

## **Discussion Paper**

### **DP23/4**

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# Regulating cryptoassets

## Phase 1: Stablecoins

**November 2023**

## How to respond

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## Chapter 1

# Overview

## Introduction

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- 1.1** The Government has announced plans to legislate for a future financial services regime for cryptoassets. It is taking a phased approach, focusing initially on fiat-backed stablecoins, including where used in payments, followed by the wider cryptoasset regime. In this Discussion Paper (DP) we cover the proposed approach to regulating fiat-backed stablecoins, which may be used for payments. Under these plans, we will regulate the issuance and custody of fiat-backed stablecoins under the Financial Services and Markets Act 2000, and the use of these stablecoins as a means of payment under the Payment Services Regulations 2017 (PSRs). We want to use this DP to help inform the development of our regime for fiat-backed stablecoins as a means of payment and ensure any regime we create meets our objectives. This will enable firms to facilitate payments safely and securely using fiat-backed stablecoins.
- 1.2** The Treasury's recent Policy Statement sets out the Government's intention to bring two new activities into the Financial Services and Markets Act 2000 through the Regulated Activities Order (the RAO) relating to fiat-backed stablecoins, covering both issuance in or from the UK and custody activities carried out from the UK or to UK based consumers for UK-issued fiat-backed stablecoins. Similar to other activities regulated through the RAO, firms will need to be authorised by us and comply with the relevant rules in our Handbook. For the purposes of this DP, we will refer to fiat-backed stablecoins that are issued in the UK and meet FCA rules as 'regulated stablecoins'.
- 1.3** The Treasury also intends to amend the PSRs to allow fiat-backed stablecoins to be used as a means of payment in the UK. This DP sets out the split between the activities brought into the RAO and how fiat-backed stablecoins may be used as a form of payment through the PSRs. Where we are seeking to apply our Handbook to the new RAO activities, we have included commentary on how requirements may apply and questions for firms to consider. The Treasury is also considering how to create a separate pathway for fiat-backed stablecoins issued outside of the UK ('overseas stablecoins') to be used for payments in the UK. One proposal the Treasury are exploring involves an overseas stablecoin being assessed by an FCA authorised or registered firm under the PSRs ('payment arranger') before being used in UK payment chains. We have provided further detail in chapters 10 and 11.
- 1.4** The design of our new regime for regulating these activities is not entirely separate from the rest of the future regime. Various aspects, including, for example, our expectations of firms that provide custody of regulated stablecoins (or the cryptographic 'private keys' to access them) would likely be the same when they provide custody of other types of cryptoassets that come into regulation.

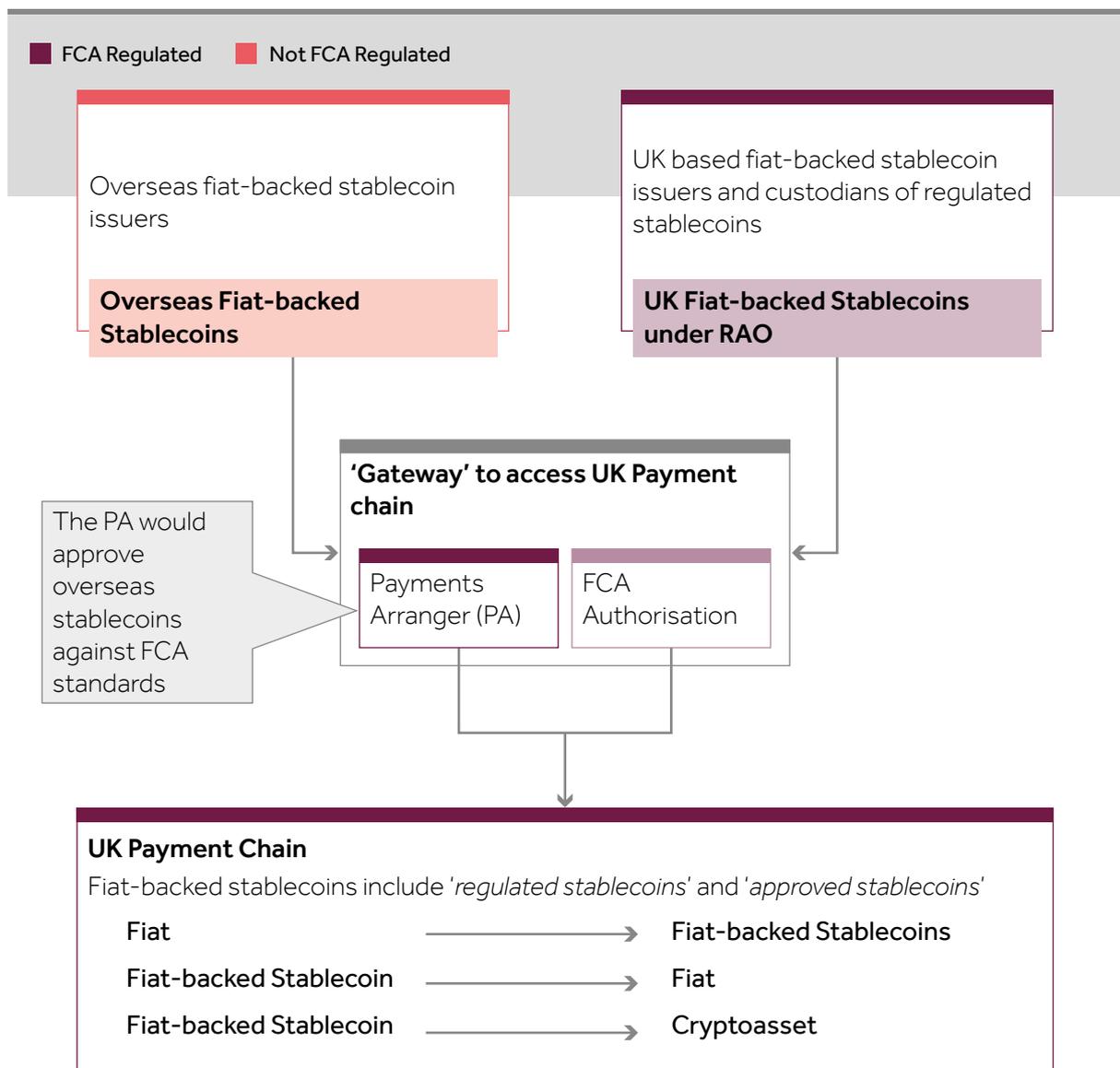
## What are stablecoins?

- 1.5** The Financial Stability Board (FSB) refers to stablecoins as ‘a category of cryptoassets that aim to maintain a stable value relative to a specified asset, or basket of assets, providing perceived stability when compared to the high volatility of unbacked cryptoassets’. This is also supported by the Treasury’s recent consultation on a future regulatory regime for cryptoassets. The Treasury’s recent Policy Statement provides that the Treasury intends to define fiat-backed stablecoins in legislation, expecting it to capture those stablecoins which seek to maintain a stable value by reference to a fiat currency, and hold (in part or wholly) currency as ‘backing’. Throughout this DP, we use the definitions of stablecoins outlined in the table below.
- 1.6** Today, stablecoins are predominantly used to facilitate transactions between cryptoassets and are a key component of the functioning of the cryptoasset market. They also provide an opportunity for consumers to enter and exit the cryptoasset market. For example, converting cryptoassets for fiat currency (‘off-ramps’) and fiat currency to cryptoassets (‘on-ramps’). The Government has also recognised the potential for fiat-backed stablecoins to become used as a widespread form of payment by consumers. This has prompted the Government to focus on fiat-backed stablecoins in its first phase of cryptoasset regulation.

Stablecoin terms used throughout this DP	Definition
Stablecoin	A category of cryptoassets that aim to maintain a stable value relative to a specified asset, or basket of assets, providing perceived stability when compared to the high volatility of unbacked cryptoassets.
Fiat-backed stablecoin	Fiat-backed stablecoins are expected to include stablecoins that seek to maintain a stabilised value of the cryptoasset by reference to, and which may include the holding of, one or more specified fiat currencies.  For the purpose of this DP, a fiat-backed stablecoin is a regulated stablecoin or an approved stablecoin.
Regulated stablecoin	A category of a stablecoins that seeks to maintain a stabilised value of the cryptoasset by reference to, and which may include the holding of, one or more specified fiat currencies.  And,  Issued by a firm which is authorised by the FCA. Regulated stablecoins may be used as a means of payment in UK payments chains.  See Chapter 2 for further detail.

Stablecoin terms used throughout this DP	Definition
Approved stablecoin	<p>A category of stablecoin issued from outside the UK (overseas stablecoin) and that seeks to maintain a stabilised value of the cryptoasset by reference to, and which may include the holding of, one or more specified fiat currencies.</p> <p>And,</p> <p>We are exploring how overseas stablecoins could be approved by an authorised 'payment arranger' before being used as a means of payment in UK payment chains.</p> <p>See Chapters 2 and 11 for further detail.</p>

### FCA Stablecoin Regime Scope



## Our existing remit over cryptoassets

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- 1.7** Cryptoassets (which includes stablecoins) are currently defined through the Financial Services and Markets Act (FSMA) as, 'any cryptographically secured digital representation of value or contractual rights that – (a) can be transferred, stored or traded electronically, and (b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology)'. This is also alongside the Government's recent legislation bringing Digital Settlement Assets (DSAs) into the scope of the Banking Act 2009 and Financial Services (Banking Reform) Act 2013 (FSBRA), providing the Bank of England and the Payments Systems Regulator powers to regulate systemic payments systems using DSAs, if recognised as systemic by the Treasury. Chapter 2 gives more information on the scope of the regime and split of responsibilities between the regulators.
- 1.8** The FCA's current regulatory remit covers the anti-money laundering (AML) and counter-terrorist financing (CTF) supervision of cryptoasset businesses registered in the UK under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs). On 12 September 2023, 42 FCA firms were registered under the MLRs for activities including operating an exchange, providing custody, and trading cryptoassets for fiat. We also regulate financial promotions of cryptoassets, as described in PS23/6: Financial promotion rules for cryptoassets.
- 1.9** Internationally, we have conducted an extensive programme of work as a member of global standard setting bodies, including the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO). We are proud to lead the development of the IOSCO Crypto and Digital Assets Recommendations, providing a baseline of regulation for cryptoassets around the world. There has also been significant work to develop international standards for stablecoins through the FSB, based on the common challenges and risks faced by regulators across the globe.

## Future phases of cryptoasset regulation

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- 1.10** The Government is introducing cryptoasset regulation in phases. The fiat-backed stablecoin regime will be the next phase of cryptoasset regulation. Further requirements for cryptoasset activities more broadly are set to follow as part of the future regime. In the future regime, the Government intends to capture other activities such as 'admitting a cryptoasset to a cryptoasset trading venue' or 'dealing in cryptoassets as principal or agent'. We will consult on proposals for all these activities in due course, in a similarly phased approach. Throughout this DP, we seek to highlight some of the regulation which would likely apply to some of the activities involving cryptoassets more broadly.
- 1.11** The initial phase of cryptoasset regulation will facilitate the use of fiat-backed stablecoins as a means of payment. The Treasury has announced plans for legislation to create a regulatory regime in the UK for fiat-backed stablecoins, ie those that will be caught by the scope of the secondary legislation they are preparing. It intends for our

new regime to cover both the issuance of fiat-backed stablecoins issued in or from the UK and custody of those regulated stablecoins, when provided to UK consumers, or held by custodians based in the UK. As outlined through the [Treasury's recent consultation](#), they intend to bring other cryptoassets related activities into the scope of the RAO and capture other cryptoassets where necessary.

**1.12** As this DP sets out, we propose to define the standards that issuers and custodians of regulated stablecoins are required to meet, once the regime comes into force. To be authorised under the new regime, issuers and custodians will need to show they can meet these standards, deliver on the promise of stability, and provide legal protections consumers can expect from a regulated stablecoin.

**1.13** We have also given further detail on the Treasury's idea for consideration to allow overseas stablecoins access to the UK payment chain, subject to being assessed by firms acting as 'payment arrangers'. Payment arrangers would be regulated through the PSRs. They would be able to initiate or arrange a payment using overseas stablecoins. However, they would first have to assess if the fiat-backed stablecoin and the stablecoin issuers meet our required standards. Further information is in Chapters 2, 10 and 11.

## How regulating stablecoins aligns with our Strategy

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**1.14** We are seeking to design a regulatory regime based on our statutory objectives, with a view to manage, so far as possible, the risks of both fiat-backed stablecoins themselves and those within fiat-backed stablecoin issuers.

**1.15** We believe that our fiat-backed stablecoins regime should:

- recognise that many of the risks and issues involved are not new and apply to existing assets and markets (eg the need to protect ownership rights)
- be outcomes-based and formed within a clear principles-based policy framework – but with sufficient detail and guidance for legal clarity (eg as to what happens on insolvency)
- be technology-agnostic and not explicitly or otherwise endorse any particular technology
- aim to achieve a balance between allowing innovation while protecting consumers and market integrity

**1.16** The design of our new regime aims to mitigate the risks and harms we have seen in the stablecoin market (detailed in Chapter 2) and to give a regulatory framework for fiat-backed stablecoin issuers, custodians, and payment arrangers, together referred to as 'stablecoin firms', that may want to establish in the UK and provide services to UK consumers. As set out in our [2023/2024 FCA Business Plan](#) and the [2022-2025 FCA Strategy](#), we want to achieve our objectives by developing a regime that reduces and prevents serious harm, sets and tests higher standards and promotes competition and positive change. In particular, through our proposed regulation of fiat-backed stablecoin activities, we are aiming to achieve the following outcomes that further align with our Strategy:

- Ensuring the UK continues to have a safe and stable regulatory environment where stablecoin firms protect consumers, markets operate with integrity, so far as possible, and foster innovation and competition among firms where appropriate. This aligns with our commitment to deliver assertive action on market abuse and supporting the Consumer Duty.
- Ensuring stablecoin firms provide services and products of appropriate standards, supporting our commitment to put consumers' needs first.
- Developing a stablecoin environment that is safe, minimises harm from firm failure and where customers can have confidence when interacting with firms and the payment ecosystem. This aligns with our commitments to reduce harm from firm failure and minimise the impact of operational disruptions.
- Greatly reducing the amount of stablecoins linked to illicit activities for firms authorised under the new regime, in line with our commitment to reduce and prevent financial crime.
- Ensuring customers are given appropriate information in a non-technical and easily understandable format, enabling them to make good decisions about the purchase of stablecoins, in line with our commitment to enable consumers to help themselves.
- Building a regime where stablecoins firms operate in line with ESG principles, meeting our commitment on environmental, social and governance.
- Promoting innovation involving, for example, the use of Digital Ledger Technology or innovative products, in line with our commitment to shape digital markets to achieve good outcomes.

## Who the new regime will affect

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**1.17** This DP will be of interest to anyone within the UK who has bought, or may in the future buy, fiat-backed stablecoins which may be used as a means of payment. This regime will also be of interest to a wide range of organisations and individuals that participate in the cryptoasset sector – with a focus on any cryptoassets that claim a form of stability and make use of a stabilisation mechanism.

**1.18** It will be of particular interest to:

- firms or individuals that design, issue or maintain a fiat-backed stablecoin, firms that provide custody for, or safeguarding ownership of, fiat-backed stablecoins – or the 'private keys' to access them (this will include any entity that takes custody of stablecoin, no matter how briefly, for example an exchange that does so to facilitate a trade)
- retail payment service providers, which may consider using fiat-backed stablecoins as an alternative means of payment
- cryptoasset firms providing services to UK consumers for fiat-backed stablecoins
- industry groups/trade bodies
- professional advisors
- consumer groups and individual consumers
- policy makers and other regulatory bodies
- industry experts and commentators
- academics and think tanks

## What this will mean for consumers

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- 1.19** Currently, firms' activities in relation to cryptoassets, including stablecoins, are largely unregulated in the UK. Due to the high-risk nature of cryptoassets, consumers should be prepared to lose all their money.
- 1.20** Our proposed regime will bring some activities involving fiat-backed stablecoins within our perimeter and will impose regulatory requirements on firms, to enhance both consumer protection and market integrity. This should enable consumers to buy stablecoins with confidence, and to ensure that they have the legal protections necessary for a money like instrument.
- 1.21** However, even once the fiat-backed stablecoin regime is introduced, consumers will need to be aware this is only an initial phase of cryptoasset regulation. Many activities involving cryptoassets will remain unregulated until addressed by the future regime. Additionally, the future regime will not remove all risks involving cryptoassets, and consumers should take this into account when participating in the cryptoasset market.
- 1.22** This is because, as set out in [the Treasury's consultation](#), even when the future regime for cryptoassets more widely is finalised it will not offer market integrity or protect consumers to the same degree as in traditional markets for financial instruments. This is due to the structure of the cryptoasset market. In particular, the inherently cross-border, fragmented nature of the market, the pseudonymity of wallets and the lack of a corporate 'issuer' of the cryptoasset. Consumers should be aware of these risks.

