of investment or other transaction

10. In proposing to prohibit the sale, marketing and distribution of crypto-derivatives to retail clients, we considered that the inherent features of such products make it difficult for retail consumers to make informed decision and this has led to poor outcomes for retail consumers. In the light of the above and, as evidenced in our cost benefits analysis, we believe that an outright ban will reduce the harm to retail consumers caused by these products.

### The principle that consumers are provided with a level of care that is appropriate given the risk involved in the transaction and capabilities of the consumer and the differing degrees of experience and expertise that consumers may have

11. As detailed in Chapter 3, crypto-derivatives are inherently difficult to value due to information asymmetries which prevent retail consumers from making well informed decisions. Also, a combination of market immaturity, financial crime, market abuse and operational issues in the cryptoasset market leads to concerns about market integrity. These, in turn, impact retail clients holding crypto-derivatives, as their products' value is directly impacted by any sudden devaluation or price dislocation in the underlying asset.
12. We are proposing to limit the scope of these measures to consumers that are treated as retail clients and not to extend their application to consumers treated as professionals on request. This reflects the fact that elective professional clients are likely to know and understand the risks better, including the significant risk of loss, and are more likely to be capable of bearing potential losses from trading.

### The needs that consumers may have for the timely provision of information and advice that is accurate and fit for purpose /the general principle that consumers should take responsibility for their decision /the different expectation that consumers may have in relation to different kinds of investment

13. The information asymmetries associated with crypto-derivatives affect customer decision-making. This can and has resulted in poor outcomes, so we believe we are justified in proposing to ban these products.

### **Having regard to any information which the consumer financial education body has provided to us in the exercise of consumer financial education function**

14. We have given due regard to this principle, but we have not received any information from a consumer financial education body in relation to retail consumers trading crypto-derivatives.

### **Having regard to any information received from the Financial Ombudsman Service**

15. We have received information from the Financial Ombudsman Service, including information on the number of complaints received and the number of complaints upheld.
16. We consider these proposals are compatible with the FCA's strategic objective of ensuring that the relevant markets function well because they aim to address the market failures identified in Chapter 3. For the purposes of the FCA's strategic objective, 'relevant markets' are defined by s. 1F FSMA.
17. In preparing the proposals set out in this consultation, the FCA has had regard to the regulatory principles set out in s. 3B FSMA.

### **The need to use our resources in the most efficient and economic way**

18. In Chapter 3, we have considered alternative options to our proposed prohibition of retail crypto-derivatives. We believe most of the alternative options will be resource intensive and likely to be less effective, particularly if a number of firms develop such products.

### **The principle that a burden or restriction should be proportionate to the benefits**

19. As evidenced in our cost-benefits analysis, our proposal leads to circa £75m to £234.3m per annum in benefits to retail consumers who would otherwise be harmed by the offering of crypto-derivatives. Firms would forgo revenues of £75m per annum.
20. As such, we believe our proposal is therefore proportionate and justified by our objective to protect consumers.

### **The desirability of sustainable growth in the economy of the United Kingdom in the medium or long term**

21. The proposed rules for prohibiting crypto-derivatives being sold to retail consumers are designed to encourage customers to purchase products that are of benefit to them, rather than products which are not appropriate for them. We see this as encouraging sustainable growth in other sectors of the UK economy. Retail sales of crypto-derivatives were not significant revenue sources for most UK firms. We expect our approach benefits wider confidence in UK markets and the UK's reputation as having a well-regulated financial sector to attract business, especially given international concerns with cryptoassets.

### **The general principle that consumers should take responsibility for their decisions**

22. The information asymmetries associated with crypto-derivatives affect customer decision-making. This can and has resulted in poor outcomes, so we believe we are justified in proposing to ban these products.

### **The responsibilities of senior management**

23. Senior managers in the relevant firms will need to ensure compliance with our proposed rule prohibiting crypto-derivatives from being marketed, distributed and sold to retail consumers.

### **The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation.**

24. We consider our proposed rules to apply consistently to firms offering these products. There are a limited number of firms conducting business related to crypto-derivatives. Our rules should not create any disproportionate effects on any individual firms' or persons' activities compared to others.

### **The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information**

25. Our proposals will not require firms to publish information, including that relating to persons subject to requirements imposed under FSMA.

### **The principle that we should exercise our functions as transparently as possible**

26. This CP sets out the detail of our concerns, our policy proposals and assessment of the likely costs and benefits, and seeks feedback. This is consistent with the principle of exercising our functions transparently. It also follows an earlier public discussion on these issues in the [CATF Report](#) which the FCA has contributed to.

### **Action to minimise the extent to which a business is used for a purpose connected with financial crime**

27. In formulating these proposals, the FCA has had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange; or (ii) in contravention of the general prohibition, to be used for a purpose connected with financial crime (as required by s. 1B(5)(b) FSMA).