## Equality and diversity considerations

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- 1.23** In our DP, we have set out how our new regime will align with our strategy and identified the risks of custody and issuance of fiat-backed stablecoins used for payments, and the potential impact on consumers and the industry. In line with this, it is also important for us to consider the equality and diversity impact our regime will have on both consumers and industry.
- 1.24** Our recent Policy Statement on cryptoasset financial promotions noted our cryptoassets consumer research which showed that cryptoasset owners are more likely to be male and younger – aged under 45. Ownership of cryptoassets is also highest in London and Northern Ireland, and those who own cryptoassets are more likely to have a higher-than-average household income. This research also showed a low awareness of stablecoins and lack of understanding as being one of the main reasons for individuals not buying stablecoins. However, post regulation, this may change and there may be an increase in the use of stablecoins, particularly for payments.
- 1.25** For the purposes of our DP, we have considered the likely impact of our policy proposals and possible mitigants of identified risks in the market, by ensuring an appropriate degree of protection for consumers and setting high standards for both fiat-backed stablecoin issuers and custodians, particularly through our consumer duty requirements.

- 1.26** Fiat-backed stablecoins used for payments have the ability to execute payments in real-time, ie 24/7, and can be designed to be used for cross-border transactions, giving consumers the potential to send money cross-borders to friends and family. The potential faster settlement speed and interoperability of fiat-backed stablecoins could help promote inclusion and allow consumers with diverse ethnic origins to send money cross-borders faster and easier – as traditionally cross-border transactions can be expensive and slow. Further, fiat-backed stablecoins can offer lower transaction fees in comparison to traditional payment systems. This may help to further promote competition in the payments sector, causing price reduction and better services for consumers and industry.
- 1.27** Although there are benefits to the use of stablecoins, we acknowledge the potential risks of exclusion from digital finance. For example, vulnerable consumers, technologically unsavvy consumers or those who are digitally excluded, would likely not be able to use fiat-backed stablecoins easily as a means of payment in the UK and be unable to make use of the benefits outlined above. Our Financial Lives Survey (2022) results showed 7% of adults were digitally excluded and of this, 73% were aged 65 and above. Consequently, we do not envisage the proposals in our DP will have direct impact on the digitally excluded population and older consumers as they are unlikely to use fiat-backed stablecoins. This is supported by our cryptoassets consumer research noting that cryptoassets owners are more likely to be male and younger – aged under 45, and so likely to be more involved in this regime.
- 1.28** Our Financial Lives Survey has identified 2.1% of adults were unbanked, meaning they do not have a current or e-money account (of these, 6% were also digitally excluded). There are several reasons why some people are unbanked – ranging from not having the documentation required for bank account opening to lack of trust in banking services. However, 22% of unbanked adults said they would like to have a current account, showing an interest in financial services. This could suggest that following the regulation of fiat-backed stablecoins, there is a potential for an increased number of consumers, such as unbanked consumers, who may wish to use fiat-backed stablecoins for payments.
- 1.29** Post regulation, we recognise there will remain some unbanked consumers. For example, those who are not able to manage their own finances due to varying factors (eg with learning difficulties or disabilities) and those who have said they do not want a bank account (53% of unbanked adults). As a result, we do not expect the regulation of fiat-backed stablecoins will have further impact on individuals that remain unbanked.
- 1.30** Overall, we do not consider that the proposals in our DP would adversely impact any of the groups with protected characteristics under the Equality Act 2010 which include: age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment. However, as we develop our regime, we will continue to consider if our work could affect the make-up of consumers in this market, or otherwise impact on equality and diversity. As with our financial promotions work, we expect consumers across all groups will benefit from the protection of a regulatory regime for fiat-backed stablecoins.

## Next steps

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- 1.31** We welcome feedback on the topics discussed. The questions we want feedback on are in Annex 1. The discussion period will end on 6 February 2024. We will consider the feedback received to decide our next steps. We will consult on any proposals in this DP if we propose to adopt them as part of our final rules.

## What you need to do

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- 1.32** You can send us your comments using the form on our website. If you are not able to use the [form](#), contact us at [SC-DP23-4@fca.org.uk](mailto:SC-DP23-4@fca.org.uk) to discuss alternative ways to respond.

## Chapter 2

# A new UK stablecoin regime

- 2.1** In this chapter, we describe the stablecoin market and consider the risks it poses and opportunities it may provide for consumers and firms in the UK. We examine the case for regulation and the potential for our regime to set higher standards for fiat-backed stablecoin issuers and custodians, and fiat-backed stablecoins when used in UK payment chains. We expect our proposals to help increase consumer and industry confidence in this market.

## The stablecoin market

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- 2.2** The global stablecoin market continues to grow and evolve, with more than 200 cryptoassets that purport to maintain a stable value against one or more fiat currencies. In 2022, on-chain stablecoin transactions exceed \$7.5 trillion on the Ethereum blockchain alone. The overall landscape primarily captures the US Dollar stablecoins issued by Circle (USDC) and Tether (USDT). As of 12 October 2023, these had a combined market dominance of approximately 87% relative to the total stablecoin market capitalisation of \$123.4 billion.
- 2.3** According to data reported by Cryptocompare, dollar-backed stablecoins USDC and USDT continue to be the most widely used stablecoin exchanged and traded on UK exchanges. We also understand there is an increase in the number of UK exchanges that allow for the trading of stablecoins to GBP, and only a few exchanges that allow trading of GBP to stablecoin. We are aware of a small number of GBP-denominated stablecoins, but we are not aware of any currently being issued from the UK.
- 2.4** While the stablecoin market continues to play an important role within the cryptoasset market, there have been various high profile failures related to cryptoassets that claim to be stable that have resulted in significant consumer harm (eg through loss of investments). This has been demonstrated through the deviations of Terra Luna and IRON of their intended 1:1 value with the US dollar ('de-peg's), as explored by the IMF and Fed respectively, and addressed by the Bank of England through recent announcements.
- 2.5** As we have seen with the cryptoasset market, there is no single source of data, however we have relied on available external data sources for our market intelligence.

## Current stablecoin use cases

- 2.6** Stablecoins play an important role in the overall cryptoasset ecosystem. They are regularly used to facilitate trading, lending and borrowing of cryptoassets. For example, a stablecoin may be used as a means of exchange to facilitate a trade between two other cryptoassets, or between a cryptoasset and a fiat currency, eg by allowing the exchange of an unbacked cryptoasset for another cryptoasset (ie stablecoin) without leaving the crypto ecosystem.

- 2.7** While some stablecoins such as Circle USDC are mainly adopted by centralised exchanges to facilitate transactions, the largest existing stablecoin, Tether USDT, is frequently used as collateral in Decentralised Finance (DeFi). Stablecoins used in DeFi provide liquidity to 'liquidity pools' and help support price discovery and price stability in market making applications. Stablecoins are also used in lending platforms to enable investors to obtain yield on their cryptoassets when placed in lending arrangements.

## Stablecoins future use cases

- 2.8** There are various benefits to the use of stablecoins, for example in relation to their global nature and interoperability, and in time, stablecoins could be used to deliver faster, cheaper, frictionless payments between consumers and merchants. In 2019, Facebook (since renamed as Meta) launched a cryptocurrency project which included a global payment system on a permissioned blockchain that was designed to facilitate mass retail payments. The project did not receive Fed or US Treasury approval to proceed in the US where it was based. There were also concerns it could become a vehicle for money laundering or threaten global monetary stability. We have also seen an emerging interconnection of stablecoins with traditional payment systems although the UK's Financial Policy Committee continues to judge that direct risks to the stability of the UK financial system from cryptoassets and DeFi are currently limited.
- 2.9** It is also theoretically possible for stablecoins to be used as assets to carry out on-chain settlement in wholesale settings. This could form the basis of a wholesale use case that would enable an alternative way to operate settlement systems in the post-trade cycle, by replacing traditional Delivery vs. Payment (DvP) settlement with more efficient arrangements. In traditional DvP systems, specialised actors such as clearing houses first ensure that the two counterparties can fulfil their obligations by making sure that they have the required amount of available funds and relevant securities to confirm the trade and make sure that settlement actors (usually Central Securities Depositories) can finalise the trade and discharge counterparties' obligation in line with the terms of the underlying contract.
- 2.10** Stablecoins can fulfil the role of tokenised funds, bringing the 'payment leg' of the settlement system 'on-chain'. Differently from traditional DvP systems that usually require two days to be finalised, on-chain payments can be executed and settled almost simultaneously. This helps to eliminate counterparty-risk and possibly also enhance liquidity. The specific efficiency gains from the tokenisation of the settlement system will depend on the specific design solution that is adopted and on whether tokenised payments settling on-chain through stablecoins are coupled with tokenised securities also transferred and settled on-chain. Any use case would need to be consistent with existing and applicable regulation, including the Principles for Financial Market Infrastructure.

## Risks and harms associated with stablecoins

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- 2.11** As discussed in Chapter 1, we have seen risks and harms in relation to stablecoins, including various fiat-backed stablecoins. These have been set out further below.

## Backing assets and interconnectedness with traditional markets

- 2.12** Having the right assets in place to back a stablecoin is crucial if the stablecoin is to maintain a stable value and ensure consumers would get their money back if the stablecoin issuer failed. Despite this, we have seen in many popular stablecoins that information about the composition of stablecoin backing assets is often unavailable, incomplete or opaque. This makes it difficult for market participants to understand whether the stablecoin is fully fiat-backed or is backed by highly liquid assets, and whether the backing assets would be available to customers if something went wrong.
- 2.13** If backing assets are insufficient or unavailable, this can present a significant risk for consumers holding the stablecoin, who may be misled into believing it is stable and/or may not be able to redeem their stablecoins. This is likely to affect confidence within the wider system and may lead to a 'run' on the stablecoin.
- 2.14** Fiat-backed stablecoins rely on fiat currency to underpin their backing, this requires the stablecoin market to become interconnected with traditional finance to purchase and safeguard the stablecoins' backing assets. Most issuers of fiat-backed stablecoins hold (at least) part of their backing assets as deposits with banks or assets with custodians. Recent events, such as the temporary de-peg of USDC with the US Dollar following the collapse of Silicon Valley Bank, have highlighted the important relationship between stablecoins and traditional financial services. It also showed how market confidence for insufficient backing assets can influence a stablecoins ability to achieve stability.

## Redemption

- 2.15** At the moment, most issuers of fiat-backed stablecoins restrict redemption to wholesale users such as exchanges – either directly, or indirectly, where restrictions (such as high fees or minimum withdrawal amounts) function as a deterrent. This leaves retail consumers only able to trade their stablecoins in the secondary market, should they wish to exchange their stablecoin for fiat. If a depeg were to happen, eg where the stablecoin loses its value relative to the underlying asset, a retail consumer would be unable to make a request to the issuer to redeem their stablecoin at par. For example, when a USD stablecoin de-pegged from the dollar to a low of \$0.87, very small trades were executed as low as \$0.12. Using a wholesale operation model, the issuer was able to offer redemption at par to their direct clients. However, this was not available for retail clients who did not have contractual recourse to the issuer. They likely lost money if they sold their stablecoins on the secondary market at a price below par, in fear that the value may drop further.

## Custody of stablecoins

- 2.16** As with other cryptoassets, harm associated with stablecoin custody primarily arises due to poor safeguarding arrangements by the custodian. Without robust custody protections in place, there is a risk that consumers' rights to their stablecoins are not protected, increasing the chance of their stablecoin being lost, hacked, or in the case of the custodian's failure, the return of their stablecoin delayed. This has been shown in recent failures of cryptoasset firms, such as Celsius Network LLC and the FTX Group that provided custody services, where consumers suffered material delay in receiving their

assets back and/or complete loss of those assets due to various issues. This included co-mingling of the firm's and consumers' assets, the lack of accurate books and records, poor security controls where private keys and sensitive data could be accessed, unclear custody contracts and poor audit trails of governance with respect to consumers' assets, and consumers' contracts not being clear on how the assets were held.

## Money laundering

- 2.17** As with other cryptoassets, stablecoins may appeal to money launderers and other criminals who do not wish to expose their money to the traditional financial system. Due to being perceived as more stable than other cryptoassets, stablecoins may be more attractive to criminals who do not wish to be as exposed to the market volatility of unbacked cryptoassets. Further, stablecoins can offer a means for criminals to 'off-ramp' their cryptoassets to fiat currency.

## Fraud, scams and consumer understanding

- 2.18** There is a risk that consumers misunderstand the nature of stablecoins and are marketed misleading claims, such as of being able to achieve a form of stability without sufficient evidence. These risks are heightened in the case of fraud and scams. Crypto is the most searched product on our ScamSmart website and reports of crypto scams to the FCA have more than doubled since 2020.

## Payments

- 2.19** At the moment, stablecoins are not used as a widespread means of payment, although they are currently used for payments to facilitate trading of cryptoassets.
- 2.20** If stablecoins were used more widely, merchants would need to be assured that on exchange for goods or services, the funds for payments will reach their wallet or be deposited in their account efficiently and there is transparency of the process. For instance, that there are no delays or hidden costs associated with the transaction or that there is limited volatility in the stablecoin to ensure that they receive the expected price in fiat currency. In addition, consumers need to be confident in transacting using stablecoins as a means of payment. This will include, for example, setting out requirements that a transaction is executed within a specified timeframe and information requirements on charges that apply.
- 2.21** There are additional risks for example where payments do not reach their destination in a timely manner or where there are errors which result in a misdirection of payments. Therefore, consideration should be given to specifying clear and accountable parties in the payment chain and specific conduct requirements that will apply to parties.

## Our new stablecoin regime

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- 2.22** As set out in the [Treasury's Policy Statement](#), the Treasury intends to bring certain fiat-backed stablecoins into regulation, including to enable them to be used to pay for goods

and services. Consumers who wish to pay for their everyday shopping with stablecoins, must be able to do so under our regime with the legal and regulatory protections suitable for a money-like instrument. Using the same risk, same regulatory outcomes approach, the proposed requirements set out in this DP aim to:

- Mitigate the risks and harms that we have observed in the market, and those that arise from existing business practices (see paragraphs 2.11-2.21)
- Create appropriate consumer protections for a money-like instrument and ensure consumers have rights to redemption.
- Enhance integrity of traditional and stablecoin markets, by tackling risks-associated with backing assets and setting clear requirements for stablecoin issuers to adopt. It is necessary that stablecoins have appropriate backing assets in place and that these are safeguarded at all times. Stablecoins must be redeemed against the backing asset into fiat at par in a timely manner, regardless of the operational or technological arrangements or the available liquidity in the secondary market.
- Ensure good outcomes for consumers choosing to use stablecoins to make or receive payments, and that firms that develop and offer stablecoin payment services do so in a way that is compatible with these good consumer outcomes.
- Provide a robust resolution regime for cryptoasset firms that are facing failure, so that they can wind down solvently or enter insolvency in a way that minimises harm to consumers and market participants.
- Ensure that stablecoins used for payments have an effective mechanism for maintaining a stable value, regardless of the movements in the secondary markets.
- Enable firms to innovate and compete in a secure environment through a clear and robust legal framework, in line with the FCA's secondary objective to advance UK competitiveness and economic growth.
- Support our recent policy statement and final guidance for cryptoasset financial promotions, by ensuring that consumers are made aware of all relevant information related to a stablecoins and financial promotions are fair, clear and not misleading.

**2.23** The Treasury's Policy Statement sets out the various avenues for a fiat-backed stablecoin to be used as a means of payment in the UK, enabling both fiat-backed stablecoins that are issued from within the UK and overseas stablecoins that are created and issued by overseas issuers to be used in UK payment chains (ie to be used as a means to buy/sell goods and services). To support this, the Treasury have created the following two avenues, subject to the details of future legal drafting:

### **RAO: FCA authorisation for UK based stablecoins and custodians**

**2.24** A stablecoin issuer will need to seek authorisation from us to issue fiat-backed stablecoins in or from the UK. This includes issuing stablecoins that are not marketed to UK consumers. As outlined in the [Treasury's Policy Statement](#), the Treasury intend to bring two new activities relating to regulated stablecoins covering both issuance in or from the UK and custody activities carried out from the UK or to UK based consumers. Similar to other activities regulated through the RAO, firms will need to be authorised by us and comply with the relevant rules in our Handbook. Fiat-backed stablecoins issued by FCA authorised firms, termed 'regulated stablecoins', will be able to be used as a means of payment for goods and services in the UK. The custody activities will

only apply to safeguarding of such regulated stablecoins where issued by an authorised person and cryptoassets that already meet the definition of a specified investment, such as security tokens. We will address the custody requirements of other cryptoassets in future policy work.

## PSRs: Payment arranger assessing overseas stablecoins

- 2.25** As set out in the Treasury's Policy Statement, the Treasury is seeking to explore how to regulate the use of overseas stablecoins in UK payment chains, including whether to give us powers within the PSRs to authorise payment arrangers who would then assess overseas stablecoins against our standards. Under the approach Treasury is exploring, payment arrangers would be regulated under the PSRs and would have to be FCA authorised to assess overseas stablecoins against a set of standards set out by the FCA. Once authorised, payment arrangers that conclude an overseas stablecoin meets, and continues to meet, our standards, would allow that overseas stablecoin to be used to make payments within the UK, under the potential label of an 'Approved Stablecoin'.
- 2.26** The proposal explored by the Treasury to accommodate overseas stablecoins in UK payments for goods and services in the real economy could have drawbacks as well as benefits. We welcome industry engagement on this proposal and encourage responses to our questions in chapter 11.

## Wholesale use cases

- 2.27** In designing our stablecoin regime, we have primarily focused on the retail use cases. However, we are keen to receive feedback from industry on potential appetite for institutional and wholesale use cases within our regime, and how we may need to differentiate for them, if necessary or possible.

**Q1: Should the proposed regime differentiate between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes? If so, please explain how.**

## Regulatory landscape

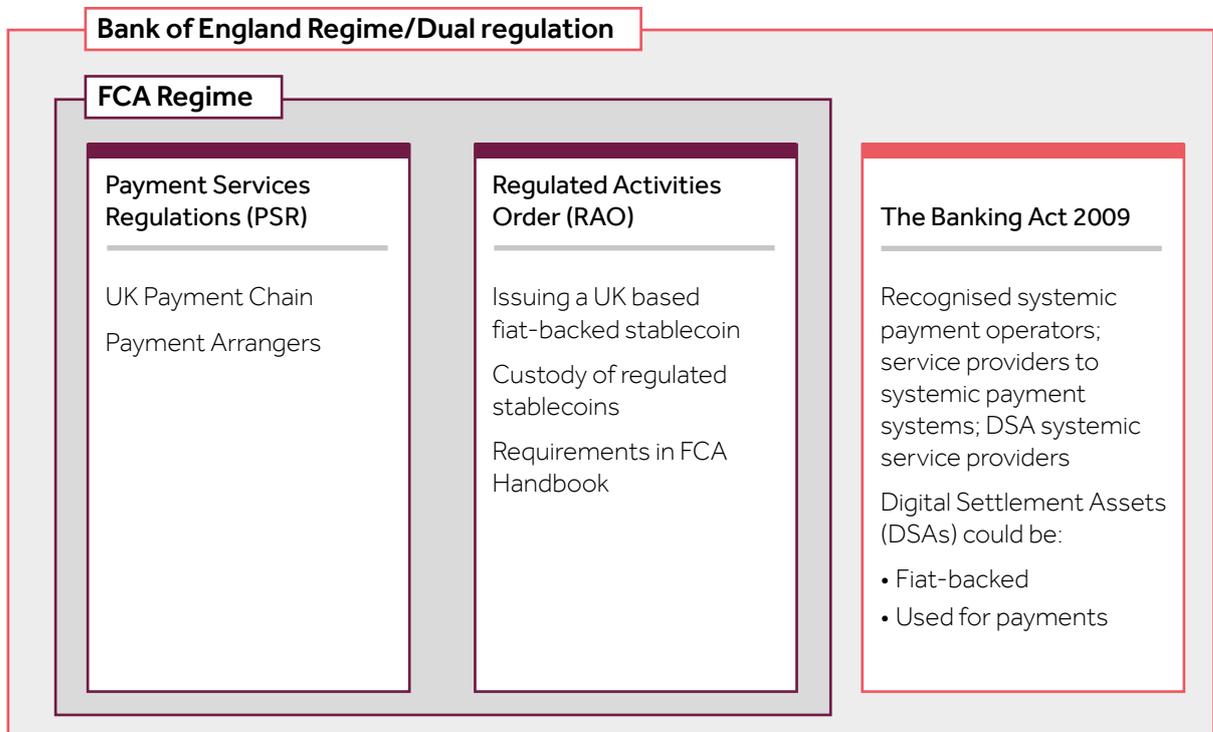
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- 2.28** Alongside our regime for regulated stablecoins, the Bank of England is developing a regulatory regime for systemic payment systems using stablecoins, and related service providers. If the Treasury recognises a stablecoin firm regulated under our regime as an operator of a (potentially) systemic payment system using stablecoins or service provider, the firm will become dual regulated by the FCA (for conduct purposes) and the Bank of England (for prudential purposes). In line with the Banking Act 2009, Treasury's assessment of whether a payment system of a firm is systemic will focus on whether any deficiencies in the design of the system, or any disruption of its operation, would be likely to threaten the stability of, or confidence in, the UK financial system, or could have serious consequences for business or other interests throughout the UK. Service

providers may also be dual regulated, and the Treasury would also use a similar criteria to assess stablecoins service providers that are likely to be systemic in their own right (see Section 2, Bank of England Discussion Paper).

**2.29** The FCA, Bank of England, PRA and Payment System Regulator are coordinating closely to identify systemic risks and to create a regulatory ecosystem for stablecoin issuers and custodians which minimise the risk of regulatory overlap. In our cross-authority roadmap with the Bank and PRA, we give further context on how stablecoins – and the regulators’ approach to them – fit into the broader landscape for money-like instruments. It also gives further clarity on how they may be subject to various regulatory regimes (eg be dual-regulated by the Bank and FCA) and how this may work in practice.

### **Future Joint Stablecoins Regulatory Regime**



## **Measuring the impact of regulation**

**2.30** The risks and harms discussed in this chapter and Chapter 1 can materialise due to issues such as negative incentives and feedback loops within stablecoin markets. The drivers of harm and market failures include information imbalances and optimism bias.

- **Information imbalances:** Custodians and issuers have better information on their business models and policies than consumers, including their safeguarding practices and composition of the stablecoin’s backing assets. Introducing higher standards would likely benefit consumers and mitigate this imbalance but will increase firms’ costs. This will likely be a consideration for firms when they decide whether to set up in the UK and be authorised under our new regime or

for overseas firms to offer their fiat-backed stablecoins to the UK as approved stablecoins.

- **Optimism bias:** Although falling sharply recently, cryptoasset prices have risen significantly in recent years, and this appreciation has led to a culture of optimism in the wider sector. Consumers may underestimate the likelihood of harm for cryptoassets including stablecoins and engage in unintended or inappropriate levels of risk-taking.

**2.31** By introducing rules and standards to address these drivers of harm, regulation can lead to better outcomes for consumers. Some of our proposed requirements will likely require changes to business models, and is likely to result in increased costs to firms associated with compliance. These may include:

- **Direct costs:** Any proposed requirements in this DP will need to be consulted on if we propose to adopt them as part of our final rules. Once any of the DP proposed requirements form part of our Handbook, firms will likely need to make changes to comply with these new requirements. Incremental costs will include costs associated with maintaining backing assets, managing redemptions, and complying with our prudential requirements. These will likely result in both one-off and ongoing costs, including IT development and maintenance of systems, staff training, communication, reporting and disclosure, and governance.
- **Indirect costs:** It is likely that regulation will incur indirect costs. These could include higher prices, if firms pass on any incremental costs (associated with compliance or business model changes) they incur to consumers. Our proposed requirements could also create barriers to entry or lead to firm exit, which may impact competition in the sector.

**2.32** We consider these costs in the context of the potential benefits of our proposed approach, including achieving, so far as possible, consumer protection and market integrity. For example, consumers can have more confidence that fiat-backed stablecoins will be protected by the proposed requirements set out in this DP, which we expect to encourage market participation. Firms can have reduced regulatory uncertainty and a more level playing field. This may lead more firms to enter the market and benefiting consumers through lower prices.

**Q2:** Do you agree with our assessment of the type of costs (both direct and indirect) which may materialise as a result of our proposed regime? Are there other types of costs we should consider?

**Q3:** Do you agree with our assessment above, and throughout this DP, that benefits, including cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, increased competition, could materialise from regulating fiat-backed stablecoins as a means of payment? Are there other benefits which we have not identified?

## Chapter 3

# Requirements for issuers: backing assets and redemption

## Why we need backing assets

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- 3.1** In this chapter, we set out the various requirements we would expect regulated stablecoin issuers to meet to ensure their regulated stablecoins maintain a stable value and can function as money-like instruments. These include issuers ensuring that their regulated stablecoins:
- maintain their value relative to their reference currency or currencies (ie 'peg')
  - can be promptly redeemed at par value by any holder of the stablecoin
- 3.2** The composition of the stablecoins' backing assets is key to achieving these 2 outcomes as well as how they are held and safeguarded. Under our regime, we propose that, at all times, issuers would need to hold backing assets that are (i) sufficient to back all their issued stablecoins; (ii) stable in value; and (iii) sufficiently liquid to support consumers' right to redeem the regulated stablecoin promptly. Backing assets would also need to be properly identified, recorded, segregated as well as protected in the event of insolvency of the stablecoin issuer.

## Amount and value of backing assets

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### Risks associated with stablecoins' backing assets

- 3.3** As set out in Chapter 2, serious risks can arise if backing assets are unavailable or insufficient. Having the right assets in place is crucial if the stablecoin is to maintain a stable value and to enable redemption that is swift and at par. It is worth noting that external factors can also impact the stability of a stablecoin. For example, external market forces may affect the value of the backing assets and weaken the mechanism for stability.
- 3.4** Risks associated with backing assets could, if materialised, affect confidence in the stablecoin and lead to a run on the stablecoin. This could have a range of impacts, it may:
- put strains on issuers (eg their ability to redeem in line with their contractual terms)
  - lead to retail consumers (who typically do not have rights to redemption at this present time) being 'forced' to accept less for their stablecoin on the secondary market in panic to sell
  - lead to a de-peg of the stablecoin
  - have a spill over effect to the wider crypto ecosystem, payment systems and traditional finance

## Purpose of requirements for backing assets

- 3.5** We aim to ensure that regulated stablecoins preserve a stable value by requiring the stablecoin issuer to constitute and maintain, on an ongoing basis and at all times, a reserve of backing assets equivalent in value to the circulating supply of the regulated stablecoin. This would also enable them to achieve prompt redemption of the regulated stablecoin on demand, in turn helping to maintain confidence in it.
- 3.6** We would also expect regulated stablecoin issuers to prudently manage the backing assets. For example, making sure a change in the stablecoin supply is always matched by a corresponding increase or decrease in the backing assets. They would also need to make sure there are adequate safeguarding arrangements for the backing assets to ensure that holders of the regulated stablecoin are able to redeem promptly, and the backing assets are protected for them if the issuer fails. Finally, customers should receive sufficient clear, non-technical and understandable information about the backing assets, including information about the backing asset's stability, sufficiency, constitution and how, and where they are held.
- 3.7** We consider that a regulated stablecoin's backing assets should be low risk, secure and sufficiently liquid. Low credit risk would reduce the possibility of the issuer facing losses from counterparty default, while low price volatility would simplify the management of the peg. To ensure smooth and timely redemption, backing assets would need to be sufficiently liquid, while the asset market should be deep enough to accommodate asset liquidations with minimal price impact. In addition, where stablecoin issuers appoint a third party (eg a credit institution or a custodian) to hold stablecoin backing assets, the issuer would need to take due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for holding those assets.

## Composition of a stablecoin's backing assets

- 3.8** We are considering a new framework where stablecoin issuers, under our oversight, are required to secure their stablecoins with government treasury debt instruments that mature in one year or less, along with short-term cash deposits. Additionally, we would not allow the use of Money Market Funds (MMFs) when investing in treasury bills to back stablecoins.
- 3.9** Short term government bonds carry little counterparty credit risk relative to other asset classes, and typically have low price volatility due to the short maturity. In addition, government bond markets usually have deep and liquid secondary markets that would allow asset liquidation to meet redemption requests. Compared to other asset classes, short-dated government bonds exhibit low credit risk, and relatively low liquidity risk even in times of stress. Further, short-term cash deposits in commercial banks exhibit no price volatility and in principle offer high liquidity. Still, deposits exhibit counterparty credit risk that would need to be managed through diversification with different banks. Later in this chapter, we outline our considerations for how regulated stablecoin backing assets should be safeguarded.
- 3.10** In developing our policy, we considered a broad set of potential backing assets such as Government term market bonds, Certificates of Deposits (CDs), Commercial Papers (CPs), High Rating Corporate bonds and Repurchase Agreements (Repo's). However,

these exhibit higher weighted risks, which we consider inappropriate for stablecoins. For instance, we do not regard instruments that rely on corporate debt or equity to be appropriate, as the weighted risk for these instruments can be too broad. In addition, corporate counterparty exposure naturally depends on credit ratings, which can fluctuate in an unpredictable manner. Finally, longer-term government debt was considered to be inconsistent in providing a low price volatility risk and liquid instrument, highlighted by notable examples of market stress during the October 2022 UK bond crisis.

**3.11** By restricting available backing assets to low risk, highly liquid and secure instruments, and cash deposits, consumers can be appropriately protected – as this will help to ensure they can promptly redeem their stablecoins on request. The low volatility of the proposed restricted backing asset list minimises the chances of disruption to the stablecoin and protects consumers, so far as possible, from adverse effects from a loss in the backing asset value.

**Q4:** Do you agree with our proposed approach to regulating stablecoin backing assets? In particular, do you agree with limiting acceptable backing assets to government treasury debt instruments (with maturities of one year or less) and short-term cash deposits? If not, why not? Do you envision significant costs from the proposal? If so, please explain.

**Q5:** Do you consider that a regulated issuer's backing assets should only be held in the same currency as the denomination of the underlying regulated stablecoin, or are there benefits to allowing partial backing in another currency? What risks may be presented in both business-as-usual or firm failure scenarios if multiple currencies are used?

## Remuneration

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**3.12** It is our understanding that currently, stablecoin issuers derive most of their revenue from the interest and returns from the backing assets. We propose that, under our regime, regulated stablecoin issuers can continue to retain, for their own benefit, the revenue derived from interest and returns from the backing assets. We are also considering that regulated stablecoin issuers should not be permitted to pay income or interest to consumers. This is in line with current market practice and would help set a clear distinction between stablecoins and deposits. However, we are conscious that this may be perceived as unfair to consumers, in the event that interest rates continue to remain high and/or go up significantly (given that the regulated stablecoin backing assets are expected to be protected as client assets).

- Q6: Do you agree that regulated stablecoin issuers should be able to retain, for their own benefit, the revenue derived from interest and returns from the backing assets. If not, why not?**

## Safeguarding the backing assets

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### Current harm and proposed regulatory approach

- 3.13** With our new regime, we would aim to ensure regulated stablecoins are fully backed, so that the backing assets are available to consumers in the event of business-as-usual redemption requests and if an issuer failed. A mismatch could arise between the backing assets and the regulated stablecoins in circulation. For example, when the value of the backing assets falls, technology errors occur, there is internal or external fraud, or the institution holding the backing assets fails. If these discrepancies are not detected and addressed promptly, there is a risk that consumers may not be able to redeem their stablecoins in a timely manner and could face losses of up to the entire value of their regulated stablecoins.
- 3.14** Traditional finance firms holding client assets experience similar risks. Our Client Assets regime (CASS) provides detailed rules for a firm to follow when it holds client money and/or custody assets (collectively 'client assets') as part of its business. These rules are aimed at ensuring a firm takes appropriate measures to protect client assets when it is responsible for them and allow for the assets to be returned as quickly, and as whole, as possible if the firm enters an insolvency process.
- 3.15** The following sections detail how we plan to apply and adapt the CASS regime to regulated stablecoin backing assets.

### Segregation and the statutory trust

- 3.16** An effective safeguarding regime needs to be based on segregating client assets from a firm's own assets and holding it in a trust for the benefit of customers. Adopting this approach for regulated stablecoin backing assets would help to protect such assets from loss, as well as ring-fencing them for consumers in case of the issuers' failure. We therefore propose that the backing assets for regulated stablecoins would be held on a statutory trust. The terms of the trust would be set out in our rules, including when the backing assets could be paid out of the trust (for example to meet redemption obligations) and how they would be distributed in a firm failure (see Chapter 9).
- 3.17** Where a firm plans to issue more than one regulated stablecoin, we are also considering a requirement to ensure each coin's backing assets are segregated from each other. This will help to guard against risks across coins and prevent cross-contamination of coins should assets become 'value shocked'.

## Should issuers back regulated stablecoins they own themselves?

- 3.18** We are aware that regulated stablecoin issuers, once authorised under our regime, may mint and hold their own coins. Since these coins are fungible with other issued regulated stablecoins, we are considering requiring these coins to be backed (like any other issued coins) by the firm. This would also ensure that, in case of a hack, unbacked regulated stablecoins could not make their way into the crypto ecosystem.
- 3.19** While this would mean a regulated stablecoin issuer would have an interest in the backing assets, we consider this would be due to its status as a consumer at the time. So, we do not think this would impact the integrity of the backing assets in the event of insolvency (see Chapter 9).

## Record-keeping

- 3.20** Accurate books and records are essential for ensuring a firm holds the correct amount of regulated stablecoin backing assets for a consumer. They help to reduce opportunities for fraud, misuse and loss of backing assets as well as facilitating a prompt distribution of backing assets if a firm fails. We are considering requiring a firm holding regulated stablecoin backing assets to:
- keep records it needs so that it can at any time, and without delay, distinguish the total amount of backing assets it should be holding for each consumer, and from its own assets
  - maintain records so they are accurate at all times and set out all activity relating to the backing assets, including records on the changing daily valuations of the backing assets
- 3.21** Due to the pseudonymity of cryptoasset wallets, firms holding regulated stablecoin backing assets may not necessarily know who owns each coin. So, we consider record-keeping will predominantly focus on the number of regulated stablecoins in issuance, the regulated stablecoin backing assets and tracking the number of regulated stablecoins entering and leaving circulation (through minting and burning respectively).
- 3.22** Reconciliations are checks undertaken by firms, comparing different sets of records, to ensure their accuracy, and to identify and resolve any discrepancies. Reconciliations would help firms check they are safeguarding the right value of regulated stablecoin backing assets for consumers, to protect them from the risk of a shortfall or an excess, and that they are segregating these assets from their own assets at all times. We are considering requiring a regulated stablecoin issuer to conduct internal and external reconciliations on at least a daily basis.
- 3.23** To conduct an internal reconciliation, a firm would compare its own record of what regulated stablecoin backing assets it is holding for consumers against its record of the number of coins in issuance and calculating whether the values match.
- 3.24** To conduct an external reconciliation, a firm would compare the firm's internal records of regulated stablecoin backing assets and regulated stablecoins in issuance against

the records of any third party with whom the regulated stablecoin backing assets are being held (eg a credit institution) and a third-party record of the regulated stablecoins in issuance (eg the blockchain).