### **Expected effect on mutual societies**

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28. The FCA does not expect the proposals in this paper to have a significantly different impact on mutual societies. Mutual societies do not currently offer crypto-derivatives.

## Compatibility with the duty to promote effective competition in the interests of consumers

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- 29. In preparing the proposals as set out in this consultation, we have had regard to the FCA's duty to promote effective competition in the interests of consumers.
- 30. Our policy proposal seeks to ensure that UK firms compete in the interests of consumers, rather than by lowering conduct standards and/or offering products or services to retail consumers for whom they are inappropriate, and who may suffer detriment as a result.

## Equality and diversity

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- 31. We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act, advance equality of opportunity between persons who share a relevant protected characteristic and those who do not, and to foster good relations between people who share a protected characteristic and those who do not.
- 32. As part of this, we ensure the equality and diversity implications of any new policy proposals are considered. The outcome of the assessment in this case is stated in Chapter 1 of the CP.

## Annex 4

### Abbreviations used in this paper

<b>5AMLD</b>	Fifth Anti-Money Laundering Directive
<b>AIF</b>	Alternative Investment Fund
<b>AML</b>	Anti-Money Laundering
<b>CBA</b>	Cost Benefit Analysis
<b>CFD</b>	Contract for difference
<b>CATF</b>	Cryptoasset Taskforce
<b>CFTC</b>	Commodities and Futures Trading Commission
<b>CP</b>	Consultation Paper
<b>CTF</b>	Counter-terrorism Financing
<b>CySEC</b>	Cyprus Securities and Exchange Commission
<b>COBS</b>	Conduct of Business Sourcebook
<b>DLT</b>	Distributed Ledger Technology
<b>EBA</b>	European Banking Authority
<b>EEA</b>	European Economic Area
<b>EMR</b>	E-Money Regulations
<b>ESMA</b>	European Securities and Markets Authority
<b>ETN</b>	Exchange Traded Note
<b>FCA</b>	Financial Conduct Authority
<b>FSB</b>	Financial Stability Board
<b>FSMA</b>	Financial Services and Markets Act
<b>ICO</b>	Initial Coin Offering
<b>MiFID</b>	Markets in Financial Instrument Directive

<b>MiFIR</b>	Markets in Financial Instrument Regulation
<b>NURS</b>	non-UCITS retail schemes
<b>PBoC</b>	People's Bank of China
<b>PSR</b>	Payment System Regulations
<b>QIS</b>	Qualified Investor Scheme
<b>RAO</b>	Regulated Activities Order
<b>SEC</b>	Securities and Exchanges Commission
<b>SFC</b>	Securities and Futures Commission
<b>SPV</b>	Special Purpose Vehicle
<b>UBD</b>	Unauthorised Business Department
<b>UCITS</b>	Undertakings for Collective Investment in Transferable Securities

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future. We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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# Appendix 1

## Draft Handbook text

## CONDUCT OF BUSINESS (CRYPTOASSET PRODUCTS) INSTRUMENT 2019

### Powers exercised

- A. The Financial Conduct Authority (“the FCA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
- (1) section 137A (The FCA’s general rules);
  - (2) section 137D (FCA general rules: product intervention);
  - (3) section 137R (Financial promotion rules);
  - (4) section 137T (General supplementary powers); and
  - (5) section 139A (Power of the FCA to give guidance).
- B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.
- C. The Financial Conduct Authority also makes the prohibitions contained within this instrument in the exercise of the power under article 42 (product intervention by competent authorities) of Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

### Commencement

- D. This instrument comes into force on *[date]*.

### Amendments to the Handbook

- E. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- F. The Conduct of Business sourcebook (COBS) is amended in accordance with Annex B to this instrument.

### Citation

- G. This instrument may be cited as the Conduct of Business (Cryptoasset Products) Instrument 2019.

By order of the Board  
*[date]* 2019

## Annex A

### Amendments to the Glossary of definitions

Insert the following new definitions into the appropriate alphabetical positions. The text is not underlined.

*cryptoasset derivative* a *derivative* where the underlying is, or includes, an *unregulated transferable cryptoasset* or an index or *derivative* relating to an *unregulated transferable cryptoasset*.

*cryptoasset exchange traded note* a *debt security*:

- (a) which is traded on a *trading venue* or a market operated by a *ROIE*;
- (b) which features no periodic coupon payments; and
- (c) whose return tracks the performance of an *unregulated transferable cryptoasset*, minus applicable fees, whether featuring delta 1, inverse or leveraged exposure or other exposure to the *unregulated transferable cryptoasset* being tracked.