**3.25** We are considering a requirement that firms have a means of validating whether the blockchain(s) or other distributed ledger accurately reflects the expected number of regulated stablecoins in issuance. This would enable firms to detect if the regulated stablecoin had been compromised and whether unauthorised (and so unbacked) regulated stablecoins had entered circulation.

**3.26** In line with existing firms subject to CASS, we are considering requiring firms to value the backing assets on a daily basis. We are considering requiring that the firm must ensure that the amount held is adjusted each day to an amount at least equal to the original currency amount to which the stablecoin is pegged, translated at either the previous day's closing spot exchange rate or the spot exchange rate at the time of the firm's reconciliation if this provides a more stable value for consumers.

### **Addressing discrepancies: scraping excesses**

**3.27** A reconciliation may identify that the backing assets are either greater in value, or less in value, than required. As set out above, we are considering that regulated stablecoin issuers should not be permitted to pay income or interest to consumers. So, we are considering applying the same approach for firms holding regulated stablecoin backing assets as we do for firms holding excess client assets in CASS. This means any income or growth in value of the regulated stablecoin backing assets should be removed from the client account by the firm within 1 business day. As this excess will become the firm's own assets, it should be transferred into firm's own accounts and treated as firm money from that point.

### **Addressing discrepancies: shortfalls**

**3.28** In our proposed regime, issuers would be required to redeem regulated stablecoins at par, even if the regulated stablecoin backing assets fall in value. To ensure that the regulated stablecoin backing assets are sufficient, we are considering requiring firms to 'top up' any shortfall promptly and at most within 1 business day. Firms will be expected to top up any identified shortfalls from its own liquid resources. We discuss liquidity requirements further in Chapter 8.

**3.29** Failure to promptly resolve a shortfall in regulated stablecoin backing assets poses various risks to consumers. These include:

- there could be a 'run' on the regulated stablecoin, causing the value of the regulated stablecoin to drop should the market become aware of the shortfall and potentially push the regulated stablecoin issuer into insolvency (see Chapter 9)
- those accepting the regulated stablecoin as a means of payment, or buying it on secondary markets, may do so on the expectation the promised backing is in place and so should the value be different from the expected due to an unidentified/ remediate shortfall, the recipient may suffer loss

- some consumers may redeem their regulated stablecoins from the issuer, withdrawing full value from the backing asset pool and concentrating the shortfall on a smaller number of consumers ('first mover advantage')
- issuers could take advantage of their knowledge of the shortfall and expectations around remedying it, at the expense of consumers (for example, selling their own regulated stablecoins on secondary markets at par value or buying up regulated stablecoins at below par).

**3.30** We are considering an approach to mitigate these risks, which would include a requirement to notify us to allow supervisors to engage directly with stablecoin issuers and identify an appropriate way to address the shortfall. After this FCA notification, supervisors and the firm would work together to assess any potential market disclosure requirements for the shortfall on an ad hoc basis. A wider market abuse regime is expected to come into force in phase 2 of the Treasury's cryptoasset regime.

### **Addressing discrepancies: Excesses**

**3.31** In traditional finance, when a firm identifies an excess in the assets that are being held for the benefit of the underlying consumer, they must act to rectify the value in the pool. Under our proposed regime, we are considering the same requirements for issuers, where if an excess was identified, the firm would be required to act upon and remove the excess from backing asset pool. Should this not happen, there is a risk that the backing asset pool becomes polluted with what is considered to be firm money. On insolvency, there is a risk that there may be a claim on the contents of the pool from the general estate due to this comingling.

### **CASS oversight officer, client assets audit and reporting**

**3.32** In traditional finance, firms are required to appoint an individual responsible for the operation and oversight of CASS compliance, including reviewing processes and controls, and clear oversight of third-party providers ('CASS oversight officer'). This helps to ensure regulatory accountability and ensure proper and timely monitoring of relevant systems and controls. We are considering requiring regulated stablecoin issuers to appoint a CASS oversight officer who is accountable for overseeing the regulated stablecoin backing assets as part of organisational requirements. For further details and discussion on the considerations of the Senior Managers and Certification Regime for regulated stablecoin issuers and custodians, see Chapter 6.

**3.33** In traditional finance, firms subject to CASS are required to provide us with an annual audit, carried out by an independent external auditor, on how they comply with the CASS rules (subject to limited exceptions). Such audits facilitate oversight and assurance of firms' controls, with a view to ensuring that each firm has the necessary systems and controls to effectively protect the client assets they are holding at all times. This is not a public or client report. We are considering a similar requirement for regulated stablecoin issuers on holding backing assets.

**3.34** CASS medium and large firms are required to submit a Client Money and Assets Return ('CMAR') to us on a monthly basis. This gives us an overview of the firm's client assets arrangements, as well as a view of industry trends. Given the nascent cryptoasset

industry, we are considering requiring all regulated stablecoin issuers to report similar information on their regulated stablecoin backing asset holdings to us monthly.

**Q7: Do you agree with how the CASS regime could be applied and adapted for safeguarding regulated stablecoin backing assets? If not, why not? In particular:**

- i. Are there any practical, technological or legal obstacles to this approach?
- ii. Are there any additional controls that need to be considered?
- iii. Do you agree that once a regulated stablecoin issuer is authorised under our regime, they should back any regulated stablecoins that they mint and own? If not, why not? Are there operational or legal challenges with this approach?

## Requiring an independent custodian to safeguard regulated stablecoin backing assets

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**3.35** We are aware that most regulated stablecoin issuers who hold the regulated stablecoin's backing assets will appoint a third party (eg a credit institution or a custodian) to hold those assets. Where that is the case, the regulated stablecoin issuer continues to be legally responsible for ensuring those assets are safeguarded appropriately. This approach is assumed for the above sections where issuers would be subject to the regulatory requirements that we put on regulated stablecoin backing assets.

**3.36** However, we are aware that a model could exist where a regulated stablecoin issuer partners with an independent institution and appoints that institution to take on the safeguarding responsibility and day-to-day administration of the regulated stablecoin backing assets (ie, an independent custodian). Where this is the case, the independent custodian is legally responsible for ensuring those assets are safeguarded appropriately. This is similar to the independent depositary model that exists for regulated funds.

**3.37** An independent custodian model would mean that the issuer of a regulated stablecoin uses a custodian to manage and safeguard the regulated stablecoin backing assets that would be completely independent from the issuer. The independent custodian would hold the regulated stablecoin backing assets directly for consumers without the issuer being involved. This would help to ensure consumers are not exposed to any insolvency risk of the issuer and minimise disruption if the issuer fails.

**3.38** However, as outlined above, an independent custodian model is fundamentally different from a regulated stablecoin issuer safeguarding backing assets and could give rise to different implications for consumers. This model helps to reduce the impact on consumers and markets from the insolvency of an issuer. But it has potential risks, including the credit risk of the independent custodian itself. We welcome views on the benefits and risks of adopting the independent custodian model for safeguarding regulated stablecoin backing assets, including whether there are alternatives that could offer equivalent levels of consumer protection, particularly if an issuer fails.

**Q8: We have outlined two models that we are aware of for how the backing assets of a regulated stablecoin are safeguarded. Please could you explain your thoughts on the following:**

- i. Should regulated stablecoin issuers be required to appoint an independent custodian to safeguard backing assets?
- ii. What are the benefits and risks of this model?
- iii. Are there alternative ways outside of the two models that could create the same, or increased, levels of consumer protection?

## Redemption on request

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### Existing harms and impact on consumers

**3.39** Redemption is a stablecoin holder's right against the issuer to cash out at par value. At the moment, redemption terms offered are generally set out in the contractual terms applying to the stablecoin, which are determined by stablecoin issuers. Although policies vary, we are concerned by the consumer harms we have seen arising from existing models. In particular, recourse to redemption is often restricted to wholesale users such as exchanges – either directly, or indirectly, where restrictions (such as high fees or minimum withdrawal amounts) act as a deterrent.

**3.40** In principle, all holders of stablecoins can sell their stablecoins on secondary markets in exchange for fiat (eg via an exchange), where they are not subject to an issuer's restrictions. During business as usual, this can be a convenient way to convert the stablecoin into fiat (although consumers will face conversion costs doing so). As long as the stablecoin maintains its peg on secondary markets, this is therefore an alternative to redemption. However, in the event of market turbulence or issuer failure, stablecoin holders may not be able to get par value for their coin on the secondary market. For example, when a USD stablecoin recently de-pegged from the dollar to a low of \$0.87 (with very small amounts of trades executed/ as low as \$0.12) it is likely that some retail consumers – who did not have contractual recourse to redemption with the issuer – lost money in a panic to sell. Further, any stablecoin holder looking to sell their coins for fiat on secondary markets is also subject to counterparty risk.

**3.41** We have also noticed that:

- restrictions are rarely clearly communicated on corporate websites and are not always reasonable or proportionate
- stablecoin issuers commonly do not commit to specific redemption periods and reserve the right to pause or halt redemption at their sole discretion (including for AML purposes)
- upon failure, retail customers may have no protected claim against the backing assets themselves and be treated as an unsecured creditor with a claim against the stablecoin issuer's own funds

## Purpose of regulating redemption

- 3.42** We aim to ensure that all holders of regulated stablecoins can convert their stablecoin into fiat at par value at all times while the issuer is a going concern. Although they can sell their stablecoins on an exchange at any time, this will allow them to redeem with the issuer at par when the coin has de-pegged on the secondary market. We are aware that this will be a significant change for stablecoin issuers who currently only seek to interact with wholesale or institutional clients. However, in our view, as long as consumers are able to get an issuer's stablecoin, they should have a right of redemption.
- 3.43** We also want to ensure that redemption requests are always executed in a timely and smooth fashion, not only to protect consumers, but also to help maintain confidence in the regulated stablecoin. Based on a survey we conducted, some firms who are currently planning to issue a regulated stablecoin in the UK, reported they are considering offering customers redemption within 24 hours of a request.

## Redemption on request

- 3.44** We propose that, where regulated stablecoin issuers are a going concern, they will need to ensure redemption at par to all holders of the regulated stablecoin by the end of the next UK business day after receiving their redemption request. For some issuers, this may be the first point of interaction with consumers. So, we are proposing that this period starts only once the consumer has submitted all the necessary/requested documents to enable the issuer to complete relevant AML/CTF checks.
- 3.45** Some regulated stablecoin issuers may be interested in considering outsourcing certain, or all, operational aspects of the redemption activity, and welcome input from industry on any arrangements they may be considering. Although we are open to allowing the outsourcing of the redemption activity (eg to a custodian), we should highlight the legal redemption claim, and any corresponding liability, would remain on the regulated stablecoin issuer at all times.
- 3.46** We are also proposing the following, additional, requirements:
- The full redemption policy must be clearly disclosed and accessible on the regulated stablecoin issuer's website at all times. Consumers cannot be expected to carry out detailed examination of terms and conditions to find out basic components of the issuer's redemption policy.
  - Any redemption fees must be cost-reflective. We do not currently see a case for allowing additional restrictions but welcome views in Question 9.
  - Regulated stablecoin issuers will be required to carry out customer AML checks when dealing with customers directly at redemption if this is the issuer's first point of interaction with those customers. Redemption requests received from unhosted wallet owners would also require AML checks at the point of redemption.
  - Redemption should take place in the same currency in which the regulated stablecoin is denominated.
- 3.47** If the regulated stablecoin issuer chooses to retain any stablecoins for re-circulation following redemption, these must continue to be backed in line with our backing requirements, from the moment of retention (see also the previous section 'Should

issuers back coins they own themselves?'). These proposals are consistent with current international standards, including the Final Recommendations on the Regulation, Supervision and Oversight of Global Stablecoin Arrangements, recently published by the FSB.

### Temporary suspension of the redemption period

**3.48** At times, external events can make it challenging for a regulated stablecoin issuer to continue redeeming stablecoins by the next UK business day. One scenario could be a run on the regulated stablecoin or a de-peg due to external, unforeseen circumstances. So we are exploring the case for temporarily suspending the 'next day redemption requirement' in certain exceptional cases, and welcome input from firms on the type of scenarios we should consider in Question 9. Consumers would still have a legal redemption claim on the regulated stablecoin issuer during this and any other time, but the issuer would have additional time to make the relevant payment out of the backing assets for the redemption request. By temporarily suspending the 'next UK business day redemption requirement' we hope that regulated stablecoin issuers are enabled to better deal with the exceptional circumstance and reduce the chance of failure of the regulated stablecoin issuer.

**Q9: Do you agree with our proposed approach towards the redemption of regulated stablecoins? In particular:**

- i.** Do you foresee any operational challenges to providing redemption to any, and all, holders of regulated stablecoins by the end of the next UK business day? Can you give any examples of situations whether this might be difficult to deliver?
- ii.** Should a regulated issuer be able to outsource, or involve a third party in delivering, any aspect of redemption? Please explain which aspects and why.
- iii.** Are there any current restrictions to redemption, beyond cost-reflective fees, that we should consider allowing? If so, please explain.
- iv.** What costs do you anticipate from our proposed redemption policy?

**Q10: What proof of identity, and ownership, requirements should a regulated stablecoin issuer be gathering before executing a redemption request?**

## Chapter 4

# Regulated stablecoin issuers: other key expectations

### Consumer needs and expectations

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- 4.1** Regulated stablecoin issuers need to give thought to their obligations to consumers, including retail consumers (if they are capable of being held by retail consumers, irrespective of who the stablecoins are initially issued to), throughout the stablecoin life cycle. In this chapter, we focus on such other key expectations of regulated stablecoin issuers, including obligations under the Consumer Duty.

### Delivering good outcomes for consumers

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- 4.2** The Consumer Duty requires FCA-regulated firms to act to deliver good outcomes for retail customers. It applies broadly to retail market business and (as discussed in Chapter 7) we propose that it, and our other Principles for Businesses, apply to both regulated stablecoin issuers and custodians.
- 4.3** Regulated stablecoin issuers, whose stablecoins could be accessed by retail consumers (including through secondary markets), will need to consider the Consumer Duty in the design and build of their stablecoins, as well their ongoing operation. As part of this, for instance, they would need to ensure the design meets the needs, characteristics and objectives of the target market and that the regulated stablecoin avoids causing foreseeable harm to the target market.

### Contractual rights and obligations

- 4.4** We would expect the terms and conditions underlying a regulated stablecoin to be reasonable and proportionate. For example, if regulated stablecoin issuers reserve the right to 'freeze' specific stablecoins, this should not impede consumers' use of the stablecoin, and only be used for narrowly defined objectives (eg for anti-money laundering purposes, to combat fraud and to comply with sanctions). Regulated stablecoin issuers would also need to consider and comply with any other law that applies to their business, including consumer protection legislation such as the Consumer Rights Act 2015, which requires terms in consumer contracts and in consumer notices to be fair and transparent.

**Q11:** Do you agree with our approach to the Consumer Duty applying to regulated stablecoin issuers and custodians? Please explain why.

## Communicating information

**4.5** In line with the Consumer Duty and our rules for cryptoasset financial promotions, we expect regulated stablecoin issuers to publish key information on their regulated stablecoins on their website and main communication channels for consumers to understand. This information would need to be communicated in a way that meets the requirements set out in our rules for financial promotions. For example, all information should be communicated in a way that is fair, clear and not misleading, updated frequently (eg on a daily basis if necessary), and, as a minimum, include:

- A description of the regulated stablecoin, details of how the form of stability or links to a fiat currency is maintained and total number of tokens in circulation.
- The composition and value of the backing assets, and any relevant evidence to support these claims (eg the most recent independent audit of the composition, value and safeguarding arrangements, such as the custodian responsible for the backing assets and the relationship with the issuer).
- Rights and obligations of the regulated stablecoin issuer and stablecoin holders (eg the terms and conditions). This includes; clear terms of redemption for consumers, the timescales for redemption, fees, proof of ownership requirements of the token that can be redeemed and clearly setting out the type of asset/ currency returned to the consumer after redemption.
- Risks that could affect the stability of the reference value and the backing assets.

**4.6** We are also considering how regulated stablecoins may interact with our existing financial promotions regime for cryptoassets. As set out through our rules, stablecoins are currently categorised as 'restricted mass-marketed investments' for the purposes of communicating financial promotions to consumers. This would allow cryptoassets to be mass marketed to UK consumers subject to certain restrictions, in addition to the overarching requirement that financial promotions must be fair, clear and not misleading. We are considering whether regulated stablecoins should be categorised differently for our financial promotion rules to reflect their new regulatory status. For example, this could be re-categorising regulated stablecoins from 'restricted mass-marketed investments' or by creating a tailored category to ensure appropriate consumer protections. In any scenario, financial promotions must continue to meet our requirements to be fair, clear and not misleading and consumers must understand all relevant information before investing.

**Q12: Do you consider that regulated stablecoins should remain as part of the category of 'restricted mass marketed investments' or should they be captured in a tailored category specifically for the purpose of cryptoasset financial promotions? Please explain why.**

## Chapter 5

# Custody requirements

## Regulating custody of cryptoassets

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- 5.1** This chapter sets out our approach to setting the standards that should apply to custody of regulated cryptoassets (or the means of accessing them, such as private keys). We recognise that consumers may not hold their cryptoassets with a custodian and may instead hold them directly ('self-custody'). This chapter focuses on situations where a custodian holds a consumer's cryptoassets.
- 5.2** This chapter is relevant to custody of both regulated stablecoins and those cryptoassets that already meet the definition of a specified investment (ie security tokens). Subject to feedback to this DP, we are likely to apply a similar approach to custody of other cryptoassets that come into regulation in the future.
- 5.3** For our proposed approach to safeguarding of regulated stablecoin backing assets, see Chapter 3.

## What is custody?

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- 5.4** In financial services, the term 'custody' broadly refers to a firm holding an asset on behalf of another. In traditional finance models, consumers and firms rely on custodians to access global markets and secure their assets to reduce risk of loss. The Client Assets Sourcebook (CASS) gives detailed rules for a firm to follow when it holds custody assets as part of its business. These rules are aimed at ensuring the custodian takes appropriate measures to protect clients' custody assets when they are responsible for them and allow for the assets to be returned as quickly and as whole as possible to clients if the custodian enters an insolvency process. (Throughout this chapter, we refer to 'clients' and 'client assets' to reflect the CASS regime.)
- 5.5** The CASS regime supports our statutory objectives and underpins FCA Principle 10 by requiring firms to arrange adequate protection for client assets when they are responsible for them. Protecting client assets is fundamental to the trust that consumers place in firms; it is at the heart of ensuring a well-functioning and robust market.
- 5.6** There are an increasing number of firms in the cryptoassets market offering custody as a service. This service allows access to, and safe storage of, assets for clients who may not be confident to self-custody their assets that they feel custodians are better placed to safeguard. As cryptoassets are increasingly being adopted and incorporated into existing financial services, large traditional financial institutions, technology providers, trading venues and intermediaries are expanding their activities to include cryptoasset custody services.

## What cryptoasset custody involves

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- 5.7** As described in Chapter 1, custody of cryptoassets is conceptually similar to traditional finance. The custodian holds itself out as being responsible for safekeeping a cryptoasset on behalf of another. However, cryptoasset custody operates differently from traditional finance custody arrangements in some important ways, and we have seen a range of business models adopted by cryptoasset custodians.
- 5.8** Information is recorded on blockchain or other distributed ledger technology (DLT), often pseudonymously, and the custodian may hold a private key that allows access and use of the cryptoasset. Custodians can use a range of technology solutions to secure the assets and private keys. This includes both online (or 'hot') and offline (or 'cold') storage wallets, as well as techniques such as multi-party computation (which seeks to increase security by securely distributing the private data required to validate transactions among multiple users). The generally irreversible, immutable nature of cryptoasset transactions contained in 'finalised blocks' means that protecting against unauthorised access to these private keys is especially important. In this DP, we refer to DLTs as being irreversible and/or immutable. We understand that due to a concept known as 'probabilistic finality', permissionless blockchains usually adopt 'finalisation rules' that treat all transactions contained in minted and/or validated blocks before a predefined time limit as final (except where a deliberate majority reverts the blockchain by forking the main chain). We recognise that due to the different protocol rules of permissionless DLTs, this will mean that finality of settlement depends on the consensus and finality rules of a particular DLT.

## What happens if a cryptoasset custodian fails

- 5.9** If a cryptoasset custodian were to fail today, the lack of a clear regulatory framework could result in uncertainty that would likely cause harm to clients through delays in the return of assets, extra costs or, worst of all, loss of their assets. Without clear regulatory standards to which cryptoasset custodians are required to adhere, cryptoassets may not be safeguarded adequately, which may lead to losses should the cryptoasset custodian enter insolvency (whether due to being treated as assets of the custodian, or through operational errors). In addition to the harm to clients, an outcome that results in uncertainty in insolvency may impact confidence in the overall regulatory regime.
- 5.10** This was shown in the recent failures of Celsius Network LLC and the FTX group, both of which provided cryptoasset custody services. According to its recent [bankruptcy filing](#), Celsius had misappropriated client assets and at the time of its insolvency owed \$4.7bn to customers. In the case of FTX, at least \$8bn of client assets were reported to be missing. According to [filings in the US bankruptcy court for Delaware on FTX Trading](#), FTX's practices included 'potential commingling of digital assets...use of an unsecured group email account as the root user to access confidential private keys and critically sensitive data...' and 'an absence of lasting records of decision-making.'

## Proposed regulatory approach

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- 5.11** Our overarching objective is to ensure adequate protection of clients' cryptoassets while a cryptoasset custodian is responsible for them and that those assets are returned as quickly and as wholly as possible to clients if a custodian enters an insolvency process.
- 5.12** We have considered others' publications to inform our thinking to date, including IOSCO's proposed policy recommendations for crypto and digital asset markets on custody of client assets and the Law Commission's final report on digital assets.
- 5.13** We are considering using existing custody provisions in CASS as a basis to design bespoke custody requirements for cryptoassets. We propose to apply the following core components of our existing regime:
- adequate arrangements to protect clients' rights to their cryptoassets
  - adequate organisational arrangements to minimise risk of loss or diminution of clients' custody assets
  - accurate books and records of clients' custody assets holdings
  - adequate controls and governance to protect clients' custody asset holdings
- 5.14** An alternative could be to adopt a more prescriptive approach to regulating safeguarding arrangements, which would be less outcomes focused. While this might help provide further regulatory clarity, it may become outdated given the fast-evolving nature of the cryptoasset market. This could hamper innovation and may not lead to better outcomes for consumers and market integrity.
- 5.15** We believe the proposals we outline in the following sections would provide an effective approach towards protecting clients' cryptoassets, while also aligning with the principle of 'same risk, same regulatory outcome'. We believe that existing CASS provisions, if properly implemented, can give appropriate levels of protection and confidence to consumers, as applies in traditional finance today. But we will consider adjusting some elements of CASS to take into account the unique characteristics of, and risks associated with, cryptoasset custody. We welcome feedback through the questions in this chapter.

## Safeguarding clients' rights to their cryptoassets

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### Segregation of client assets

- 5.16** In traditional finance, custodians are required to segregate client assets from their own so that in the event of insolvency, client assets are adequately ringfenced and protected from any other creditors' claims to the failed custodian's estate. We are considering requiring custodians to segregate clients' cryptoassets from their own through recording of ownership and wallet labelling. This would help to ensure that beneficial ownership of clients' cryptoassets is protected at all times while held in custody.
- 5.17** Omnibus wallet structures can create operational efficiencies and reduce costs for custodians safeguarding clients' cryptoassets, particularly for high frequency

transactions. We are considering continuing to permit firms the use of omnibus wallets to safeguard clients' cryptoassets, provided that clients' ownership rights are preserved at all times.

**Q13: Should individual client wallet structures be mandated for certain situations or activities (compared to omnibus wallet structures)? Please explain why.**

**Q14: Are there additional protections, such as client disclosures, which should be put in place for firms that use omnibus wallet structures? Are different models of wallet structure more or less cost efficient in business-as-usual and firm failure scenarios? Please give details about the cost efficiency in each scenario.**

## Recording ownership

- 5.18** Keeping accurate and up-to-date records helps firms to correctly identify the owners of assets held in custody at all times. We are considering requiring a record of ownership of safeguarded cryptoassets, including records identifying that they hold the means of access to cryptoassets (eg private keys).
- 5.19** DLT can enable simultaneous access to, validation and updating of records that are generally immutable. Where a cryptoasset custodian is undertaking all transactions on-chain (ie all transactions occur on the blockchain or other DLT), we are considering permitting an on-chain record of ownership rights, providing it accurately reflects ownership at the time it is made, and adequate measures are in place to preserve its integrity at all times. We are keen to understand the extent to which additional controls may be required to maintain accuracy and integrity of the on-chain record at all times. This includes where custodians use a mix of on-and off-chain records.
- 5.20** Alternative approaches to recording ownership, such as requiring custodians to use off-chain records, could increase security but would limit efficiencies in terms of access, validation and updating of records through DLT. We welcome feedback on this alternative, and our approach to recording ownership, in Question 16.

## Use of clients' cryptoassets

- 5.21** In traditional finance, custodians are generally prohibited from using client assets held in custody for their own, or another client's, benefit. This is to preserve clients' ownership rights and to protect their assets at all times. In some instances, custodians are permitted to use custody assets for other purposes (eg re-use, rehypothecation), providing the client has given express prior consent, use is restricted to the specified terms to which the client consents and custodians are required to report certain use of assets to clients. There are further restrictions in CASS for retail clients, whereby such arrangements are only permitted for securities financing transactions. Separately, where a client entrusts their assets with a custodian for collateral purposes, these are subject to our collateral rules.

- 5.22** In these arrangements, clients generally do not remain the beneficial owners of their assets. If a custodian enters insolvency, clients would become unsecured creditors of the custodian and would be unlikely to get their assets back as they now belong to the custodian (and would likely be liquidated as part of the custodian's estate).
- 5.23** There are cryptoasset service providers carrying out multiple functions for their clients, in addition to custody. We are considering whether to permit the use of clients' cryptoassets held under custody, for example to provide staking services, hold cryptoassets as collateral, or in some instances lend them to other clients. We recognise that cryptoasset custodians may lose revenue if they are no longer permitted to use clients' cryptoassets for other purposes and so may decide to change their business models. We also recognise that there are risks associated with these arrangements and are considering whether to apply similar restrictions as our requirements for traditional finance custodians outlined above.

**Q15: Do you foresee clients' cryptoassets held under custody being used for other purposes? Do you consider that we should permit such uses? If so, please give examples of under what circumstances, and on what terms they should be permitted. For example, should we distinguish between entities, activities, or client types in permitting the use of clients' cryptoassets?**

## Minimising the risk of loss or diminution of clients' cryptoassets

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### Adequate organisational arrangements

- 5.24** Organisational arrangements relate to how a firm organises its operations, systems and controls. Inadequate organisational arrangements by cryptoasset service providers, including poor record-keeping practices, and weak systems and controls, have led to hacks and thefts of clients' cryptoassets. This has resulted in significant financial losses to consumers, such as in the [2014 hack of cryptoasset exchange Mt. Gox](#), the [2019 hack of cryptoasset exchange Binance](#) and the [2020 hack of cryptoasset exchange KuCoin](#).
- 5.25** We are considering requiring cryptoasset custodians to have adequate organisational arrangements to minimise risk of loss or diminution of clients' cryptoassets due to misuse, fraud, poor administration, inadequate record-keeping, use of assets as part of money laundering, illicit activities or negligence. We are also considering requiring custodians to have policies and procedures that are reviewed regularly and amended as required, including on the skills and expertise of their employees. This approach aligns with current requirements applied to custodians in traditional finance.
- 5.26** We discuss our approach to organisational requirements for regulated stablecoin issuers and custodians further in Chapter 6.

## Liability for loss of cryptoassets

**5.27** Liability standards for cryptoasset custodians would generally be set in legislation (rather than FCA rules). We understand that the Treasury proposes to take a proportionate approach to cryptoasset custody, which may not impose full, uncapped liability on the custodian in the event of a malfunction, hack or other loss that was not within the custodian's control. If clients' cryptoassets were lost in a sub-custodian arrangement, the assignment of liability would depend on the terms of the contract between the custodian, sub-custodian, and client (see paragraphs 5.36-5.41 for additional requirements to use third parties). In line with that approach, we are considering requiring custodians (and sub-custodians, if applicable) to disclose their safeguarding controls and liability if at fault for loss of clients' cryptoassets explicitly in client agreements. This would help make clients aware of our expectations and the avenues available to clients for recourse in the event of loss.

## Recording clients' custody cryptoasset holdings

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### Accurate books and records

**5.28** Accurate books and records are essential for ensuring a custodian holds the correct amount of custody assets for a client at all times, helping to reduce opportunities for fraud and loss of assets as well as facilitating a prompt return of assets if a firm fails.

**5.29** We recognise the differences and potential benefits of DLT compared to traditional methods of record-keeping – namely the simultaneous access to, validation and updating of records that are immutable. We are also exploring the implications of custodians using a mixture of both on-and off-chain records for clients' cryptoasset holdings. As such, we are considering requiring a custodian to:

- keep records as necessary to enable it any time and without delay to distinguish cryptoassets held for one client from cryptoassets held for any other client, and from the firm's own cryptoassets
- maintain records in a way that ensures their accuracy and that they may be used as an audit trail
- maintain a client-specific cryptoasset record

**5.30** We are considering permitting firms to use on-chain records to meet the above expectations, providing adequate measures are in place to preserve accuracy and integrity of the record at all times.

**5.31** These requirements would help to ensure a custodian can at any time, and without delay, distinguish the cryptoassets, or means of access to them, held for one client from another and from the custodian's own. Accurate records are also important if a firm fails, whether that be of the custodian or of the provider of the blockchain, by helping to ensure clients' cryptoassets are protected and, if necessary, returned to clients promptly.

**Q16: Do you agree with our proposals on minimising the risk of loss or diminution of clients' cryptoassets? If not, please explain why not? What additional controls would you propose? Do you agree with our proposals on accurate books and records? If not, please explain why not.**

## Reconciliations

- 5.32** Reconciliations are checks undertaken by firms, comparing different sets of records, to ensure their accuracy, and to identify and resolve any discrepancies. Reconciliations help firms check they are safeguarding the right amount of custody assets for the right clients, to protect them from the risk of a shortfall or excess, and that they are segregating clients' assets from their own at all times.
- 5.33** In traditional finance, firms are required to conduct regular internal reconciliations, checking the record of what client assets should be held against the record of client assets that are being held. Firms are also required to conduct regular external reconciliations, checking the firm's internal records of client asset holdings against those of relevant third parties, eg sub-custodians.
- 5.34** In some custody business models, transactions take place off chain due to operational efficiencies. As a result, on-chain records may not be a reliable source at all times. For this reason, we are exploring the use of both on-and off-chain records in our requirements.
- 5.35** We are considering requiring custodians to conduct reconciliations of each client's cryptoassets on a real-time basis to identify and resolve discrepancies promptly, taking into account on-and off-chain internal and relevant external records. We are also considering requiring a custodian to take appropriate steps to cover any shortfalls that arise if discrepancies are not resolved following reconciliations.

**Q17: Do you agree with our proposals on reconciliation? If not, please explain why not? What technology, systems and controls are needed to ensure compliance with our proposed requirements?**

## Governance and control over safeguarding arrangements of clients' custody asset holdings

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### Use of third parties

- 5.36** In traditional finance, firms can use third parties (including sub-custodians) to provide custody services for a particular market or jurisdiction where they do not themselves operate.

- 5.37** In CASS, firms are required to take steps when appointing sub-custodians to safeguard client assets. These help to ensure adequate governance and control, so that firms engaging the services of sub-custodians still have sufficient oversight and custody assets are adequately protected in these arrangements.
- 5.38** In cryptoasset custody, the use of DLT facilitates real-time transactions across global markets and jurisdictions. Custodians in this space are exploring the use of sub-custodians and other third parties, such as technology providers, to provide technology infrastructure, specialist expertise or storage facilities to safeguard clients' cryptoassets. Such arrangements are likely to be subject to our proposals on operational resilience requirements (see Chapter 6). Whether technology providers will also be caught by our custody requirements will depend on whether they undertake custody activities that would be captured by the new custody regulated activity created by the Treasury.
- 5.39** In addition, we are considering requiring custodians that use sub-custodians and other third parties to comply with the following requirements:
- undertake adequate due diligence in the selection, appointment and periodic review of the third party
  - consider the expertise and market reputation of the third party and any legal requirements related to holding custody assets that could adversely affect clients' rights
  - ensure that any custody assets deposited with a third party are identifiable separately from the assets belonging to the custodian and assets belonging to the third party
  - have a written agreement whenever they place custody assets with a third party, which must clearly set out the custody service (or services) that the third party is contracted to provide.
- 5.40** Allowing the use of third parties could result in risks to controls and governance, and an alternative approach could be prohibiting the use of third parties. However, we believe we can mitigate these risks by having strict due diligence requirements on cryptoasset custodians.
- 5.41** We believe the use of third parties could improve custodians' operations, systems and controls, providing greater protection to clients' cryptoassets (particularly if they provide infrastructure or services that custodians otherwise could not). Permitting the use of third parties could also foster innovation and competition in the cryptoasset custody market, potentially providing clients with more choice and better prices for custody services.

**Q18:** **Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.**

## Client disclosures and statements

- 5.42** In traditional finance, custodians are required to provide certain disclosures to clients about their safeguarding arrangements. This includes how certain arrangements may give rise to specific consequences or risks for those client assets. Custodians are also required to provide periodic statements to each of their clients of the assets they hold for that client.
- 5.43** We are considering similar client disclosure requirements by custodians for clients' custody cryptoassets and whether this should include Proof of Reserves (PoR). PoR involves a cryptographically proved, independent audit process that cryptoasset custodians can use to verify that the amount of client cryptoassets held in custody corresponds precisely with the assets they are actually holding in reserve on behalf of those clients. We are also considering requiring custodians to give clients a statement of account, with information on their cryptoasset holdings and transactions. We welcome feedback on these disclosure requirements in Question 19.