*unregulated transferable cryptoasset* a cryptographically secured digital representation of value or contractual rights that uses distributed ledger technology and which:

- (a) is capable of being traded on or transferred through any platform or other forum;
- (b) is not limited to being transferred to its issuer in exchange for a good or service, or to an operator of a network that facilitates its exchange for a good or service;
- (c) is not *electronic money*; and
- (d) is not a *specified investment*.

[*Editor's note (1)*: when the UK leaves the EU, the rules in this instrument are intended to continue to apply to the same firms after exit as were covered by the rules before exit. In particular, the rules will automatically apply to temporary permission firms and to supervised run-off firms covered by the financial services contracts regime. They will also apply to contractual run-off firms by virtue of article 59 of the EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018 . We will consider whether to amend the instrument to provide further guidance or other clarifications about this but do not expect to re-consult on any such changes.]

[*Editor's note (2)*: this instrument takes account of changes that will be made to the Handbook as outlined in PS 19/18 'Restricting contract for difference products sold to retail clients'.]

## Annex B

### Amendments to the Conduct of Business sourcebook (COBS)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

#### 4 Communicating with clients, including financial promotions

...

#### 4.7 Direct offer financial promotions

...

4.7.6A G ...

4.7.6B G Firms are reminded of the prohibitions in relation to the marketing, distribution and sale of *cryptoasset derivatives* and *cryptoasset exchange traded notes* in COBS 22.6.

...

#### 22.5 Restrictions on the retail marketing, distribution and sale of contracts for differences and similar speculative investments

...

22.5.5 R The *rules* in this section do not apply to: ~~derivative instruments for the transfer of credit risk to which article 85(3) of the *Regulated Activities Order* applies.~~

- (1) derivative instruments for the transfer of credit risk to which article 85(3) of the *Regulated Activities Order* applies; or

(2) cryptoasset derivatives.

22.5.5A G Firms are reminded of the prohibitions in relation to the marketing, distribution and sale of cryptoasset derivatives and cryptoasset exchange traded notes in COBS 22.6.

...

22.5.11 R ...

(3) 10% of the value of the exposure that the trade provides when the underlying asset is a *minor stock market index* or a *commodity* other than gold; or

(4) ~~50% of the value of the exposure that the trade provides when the underlying asset is a cryptocurrency; or~~ [deleted]

...

Insert the following new section after COBS 22.5 (Restrictions on the retail marketing, distribution and sale of contracts for differences and similar speculative investments). The text is not underlined.

## **22.6 Prohibition on the retail marketing, distribution and sale of cryptoasset derivatives and cryptoasset exchange traded notes**

Application

22.6.1 R (1) Subject to (2), this section applies to:

- (a) *MiFID investment firms*, with the exception of *collective portfolio management investment firms*;
- (b) *branches of third country investment firms*; and
- (c) *MiFID optional exemption firms*,

in relation to the marketing, distribution or sale of *cryptoasset derivatives* and *cryptoasset exchange traded notes* in or from the *United Kingdom* to a *retail client*.

(2) This section does not apply to the marketing, distribution or sale of *cryptoasset derivatives* and *cryptoasset exchange traded notes* to a *retail client* in another *EEA State* to the extent that those activities are subject to stricter requirements imposed under article 42 of *MiFIR* by the *competent authority* of that *EEA State*.

- 22.6.2 G The *rule* in COBS 22.6.1R(2) means that a *firm* must comply with the *rules* in this section unless there are stricter requirements in the *EEA State* where the *retail client* is. Given that the *rules* in this section are prohibitions, *firms* will, in practice, always need to comply with them when they are marketing, distributing or selling a *cryptoasset derivative* or a *cryptoasset exchange traded note* in or from the *United Kingdom* to a *retail client*. However, *firms* will also need to comply with requirements in the *EEA State* where the *retail client* is if those requirements go beyond the scope of the *rules* in this section.
- 22.6.3 G *Firms* are reminded that the *Glossary* definition of *MiFID investment firm* includes *CRD credit institutions* when those institutions are providing an *investment service or activity*.
- 22.6.4 G For the avoidance of doubt, in COBS 22.6.1R, “marketing” includes *communicating* and/or *approving financial promotions*, and “distribution or sale” includes *dealing* in relation to *cryptoasset derivatives* and *cryptoasset exchange traded notes*.

#### Prohibitions

- 22.6.5 R (1) A *firm* must not:
- (a) sell a *cryptoasset derivative* or a *cryptoasset exchange traded note* to a *retail client*; or
  - (b) distribute a *cryptoasset derivative* or a *cryptoasset exchange traded note* to a *retail client*; or
  - (c) market a *cryptoasset derivative* or a *cryptoasset exchange traded note* if the marketing is addressed to or disseminated in such a way that it is likely to be received by a *retail client*.
- (2) “Marketing” includes, but is not limited to, *communicating* and/or *approving financial promotions*.