## CASS oversight officer

- 5.44** In traditional finance, firms are required to appoint an individual responsible for the operation and oversight of CASS compliance, including reviewing processes and controls, and clear oversight of third-party providers ('CASS oversight officer'). This requirement was introduced to enhance firms' focus on client asset protection, increase regulatory accountability, and ensure proper and timely monitoring of relevant systems and controls. We are considering requiring cryptoasset custodians to appoint a CASS oversight officer who is accountable for overseeing the custody arrangements.

## Client assets audit

- 5.45** In traditional finance, custodians are required to provide us with an annual audit, carried out by an independent external auditor, on how they comply with the CASS rules (subject to limited exceptions). CASS audits facilitate oversight and assurance of firms' controls, with a view to ensuring that a firm has the necessary systems and controls to protect client assets at all times. This is not a public or client report. They also provide firms the opportunity to gather, review and interrogate CASS data and remedy weaknesses in their systems and controls.
- 5.46** We are considering how to apply this requirement to cryptoasset custody, and what additional controls may be needed to ensure the quality of audits in this space. We are engaging with auditors to understand their views on industry best practices and the Financial Reporting Council (FRC), which sets standards for auditors.

## Regulatory reporting

- 5.47** CASS medium and large firms are required to submit a monthly Client Money and Assets Return ('CMAR') to us. This gives us an overview of the firm's client assets arrangements, as well as a view of industry trends. We use this information to assess risks, develop policy and set supervisory priorities.

**5.48** Given the nascence and potential for unforeseen risks of a previously largely unregulated industry, we are considering requiring custodians of all sizes to report similar information on their clients' cryptoasset holdings to us monthly.

**Q19:** Do you agree with our proposals on adequate governance and control? If not, please explain why not? What (if any) additional controls are needed to achieve our desired outcomes? What challenges arise and what mitigants would you propose?

**Q20:** Should cryptoasset custodians undertaking multiple services (eg brokers, intermediaries) be required to separate custody and other functions into separate legal entities?

## Ancillary activities to cryptoasset custody

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### Custody-like activities conducted within centralised cryptoasset exchanges

**5.49** Centralised cryptoasset exchanges may perform a variety of services including operating a trading venue, brokerage, market-making, margin trading, clearing and settlement, payment, lending, and staking. This is often referred to as vertical integration. As part of offering these services, cryptoasset exchanges may hold client assets to prefund transactions. In such cases, cryptoasset exchanges require cryptoassets to be first transferred to wallets under their direct control before they will execute trades. This is similar to margin requirements for central trading and clearing in traditional finance but differs from standard trading practices where trades are executed independently from, and before, the verification of the availability of the traded instrument. As a result, prefunding supports, and is consistent with, on-chain real-time settlement of the trade and can also happen alongside standalone custody services.

**5.50** Potential conflicts of interest may arise because of the multiple services that cryptoasset exchanges provide. Providing multiple services within one entity can mean that the distinction between what is a client asset versus what is the custodian's asset can be unclear to clients, particularly when there are no specific contractual arrangements setting this out.

**5.51** Since the failure of FTX, we have seen more trading venue or brokerage platform models provide a custody service through a separate legal entity. This allows for cryptoassets to remain segregated when they are traded on the exchange and allows for account segregation. These services are primarily directed at institutional clients. For retail models, we understand cryptoasset exchanges typically require all retail clients to prefund their trading and transfer their assets to the exchange, which are then usually

held for the benefit of clients in omnibus client accounts. We have also seen other regulators exploring the need for cryptoasset exchanges to appoint an independent or separate custodian for safeguarding cryptoassets.

**5.52** In line with the principle of 'same risk, same regulatory outcome', and to address the risks that have materialised in recent years, we have seen that the strongest level of protection of client assets would be achieved by cryptoasset exchanges establishing separate legal entities for all custody-like activities. This would include a separate governance structure for the cryptoasset custodian and developing a mechanism by which cryptoasset exchanges did not take possession of clients' cryptoassets to prefund trading activities. We believe this would:

- protect client assets by reducing the risk of cryptoasset exchanges misusing client assets for their trading activities
- provide a clearer legal distinction between custody and trading activities which ultimately provides a clearer separation of roles and responsibilities, mitigating potential conflicts of interest regarding safeguarded assets
- reduce complexity (and consequently time and cost) in returning client assets if the cryptoasset exchange fails
- create consistency with the current architecture of traditional financial markets, as traditional trading venues do not usually directly hold the assets of the trading counterparties, but they simply receive orders from the brokers or investment firms and transmit the relevant information of the trades back to clearing and settlement agencies

**5.53** Adopting this model for both retail and institutional actors would incur costs and require a change in current business practices, particularly for those entities that primarily service retail clients. We would like to understand whether alternatives exist that could offer equivalent levels of protection of client assets. We would also welcome views as to the benefits that integrating services within entities can provide to end clients, if any. (See Chapter 7 for further information on our thinking towards conflicts of interest management.)

**Q21: Are there any practical issues posed by requiring cryptoasset exchanges to operate a separate legal entity for custody-like activities? Specifically, please could you explain your thoughts on the following:**

- i. Would these issues differ between institutional and retail clients?
- ii. What would be the operational and cost impact?
- iii. What are the benefits to clients of cryptoasset exchanges prefunding trades? Can these be achieved if there is legal separation of entities?
- iv. Would separating custody and exchange functions impact the way clients' accounts are managed and structured (in omnibus and individual client wallets)?

- v. Do you agree that the conflicts of interest we have identified exist? Are there other conflicts of interest we should consider?
- vi. Are there alternative ways to ensure the same level of consumer protection?

## Client money safeguards

- 5.54** Within our CASS framework, we have separate rules for client money and custody asset holdings. The focus of this chapter is the latter. But there may be instances where a firm may hold client money that arises in connection with regulated activities involving cryptoassets held in custody. For example, where fiat currency is held for the purpose of purchasing regulated cryptoassets on behalf of clients.
- 5.55** We are considering whether we need to apply our client money rules where a firm holds client money (in fiat currency) that arises in connection with regulated cryptoassets held in custody. We are keen to understand key considerations to ensure adequate protection of such client money at all times and welcome feedback on this in Question 22.

## Redemption

- 5.56** As discussed in Chapter 3, redemption of a regulated stablecoin refers to a consumer's right against the issuer of the regulated stablecoin to cash out at par value. This is a key part of the regulated stablecoin lifecycle.
- 5.57** We are considering the role of custodians in the redemption process. For example, where they may redeem coins on behalf of clients or enable clients to directly interact with regulated stablecoin issuers to do so – and how to safeguard clients' ownership rights at all times. This includes if a firm fails (either the regulated stablecoin custodian or issuer).
- 5.58** We are keen to understand respondents' views on the role of custodians in regulated stablecoin redemption. This includes key considerations and controls to adequately safeguard clients' ownership rights at all times, and welcome feedback on this in Question 22.

**Q22: What role do you consider that custodians should have in safeguarding client money and redemption? What specific safeguards should be considered?**

## Chapter 6

# Organisational requirements

## Applying organisational requirements to regulated stablecoin issuers and custodians

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- 6.1** In this chapter, we consider applying requirements in various areas of our Handbook to regulated stablecoin issuers and custodians. We would also like to understand whether there are other approaches which would offer the same or equivalent levels of protection.

## Organisational requirements: Systems and Controls

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### Our Senior Management Arrangements, Systems and Controls sourcebook

- 6.2** Our Senior Management Arrangements, Systems and Controls (SYSC) sourcebook sets out our general requirements for the organisation of business affairs. It is designed to ensure that responsibility for proper organisation of the business is given to specific, competent individuals, and to ensure that directors and senior managers take direct and practical responsibility for the organisation of the business which are FCA authorised. It highlights the principle that firms must 'take reasonable care to organise and control their affairs responsibly and effectively, with adequate risk management systems' (Principle 3 from our Principles for Businesses).
- 6.3** It seems appropriate that requirements in SYSC should apply to regulated stablecoin issuers and custodians. For example, we would expect cryptoasset firms carrying out these activities to have robust governance arrangements with clear lines of responsibility, effective risk management and internal control mechanisms; even if those structures and systems differ in some ways from those used in other areas of financial services. For example, regulated stablecoin issuers would likely make use of transactional data from the distributed ledger when conducting risk management. Similarly, we would expect regulated stablecoin issuers and custodians to identify and either avoid or manage any conflicts of interest, or potential conflicts of interest, they face in line with our requirements in SYSC.
- 6.4** We would be keen to receive views on both the applicability of our existing systems and controls rules and any areas where more specific rules or guidance would be appropriate.

**Q23:** Do you agree that our existing high-level systems and controls requirements (in SYSC) should apply to the stablecoin sector? Are there any areas where more specific rules or guidance would be appropriate?

## Operational resilience

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### Our current operational resilience framework

- 6.5** Operational disruptions and the unavailability of important business services have the potential to cause wide-reaching harm to consumers and markets, threaten the viability of firms and cause instability in the financial system. We define operational resilience as the ability to prevent, adapt, respond to, recover and learn from operational disruptions.
- 6.6** Our existing framework for operational resilience is technology agnostic and applicable across firms performing financial service activities. It helps to strengthen financial integrity and reduce harm to consumers from poor operational and technological resilience. We expect firms to be operationally resilient. This includes having a comprehensive understanding and mapping of the people, processes, technology, facilities, and information necessary to deliver each important business service. We expect firms to assess the risks and controls in place to ensure they are operationally resilient.

### Operational technological vulnerabilities within the cryptoasset sector-impact on regulated stablecoin issuers and custodians

- 6.7** Underlying DLTs and blockchains underpin the operation of many stablecoins. Disruptions that are not appropriately managed (such as hard forks) can severely impact the functionality of a stablecoin, harm consumers and the wider market. According to The 2023 Chainalysis Crypto Crime Report and the TRM Labs Illicit Crypto Ecosystems report, in 2022 \$3.8bn cryptoassets were compromised through hacks across over 175 incidents. Decentralised finance was the main target, with the average hack being over \$20m per incident. The clear lack of cyber resilience measures in place for cryptoasset firms continues to make them vulnerable to cyber-attacks and puts consumers at risk from losing their cryptoassets or other sensitive information.
- 6.8** As addressed in Chapter 5 on custody requirements, cryptoasset custodians will be responsible for the safeguarding of consumer cryptoassets, such as through the safeguarding of private keys. As seen with high profile hacks of firms that hold cryptoassets (such as the reported hack of FTX), it is vital that cryptoasset custodians ensure internal systems, people, processes and controls are in place to adequately safeguard consumer assets and to be able to react quickly if something goes wrong.
- 6.9** At the moment, stablecoins are primarily used to facilitate trading of cryptoassets. However, due to their potential widescale adoption and use, they also have the ability to interact with many areas of the wider cryptoasset ecosystem, as well as the traditional finance services sector, and may be susceptible to operational and technological vulnerabilities outside of the issuers' control. For example, through exposure from cross-chain bridges. It is important the underlying DLT, and the mechanisms for maintaining stability, remain operationally resilient and issuers of regulated stablecoins have robust systems and controls to react quickly if something goes wrong. Where issuers of regulated stablecoins use services provided by third parties they should seek

to have arrangements in place (eg contractual agreements), to ensure operational and technological vulnerabilities are appropriately managed by the third party and they are able to oversee these arrangements.

- 6.10** There are technological differences between cryptoassets and the traditional financial services sector to consider when assessing operational risk for regulated stablecoins. For example, the integration of DLT and how scenario tests are performed to ensure the underlying DLT remains resilient. We want to ensure future operational resilience requirements that apply to regulated stablecoin issuers and custodians are balanced. We want to minimise operational and technological risk, to protect consumers, safeguard market integrity, but also not undermine the underlying technology.
- 6.11** The risks of operational failure of DLTs and blockchains can be significant for regulated stablecoins. We are keen to explore further how firms assess these risks and perform scenario testing to look for vulnerabilities before possible failure. We are also aware many regulated stablecoins issuers rely on third party DLTs that are often outside of their direct control. We are interested in understanding how regulated stablecoin issuers and custodians assess the risk with using third parties and ensure the right arrangements are in place to react before, and when, disruption occurs. We are also interested in understanding how issuers of stablecoins respond to issues outside of their control. For example, a compromise on a cross-chain bridge which results in regulated stablecoins becoming effected.

### **Applying our operational resilience framework to regulated stablecoins**

- 6.12** To fulfil our consumer protection and market integrity objectives, we are considering applying our framework for operational resilience (SYSC 15A) to regulated stablecoin issuers and custodians. In this context, we note the [IOSCO Policy recommendations for Crypto and Digital Asset Markets](#) highlights the importance of cryptoasset firms being able to identify relevant important operational and technological risks and adopt appropriate processes and procedures to address these, and other, risks.
- 6.13** Under the proposed stablecoins regime, we would expect regulated stablecoin issuers and custodians, like all traditional financial services firms, to be operationally resilient by having a comprehensive understanding and mapping of the people, processes, technology, facilities and information necessary to deliver each of important business service. We are keen to explore how our existing SYSC 15A operational resilience framework could be applied to regulated stablecoin issuers and custodians. Below we have provided a high-level infographic that outlines the key requirements firms must follow when complying with SYSC 15A for operational resilience. Firms unaccustomed to our operational resilience requirements may want to read our [Policy Statement 21/3, Building operational resilience: Feedback to CP19/32 and final rules](#).
- 6.14** It is essential regulated stablecoin issuers and custodians have strong cyber resilience measures in place to ensure they are operationally resilient, and consumers have the highest levels of protection against potential cyber-attacks. When conducting a risk

management exercise against their important business services, regulated stablecoin issuers and custodians should consider internationally recognised risk management frameworks for cyber resilience and understand how these may be applicable to their business.

- 6.15** To ensure effective cyber resilience practices are in place, we would also expect regulated stablecoin issuers and custodians to consider, but not limited to, the following:
- conducting regular security assessments to identify potential security vulnerabilities relating to their IT infrastructure, and to remediate appropriately
  - deploying strong encryption and security protocols to protect data and code
  - implementing detection capabilities such as firewalls and intrusion detection systems
  - patching and updating software in a timely manner
  - ensuring information is regularly backed up, and disaster recovery and business continuity plans are in place and embedded
  - creating effective incident management plans to minimise the impact of an incident and openly share information with authorities on request
  - having employee training programmes on cyber security to educate staff on security risks
- 6.16** We would like to stress that, under our rules, when a firm uses outsourced and other third-party service providers, it retains responsibility for managing risks arising from those arrangements. We are considering how this would apply to arrangements between regulated stablecoin issuers and other firms, and particularly for the use of sub-custodians when safeguarding regulated stablecoins (this is also addressed in previous chapters). Greater levels of risk management are needed when a firm increases its dependence on outsourced and third party service providers as outlined in SYSC 8. Further, where a firm relies on a third party for the delivery of an important business service, we would expect the firm to have sufficient understanding of the people, processes, technology, facilities and information that support the provision by the third party of its services to or on behalf of the firm, so as to allow the firm to comply with its obligations under SYSC 15A.
- 6.17** We expect this approach to operational resilience to reduce consumer harm and increase market integrity. In addition, by considering impact tolerances and assessing their systems and processes, regulated stablecoin issuers and custodians are likely to be able to provide better customer service by identifying and responding to risks, and being able to react in the event of operational disruption.
- 6.18** While we are considering how to apply our existing operational resilience framework to regulated stablecoin issuers and custodians, we will continue to explore how we can apply it, and how this framework may be relevant, to the next phase of cryptoasset regulation.

## SYSC 15A Operational Resilience Framework

<p><b>Important business services</b> →</p>	<p>A firm must identify its important business services which, if disrupted, could:</p> <p>(1) <i>cause intolerable levels of harm to any one or more of the firm's clients; or</i></p> <p>(2) <i>pose a risk to the soundness, stability or resilience of the UK financial system or the orderly operation of the financial markets.</i></p>
<p><b>Impact tolerances</b> →</p>	<p>A firm must, for each of its important business services, set an impact tolerance.</p>
<p><b>Strategies, processes and systems</b> →</p>	<p>A firm must have in place sound, effective and comprehensive strategies, processes and systems to enable it to comply with its obligations.</p>
<p><b>Mapping</b> →</p>	<p>A firm must identify and document the people, processes, technology, facilities and information necessary to deliver each of its important business services.</p>
<p><b>Scenario testing</b> →</p>	<p>A firm must develop and keep up to date a testing plan that appropriately details how it will gain assurance that it can remain within the impact tolerances for each of its important business services.</p>
<p><b>Testing</b> →</p>	<p>A firm must carry out scenario testing, to assess its ability to remain within its impact tolerance for each of its important business services in the event of a severe but plausible disruption of its operations.</p>
<p><b>Lessons learned</b> →</p>	<p>A firm must, following scenario testing or, in the event of an operational disruption, after such event, conduct a lessons learned exercise.</p>
<p><b>Self-assessment</b> →</p>	<p>A firm must make, and keep up to date, a written record of its assessment of its compliance with the requirements in this chapter.</p>
<p><b>Governance</b> →</p>	<p>A firm must ensure that its governing body approves and regularly reviews the Self-assessment and lessons learned exercise documentation.</p>
<p><b>Communications</b> →</p>	<p>A firm must ensure that its governing body approves and regularly reviews the Self-assessment and lessons learned exercise documentation.</p>

**Q24: Do you agree with our proposal to apply our operational resilience requirements (SYSC 15A) to regulated stablecoin issuers and custodians? In particular:**

- i. Can you see how you might apply the operational resilience framework described to your existing business (eg considering your important business services and managing continuity)? Please set out any difficulties with doing this.
- ii. What approach do you take when assessing third party-providers for your own internal risk management (such as responding to, testing and managing potential disruption)?
- iii. Are there any minimum standards for cyber security that firms should be encouraged to adopt? Please explain why.

## Financial crime

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- 6.19** We have seen the negative impact of financial crime connected with the use of cryptoassets can have on consumers, financial markets, and wider society. We believe it is of the highest importance that financial crime rules are considered for issuers of regulated stablecoins and custodians. As outlined through Chainalysis' [Crypto Crime Report \(2023\)](#), there has been a general increase in the amount of cryptoassets sent by criminals from illicit addresses since 2015, with the biggest increase between 2021 to 2022. In 2021 the data showed that \$14.2bn worth of cryptoassets were sent from illicit addresses, compared to \$23.8bn in 2022 – an increase of 68% between the years. The National Crime Agency (NCA) have acknowledged that cryptoassets are among the means which criminals use to launder money acquired from criminal activities. The NCA's [National Strategic Assessment of serious and organised crime \(2023\)](#) reported that more than £10bn (cash and non-cash based money) was estimated to be laundered in the UK annually. This highlights the importance of ensuring robust financial crime standards, that are consistent with standards for traditional financial services, are considered for regulated stablecoins and custodians.
- 6.20** Additionally, in recent years, we have seen an increase in the volume of scams and fraud cases in the cryptoasset market, creating significant losses to consumers. The NCA's assessment noted that fraud remains the most common crime type experienced by victims in England and Wales – with 3.7 million individuals having experienced fraud in 2022. In addition, [Action Fraud's 2021 data](#) reveals over £145m has been lost to cryptoasset fraud, with the average loss per victim at just over £20,500. As innovation increases, so do the ways criminals use to disguise their illegally obtained funds, therefore we should continue to develop our rules to mitigate the potential harms from fraud and protect consumers in line with this new technological development.
- 6.21** As with other cryptoassets, stablecoins may appeal to money launderers and other criminals who do not wish to expose their money to the traditional financial system. Being perceived as more 'stable' than other cryptoassets, stablecoins may be more attractive to criminals who do not wish to be as exposed to the market volatility of unbacked cryptoassets.
- 6.22** Since January 2020, cryptoasset exchanges and custody wallet providers in the UK must be registered with the FCA and comply with the anti-money laundering (AML) and counter terrorist financing (CTF) obligations contained in the Money Laundering Regulations (MLRs). This requires registered firms to demonstrate they have adequate systems, controls, policies, and procedures to deal with the risks associated with money laundering and terrorist financing in the cryptoasset market. Furthermore, it also requires any officers, managers and beneficial owners of the cryptoasset business to be fit and proper.
- 6.23** Financial crime requirements can be found under the Financial Services and Markets Act 2000 (FSMA) and the MLRs. Our Handbook and [guidance](#) set out the requirements that apply to all authorised and MLR registered firms, including a number of specific AML requirements. All authorised firms are required to comply with financial crime requirements under FSMA and some are subject to both FSMA and MLRs. Firms which are registered for AML purposes are required to comply with the MLRs. Registered firms

that fall within the scope of the new regime will require full authorisation and therefore be required to comply with the financial crime requirements under FSMA and MLRs.

- 6.24** Additionally, firms should consider the recent guidance on cryptoassets published by the Joint Money Laundering Steering Group (JMLSG) Guidance Part 2, Sector 22. We in conjunction with other stakeholders, have worked closely with JMLSG in the development of this guidance and the recent updates on cryptoasset transfers. This guidance will be beneficial for regulated stablecoin issuers and custodians to implement ahead of the upcoming regime for fiat-backed stablecoins.
- 6.25** The financial crime rules in FSMA are broader than the rules contained in the MLRs, covering anti-bribery and corruption, sanctions, fraud, and other aspects of financial crime. We intend for the upcoming regime to maintain a robust framework for financial crime to mitigate these risks and ensure high standards and reputational integrity, enabling us to fulfil our objectives.
- 6.26** For our proposed regime for regulated stablecoins, we are exploring how our existing financial crime framework in FSMA and MLRs can be applied, and any potential amendments to our handbook that may be required, in line with the approach of same risk, same regulatory outcome. We consider that it is proportionate for regulated stablecoins issuers and custodians to be subject to the same financial crime rules and operate in the same way we expect all FSMA authorised firms to act.

### **Applying our financial crime framework to regulated stablecoins**

- 6.27** Under our financial crime framework, we require all firms to have systems and controls to counter the risk that regulated stablecoins are misused for the purposes of financial crime. We are considering applying all our financial crime rules set out in SYSC 6 of our Handbook to regulated stablecoin issuers and custodians as well as the existing requirements under the FSMA and the MLRs. By applying these rules, a firm would be required to assess how their operations might be misused by criminals. For example, those seeking to launder money or the proceeds of corruption, commit fraud and breach sanctions.
- 6.28** In addition to the MLRs, which already apply to UK cryptoasset exchanges and custodian wallet providers (set out in Regulation 14A of the MLRs), regulated stablecoin issuers and custodians would be expected to establish and maintain effective systems and controls to counter the risks of financial crime. As outlined in our rules under SYSC 6.1.1R, regulated stablecoin issuers and custodians would be required to have policies and procedures which are sufficient to ensure compliance with their obligations under the regulatory system and to counter risks that regulated stablecoin issuers and custodians might be used to further financial crime. We are also proposing to apply the guidance in 'Financial Crime: a guide for firms' to regulated stablecoin issuers and custodians.
- 6.29** As part of SYSC 6, regulated stablecoin issuers and custodians will also be required to appoint a laundering reporting officer (MLRO) (SYSC 6.3.9) responsible for the oversight of the activities of the firm and to ensure the firm is compliant with our financial crime and anti-money laundering rules. This is consistent with existing FSMA firms and will ensure regulated stablecoin issuers and custodians have adequate oversight of

the activities the firm is undertaking and that someone can be held accountable if something goes wrong. We would also expect the MLRO to provide annual financial crime reports and provide fraud information when incidents occur to us.

**Q25: Do you agree with our proposal to use our existing financial crime framework for regulated stablecoin issuers and custodians? Do you think we should consider any additional requirements? If so, please explain why.**

## Senior Managers & Certification Regime (SM&CR)

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**6.30** The SM&CR has 3 elements: the Senior Managers Regime, the Certification Regime and the Conduct Rules. It aims to support the transformation of culture in financial services by creating clear accountability, promoting personal responsibility, and improving conduct in firms. First introduced in 2016 for banks, the regime was extended in 2018-20 and now applies to all firms who have been granted permission to carry out regulated activities (ie part IV authorised FSMA firms). SM&CR does not apply to firms which are not FSMA authorised, such as e-money institutions, payment and cryptoasset firms.

### Review of the SM&CR

**6.31** In December 2022, the Government announced a review of the SM&CR as part of the Edinburgh Reforms. In March 2023, we published a Discussion Paper on the SM&CR jointly with the PRA, DP23/3, which reviews the effectiveness, scope and proportionality of the regulatory regime. In parallel, the Treasury launched a Call for Evidence to look at the legislative aspects of the regime.

**6.32** The review seeks to understand stakeholders' views on the functioning of the SM&CR and identify ways to improve the regime to help it work better for firms and regulators, while ensuring the aims of the regime are met. The review may result in changes to the SM&CR which would affect how it may be applied to regulated stablecoin issuers and custodians as their activities become regulated. Respondents are encouraged to respond to this DP while taking into account the SM&CR Review.

### Application of SM&CR requirements to regulated stablecoin issuers and custodians

**6.33** In the absence of changes to our Handbook, the SM&CR rules will apply to regulated stablecoin issuers and custodians. We are considering whether we should make changes to the application of the SM&CR, however, our current consideration for the application of the SM&CR to regulated stablecoin issuers and custodians is as follows:

- The **Senior Managers Regime** (SMR): Senior Managers hold one or more roles designated as Senior Management Functions (SMFs). The individuals holding such roles are a firm's most senior individuals. These include executive roles, such as

chief executives and finance directors, as well as some oversight roles, such as chairs of boards and their sub-committees and senior independent directors.

- The **Certification Regime**: covers functions at a firm that are not SMFs and that have a material impact on risks to customers, markets and the risk profile of the firm.
- The **Conduct Rules**: these set minimum standards of conduct for all professional employees. There are additional rules applicable to Senior Managers.

**6.34** The SM&CR applies to all FSMA authorised firms, but there are differences in the requirements depending on the size and complexity of the firm, the potential harm arising from its business and whether the firm is solo or dual regulated. For greater clarity, solo-regulated firms (those only regulated by the FCA) can be classified as Limited Scope, Core or Enhanced. The criteria for our classification of solo-regulated firms and how SM&CR applies is explained below.

**6.35** Where a regulated stablecoin issuer or custodian is classified as systemic, the firm will become dual regulated (regulated by the FCA and PRA) and will be required to comply with both the FCA's regime and the Bank of England's Code of Practice for the governance of recognised payment system operators. However, for this DP, we are only considering firms that would be solo regulated by the FCA.

**6.36** In most cases, the Certification Regime and the Conduct Rules apply in the same way to all categories of firms. For the SMR, different rules apply depending on whether a firm is classified as Limited Scope, Core or Enhanced. Further information is given below on the proposed application of each SM&CR category.

## Application of the SMR

**6.37** The SMR imposes high standards to the most senior people in the firm who perform key roles and, it allows regulators to hold the most senior decision makers accountable if something goes wrong. In instances where a regulated stablecoin issuer or custodian breaches one of our requirements, the senior manager responsible for that area would be held accountable if they did not take reasonable steps to prevent the breach.

**6.38** There are additional requirements for Enhanced firms. For example, more roles are designated as Senior Manager Functions (SMF) and require regulatory pre-approval. Limited Scope firms, that we consider pose smaller risks of harm, have fewer SMR requirements. However, regardless of the categorisation of the firm, the SMR will apply to all FSMA authorised firms.

**6.39** As mentioned above, SMF require regulatory pre-approval before carrying out certain activities on behalf of the firm. They must be approved as fit and proper by their firm and by us before appointment. When assessing fitness and propriety, firms and us, must consider 3 areas: (i) honesty, integrity, and reputation; (ii) competence and capability; and (iii) financial soundness. Firms must also take up regulatory references and perform criminal records checks as part of the application process.

**6.40** In ensuring an effective system of individual accountability, firms and the FCA need to be clear about the key responsibilities of each Senior Manager. To that end:

- Senior Managers each must have a Statement of Responsibilities (SoR), a single document that clearly sets out their responsibilities within the firm. This is prepared by the firm and shared with the regulator as part of the application for approval of the individual.
- Firms must also allocate a set of mandatory prescribed responsibilities (PRs) across their Senior Managers. These are specific responsibilities defined in our [handbook](#) and are in addition to the inherent responsibilities of a SMF's role. There are 5 PRs for Core firms and 12 for Enhanced firms (Limited Scope firms do not have PRs), some PRs include: responsibility for firm's obligation for individual conduct rules for training and reporting (4a, b), responsibility for policies and procedure to prevent financial crime risk (3).
- Further, enhanced firms must prepare and maintain a Management Responsibilities Map. This is a firm-wide document that contains summary information covering each Senior Manager and their responsibilities, the allocation of the prescribed responsibilities among Senior Managers and details of the firm's governance arrangements.

**6.41** We intend to apply all existing components of the Senior Managers Regime, as outlined above, to regulated stablecoin issuers and custodians. As for other regulated firms, regulated stablecoin issuers and custodians will be categorised at the gateway to ensure the appropriate SMR rules are applied.

### **The scope of enhanced criteria for regulated stablecoin issuers and custodians**

**6.42** We are considering applying the current 'enhanced criteria' categorisation to regulated stablecoin issuers and custodians if they meet the criteria. There are currently 6 criteria for determining whether a firm falls into the Enhanced category (capturing less than 1% of solo-regulated firms), of which those that are most likely to apply to regulated stablecoin issuers and custodians are:

- a. Significant SYSC firm – certain investment firms which meet 1 of 5 criteria set out in SYSC 1.5, which includes, total assets and liabilities in excess of £530m and £380m respectively and values relating to annual fee/commission income, client money and client assets.
- b. CASS Large firm – firms holding significant balances of client assets, currently in excess of £1bn of client money and/or £100bn in custody.
- c. A firm with Assets Under Management of £50bn or more calculated as a 3-year rolling average.

**6.43** We are considering whether to add additional criteria to the existing enhanced categories specific to regulated stablecoin issuers and custodians when determining whether a firm should be considered as Enhanced SM&CR. For example, this could relate to the size of market capitalisation, circulating supply of regulated stablecoins or volume over 24hrs. We welcome views from industry as to whether there are other factors that should be considered in determining whether a firm is Enhanced SM&CR.

## Application of certification functions

- 6.44** The Certification Regime relates to specific roles that are not Senior Manager Functions but can have a significant impact on customers and/or the firm. These roles are called Certification Functions. The Certification Regime requires firms to certify the fitness and propriety of employees who perform these roles.
- 6.45** Certification staff need to be assessed and issued with a certificate by the firm on appointment and at least annually thereafter. They do not need approval from us; instead, firms must ensure they have individuals with the necessary expertise performing specific roles, to ensure a well-functioning firm.
- 6.46** There are currently 8 certification functions defined in our Handbook at [SYSC 27.8](#), this includes:
- significant management
  - CASS oversight
  - anyone who supervises or manages a Certified Person
  - proprietary traders
  - material risk takers
  - client dealing
  - algorithmic trading
  - functions requiring qualifications
- 6.47** Based on our current assessment of the Certification Regime we would expect the certification functions linked to 'significant management', 'CASS oversight' and 'anyone who supervises or manages a Certified Person' to apply to regulated stablecoin issuers and custodians. For further details on CASS oversight, see Chapter 5 on safeguarding cryptoassets.
- 6.48** Additionally, we are also considering including further activities under the Certification Functions that are more focused to regulated stablecoin issuers and custodians. These include, for example, the liquidity management of backing assets held for regulated stablecoins. These additional requirements are to ensure the SM&CR regime captures all functions that can cause significant harm in regulated stablecoin issuers and custodians.
- 6.49** Further to the 8 certification functions, the Certification Regime also includes requirements on firms to:
- obtain and provide regulatory references for Certification staff
  - provide us with information about their Certification staff for our [Directory of certified and assessed persons](#) on the Financial Services Register
- 6.50** We intend to apply all existing components of the certification regime, as outlined above, to regulated stablecoin issuers and custodians.

## Application of conduct rules

- 6.51** The conduct rules set a minimum standard of individual's behaviour in financial services. All individuals working at firms other than those performing purely ancillary functions

need to comply with the Individual Conduct Rules. There are 6 conduct rules, including the newest conduct rule relating to Consumer Duty (which came in force from July 2023). Further information on the conduct rules in the FCA Handbook.

- 6.52** In addition, Senior Managers must also comply with the Senior Manager Conduct Rules. There are 4 additional conduct rules for senior managers which cover the reasonable steps they must take and their obligation to disclose information to us or PRA.
- 6.53** Firms are required to provide training to ensure staff are aware of the conduct rules and understand how they apply to them in their roles. They must also notify us where they have taken disciplinary action against a member of staff for a conduct rule breach.
- 6.54** We intend to apply all existing components of the conduct regime, as outlined above, to regulated stablecoin issuers and custodians, with no changes.

**Q26: Do you agree with our proposal to apply our existing Senior Managers and Certification Regime to regulated stablecoin issuers and custodians? In particular:**

- i.** Should we apply the current SMR and requirements to issuers and custodians of regulated stablecoins? Are there additional SMFs or requirements needed to capture the nature of regulated stablecoin business services?
- ii.** Should we create additional criteria to determine when the 'enhanced category' of the regime should apply to regulated stablecoin issuers and custodians?
- iii.** Should we apply the current certification functions and requirements to regulated stablecoin issuers and custodians? Are there any additional functions needed to capture the nature of regulated stablecoin issuers and custodians business services?
- iv.** Do you agree that we should apply the existing Conduct Rules to regulated stablecoin issuers and custodians?

## Chapter 7

# Conduct of business and consumer redress

## Applying different areas of regulation to regulated stablecoin issuers and custodians

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- 7.1** In this chapter we consider conduct of business requirements and consumer redress for regulated stablecoins. Once UK based fiat-backed stablecoin issuance and custody activities are brought within the scope of our regulation, some requirements, such as our Principles for Businesses, the Consumer Duty, and certain other requirements in our Handbook will apply to them, in the absence of rule changes.
- 7.2** Below, we describe how we are considering applying some of these requirements, and other areas of our Handbook, to regulated stablecoin issuers and custodians. This includes our rules on consumer redress, including what should happen when firms make mistakes that harm their clients, or are unable to meet the resulting liabilities.

## High-level standards

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- 7.3** In the previous chapter, we considered the application of our organisational requirements to regulated stablecoin issuers and custodians. It is important that we consider our Principles for Businesses and other high-level standards in our Handbook – and consider why they might, or might not, apply to activities associated with regulated stablecoins.

## Principles for Businesses

- 7.4** The Principles for Businesses set out in the FCA Handbook apply in whole or in part to every regulated firm. They are a general statement of the fundamental obligations of firms and the other persons to whom they apply under the regulatory system. They express key dimensions of the 'fit and proper' standards that were set for regulated firms by the Threshold Conditions in the Financial Services and Markets Act 2000. Being ready, willing and organised to abide by the Principles is a critical factor in applications for permission to conduct and carry on regulated activities, and breaching the Principles may call into question whether a firm is fit and proper. In general, we consider it to be both reasonable and appropriate for our Principles for Businesses to apply to regulated stablecoin issuers and custodians.
- 7.5** Principle 12 (Consumer Duty) applies to retail market business and is discussed in more detail below. For other business, and for institutional customers, firms will be subject to Principles 6 and 7.

## The Consumer Duty

- 7.6** We propose that regulated stablecoin issuers and custodians will be subject to the Consumer Duty, which came into force earlier this year. The Consumer Duty sets higher expectations for the standard of care firms provide in the retail market. In Chapter 4, we have already discussed some of our key expectations of regulated stablecoin issuers, which reflect the Consumer Duty.
- 7.7** Further information on our expectations under the Consumer Duty is in the non-Handbook Guidance for firms on the Consumer Duty. In summary, the Consumer Duty has the following components:
- The Consumer Principle, Principle 12, which requires firms to act to deliver good outcomes for retail customers. This reflects the overall standard expected of firms and is defined further by the other elements of the Consumer Duty.
  - The 'cross-cutting rules' which require firms to:
    - act in good faith towards retail customers
    - avoid causing foreseeable harm to retail customers
    - enable and support retail customers to pursue their financial objectives
  - The '4 outcomes' which are a suite of rules and guidance setting more detailed expectations for firm conduct in 4 areas that represent key elements of the firm-consumer relationship:
    - **products and services:** must be designed to meet the needs, characteristics, and objectives of a specified target market – for example, issuers may need to consider this in the design of their regulated stablecoins and custodians may need to consider it for the service they provide.
    - **Price and value:** products and services must provide fair value with a reasonable relationship between the price consumers pay and the benefit they receive – this may be relevant, for example, for both issuers and custodians in relation to their charges.
    - **Consumer understanding:** firms communicate in a way that supports consumer understanding and equips consumers to make effective, timely and properly informed decisions – for example, custodians may need to consider this outcome in their communications with customers.
    - **Consumer support:** firms provide support that meets consumers' needs throughout the life of the product or service – for example, regulated stablecoin issuers may need to consider this outcome in their support to make sure that consumers understand their redemption rights.
- 7.8** The Consumer Duty applies to the firms we regulate and covers all regulated activities, from product and service origination through to distribution and post-sale activities. It also applies to a firm's ancillary activities (which are unregulated activities in connection with, or held out for the purposes of, regulated activities). For example, while there are no detailed rules for the pricing of transaction fees, under the Consumer Duty, firms would be expected to offer fair prices and value to consumers. Obligations on firms to disclose

details around backing assets would also likely require firms to consider the Duty to ensure there is consumer trust through accurate reporting and the communication of reserves (such as the composition of reserves and redemption of reserves).

**7.9** The Duty applies to firms across the distribution chain, even if they do not have a direct client relationship with retail customers, where they can determine, or have a material influence over, retail customer outcomes. As an example, the Consumer Duty may apply if a regulated stablecoin issuer that does not issue directly to retail customers designs or operates a product that will be used by retail customers, approves communications for them or provides support to them. This means that even a regulated stablecoin issuer that does not issue directly to retail customers, but only to wholesale clients, may be subject to the Consumer Duty, if they are in a retail distribution chain and have a material influence over outcomes for retail customers. For example, where the firm approves communications that will reach retail consumers, it would need to comply with the relevant rules under the Duty, as well as the financial promotions regime and, if issues are found, make appropriate changes.

**7.10** Where firms hold regulated stablecoins for retail consumers, eg providing custody services, including sub-custodians, they are likely to be subject to the Duty as they typically face customers more directly. The Consumer Duty is underpinned by the concept of reasonableness and the extent of a firm's responsibilities will depend on factors such as the firm's role and the extent of its influence over retail customer outcomes.

## Conduct of business

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**7.11** In regulating various sectors of the market, our conduct of business sourcebooks set out our high-level standards. The sourcebooks include our investment Conduct of Business Sourcebook (COBS), which includes our new financial promotion requirements for cryptoassets, and our Banking: Conduct of Business Sourcebook (BCOBS).

**7.12** We are considering that under our new regime, issuers of regulated stablecoins and custodians will be subject to the rules set out in COBS to reflect the important role they will play within the financial market.

**7.13** The application of COBS is to manage the potential risks related to the evolving nature and use of regulated stablecoins which may expand to be used as investments as well as payments in future. Further, due to the principle of same risk, same regulatory outcome, we think it is appropriate to apply the same conduct rules to regulated stablecoin custodians as existing custodians of traditional finance assets, setting the same standards and protection for all consumers of custodian services. For these reasons, we consider the broader application of COBS to be more appropriate than BCOBS which applies only to deposit-taking, payment services, and lending. We welcome views on this in Question 28, including any considerations into why it would be more appropriate to create a brand-new conduct of business sourcebook for cryptoassets.

## Inducements

- 7.14** Our detailed rules in COBS, which we propose to apply to regulated stablecoin issuers and custodians, restrict the inducements that firms can accept from third parties – covering, for example, commissions and non-monetary benefits (at COBS 2.3 and 2.3A), and third-party research (at COBS 2.3B and COBS 2.3C). We remind firms that our final rules for cryptoasset financial promotions (at COBS 4.12A), which include stablecoins, require firms not to communicate or approve a financial promotion which offers to a retail client any monetary or non-monetary incentive to invest.
- 7.15** We welcome views on both the general and specific applicability of rules on inducements for regulated stablecoins. We are considering whether additional specific rules or guidance are needed. For example, if a stablecoin issuer has stablecoins themselves, this could create an incentive for them to consider their own interests as a consumer, eg in response to any market turbulence. We welcome views on both the general and specific applicability of rules on inducements for regulated stablecoins.

## Categorising clients

- 7.16** Under our Principles for Businesses, we expect firms to pay due regard to the interests of institutional consumers and treat them fairly (Principle 6) and, as already discussed, we expect higher standards for retail consumers under our Consumer Duty (Principle 12).
- 7.17** In COBS 3, which we propose to apply to regulated stablecoin issuance and custody activities, we set out our expectations on firms when it comes to categorising clients as either 'retail' or 'professional'. Professional clients can include, for example, entities which are authorised to operate in the financial markets. We would be interested in views on whether such differentiation is suitable for our regulated stablecoin regime.

## Being transparent and providing information

- 7.18** In COBS, which we propose to apply to regulated stablecoin issuers and custodians, we set out specific requirements for when and how to disclose certain information to clients. This includes information about the firm and its services, costs and charges (in COBS 6), information about a particular product (in COBS 13 and 14) and reporting to clients about, for example, a transaction carried out for them (in COBS 16 and 17).
- 7.19** We also recognise the important role that disclosure by cryptoasset exchanges will play, for regulated stablecoins and will consult on this as appropriate as part of the wider regime.

## Other high-level standards

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- 7.20** While Principle 8 requires that a firm must manage conflicts of interest fairly, we also have more detailed rules on conflicts of interest for other sectors in both SYSC and conduct of business rules. Our conflicts of interest rules at SYSC 10 set out the importance of identifying and preventing, or otherwise managing, conflicts of interest between, for example, the firm and its client, or individual clients.

- 7.21** In time, we will develop an appropriate regime to address the potential conflicts of interests present in other areas of the cryptoasset market. This includes conflicts that arise owing to cryptoasset exchanges and intermediaries carrying out multiple different roles (in Chapter 5, we explore how we may address potential conflicts of interest for cryptoasset exchanges that provide custody services). So we are seeking views on whether, for example, a cryptoasset exchange that wishes to issue a regulated stablecoin would require a legal separate entity to act as the regulated stablecoin issuer to manage the potential conflicts involved.
- 7.22** We also propose that many of our other high-level standards should apply to regulated stablecoin issuers and custodians, including:
- Our General Provisions (GEN) – these include rules on how firms should refer to their regulatory status, interpret rules in our Handbook and behave in an emergency, all of which are relevant for regulated stablecoin issuers and custodians.
  - Our Fees Manual (FEES) – these rules set out how regulated stablecoin issuers and custodians will pay fees.

**Q27:** Do you agree with our consideration to apply our Principles for Businesses and other high-level standards to regulated stablecoin issuers and custodians? Are there any particular areas you think we should apply detailed rules regarding information disclosure to (other than those for backing assets set out in Chapter 3)?

**Q28:** Do you do you consider that we should design more specific conduct of business rules to regulated stablecoins issuers and custodians? In particular what approach should we take to applying rules on inducements and conflicts of interest management to regulated stablecoin issuers and custodians?

## Dispute resolution and redress for consumers

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- 7.23** We want consumers to only acquire regulated stablecoins and other cryptoassets when they understand the risks involved. Our past consumer publications have referred to the risk of cryptoassets, and we have been clear to consumers that if they invest in cryptoassets they should be prepared to lose all their money (consistent with the disclosure requirements in our recent financial promotion rules on cryptoassets). As further explored in PS23/6, cryptoassets have continued to demonstrate significant risks of sudden, large and unexpected losses, firm failures, comingling of funds, cases of financial crime facilitation, and cybercrime.
- 7.24** Regulated stablecoins, issued in line with the regulatory regime proposed in this DP, and whose issuers remain compliant, should mitigate many of these risks. However, risks will remain, and there may be times when things go wrong.

**7.25** Regulatory controls are only as effective as firms' implementation and compliance. Unforeseen issues, operational challenges and a firm's attitude to responsibility all play a part in what might happen when things go wrong. There are well known and understood mechanisms for achieving appropriate redress within traditional financial services in terms of expectations on firms: to handle complaints effectively, FSMA powers for the FCA to impose requirements on firms or sectors to pay redress, access to the Financial Ombudsman Service (the Ombudsman Service), and, in some cases, the ability to make a claim to the Financial Services Compensation Scheme (FSCS) if a firm has gone into default and cannot pay certain liabilities.

## Dispute resolution

- 7.26** In the event of a complaint or dispute with a regulated stablecoin issuer or cryptoasset custodian, customers can ask the firm to put right the issue or, where relevant, pursue a claim through the courts. Unless we set expectations for how firms should consider complaints, firm's incentives to maintain high standards of behaviour and governance could be undermined and consumers could experience harm, if firms are operating in an unfair manner or unwilling to address customer complaints or disputes properly and promptly.
- 7.27** So we propose to apply similar requirements to those in traditional finance for complaints to, or disputes with, regulated stablecoin issuers and custodians.
- 7.28** The 'Dispute resolution: Complaints' sourcebook (DISP) sets out our expectations for firms when considering complaints from their customers and describes the circumstances in which complaints must be referred to the Ombudsman Service.
- 7.29** In addition, there are rules and guidance under the Consumer Duty which bolster those in the DISP, by requiring firms to proactively consider whether remedial action, such as redress, is appropriate where they identify that customers have suffered harm because of the firm's conduct, either through action or inaction.
- 7.30** We know that some cryptoasset custodians have already started to either develop policies and procedures for considering complaints about cryptoassets in line with our existing requirements or are using those already developed for their traditional business lines. We also think it is appropriate that all firms that come into our perimeter should handle complaints from consumers fairly and effectively. We are proposing applying our current complaints handling expectations (DISP Chapter 1) to regulated stablecoin issuers and custodians.
- 7.31** Not all complaints are satisfactorily resolved between firms and consumers. And in most cases, there is a power asymmetry between a consumer and a firm in reaching a fair and appropriate resolution. In this scenario complaints can be referred to the Ombudsman Service. The Ombudsman Service has a statutory duty to resolve disputes 'quickly and with minimal formality', offering an alternative to the courts, a route that most consumers would be unlikely to be able to afford. The Ombudsman Service's decisions are based on what, in its opinion, is fair and reasonable in the individual circumstances of a case.

- 7.32** The Ombudsman Service is free for complainants. When the Ombudsman Service decides to uphold a complaint, it can order the firm to make a monetary award to the complainant for an amount it considers fair compensation for the loss or damage suffered. The Ombudsman Service can also direct the firm to take such steps in relation to the complaint as it considers 'just and appropriate'. By introducing the Ombudsman Service for consumers, instances of harm can be resolved promptly and effectively, as well as providing examples of good practice for other firms.
- 7.33** We understand that, based on current market practices, consumers are unlikely to have a direct relationship with a regulated stablecoin issuer (and may direct any complaint to a service provider with whom they are directly engaged). These relationships are likely to be considered as part of the wider regime, as the Ombudsman Service is only able to consider complaints between a consumer and service providers with which they have a direct relationship. This market practice may change, however, as customers are likely to have more visibility of the regulated stablecoin issuer when redemption requirements are in place.
- 7.34** We consider the reasons why we make a statutory alternative dispute resolution service available in traditional finance should also apply in the case of regulated stablecoin activities. Access to the Ombudsman Service, if a firm is not able to resolve a complaint received by a customer, improves trust and confidence in financial services markets. We think it is appropriate for customers of regulated stablecoin issuers and custodians to have access to the Ombudsman Service when those activities are introduced into our regulatory perimeter.
- 7.35** Firms may require additional resources and staff to manage and handle complaints in line with those expectations. In addition, firms will also need to contribute to the Ombudsman Service's operating costs through the general levy as well as be liable to pay the case fee for complaints referred over and above the free allowance. Firms will also need to comply with any monetary awards as decided by the Ombudsman Service in the event of a complaint. We consider these costs in the context of the benefits of reduced consumer harm to be appropriate and necessary to ensure fair outcomes and trust in the financial system.

**Q29: Do you agree that the dispute resolution mechanisms provided in traditional financial services (ie the application of the DISP sourcebook and access to the Ombudsman Service) should be applied to the business of regulated stablecoin issuers and custodians? Have you identified any gaps or issues in relation to dispute resolution? Please explain.**

### **Consumer compensation when firms fail**

- 7.36** The FSCS is the UK's statutory compensation scheme of last resort. FSCS's protection covers valid civil claims against firms that have gone into default in connection with certain activities such as deposits, specified insurance provision and distribution, investment business, home finance advice or debt management activities. For those

financial services activities that have protection, the FSCS protects eligible consumers who have a valid civil claim against a failed firm and so plays an important part in maintaining consumer confidence. Firms from across the financial services industry that conduct those protected activities pay levies to fund both the FSCS's operating costs and the compensation it pays out.

- 7.37** In broad terms, and further described in the FCA's sourcebook relating to compensation (COMP) a valid claim arises where (i) an eligible claimant suffers harm as a result of the act(s) or omission(s) of a relevant person (generally a UK-authorized firm) in the performance of an eligible regulated activity provided that this could give rise to a valid civil claim by the claimant against that firm, and (ii) that firm has been declared in default by the FSCS. The claim could, for instance, arise from the firm not meeting regulatory or legal requirements (for example where it has acted outside the terms of the contractual relationship, or breached the regulatory requirements imposed on it or acted negligently) and as a result of this behaviour, consumers have suffered harm. This conduct needs to have caused a loss to the consumers. Where the firm is unable to pay redress, because, for example, it has entered insolvency proceedings, and has been declared in default, the FSCS can pay compensation up to a limit of £85k per eligible claimant in most cases. The FSCS does not protect against poor investment performance or when product risks crystallise in the absence of a valid civil claim.
- 7.38** FSMA gives us the powers to extend FSCS protection to regulated activities that we consider to be appropriate following public consultation. So FSCS protection applies to some regulated activities and not others, for example consumer credit lending. We cannot extend FSCS protection to activities that are not in the Regulated Activities Order. For example, we cannot extend FSCS protection to activities related to electronic money or payment services which are activities in the Payment Services Regulations. So, FSCS cover could not be applied to, for example, firms facilitating payments using fiat-backed stablecoins.
- 7.39** We have considered whether to propose that FSCS cover should be applied to the new activities of regulated stablecoin issuers and custodians which the Government are intending to describe in the Regulated Activities Order. Any decisions we make on this need to be consistent with the principles we set out in our December 2022, Compensation Framework Review Feedback Statement. We note the overarching principle is that the FSCS is a fund of last resort and should not be the first line of defence for protecting customers of authorised firms from harm. It should be a backstop if other mitigants are not sufficient.
- 7.40** The regulatory regime for fiat-backed stablecoins is being developed, as set out in this Discussion Paper, to ensure the governance, conduct and financial resilience of firms will provide consumers with an appropriate degree of consumer protection and protect them from the foreseen harms. As the market develops and the ecosystem evolves under the proposed regulatory framework, there may be unforeseen harms or residual risks that we cannot currently quantify.
- 7.41** We have also stated previously that compensating consumers where they have chosen to engage in higher risk services or products (which may be appropriate in some, but not all, circumstances) may create the wrong incentives among consumers and firms.

**7.42** We also do not yet know how many firms will operate in the market, what size the firms will be, and what scale of revenues we will see. As well as being unable to quantify what potential exposure there could be to, for example, unpaid redress liabilities from failed firms doing these activities, or loss of custody assets, we are also unable to determine the extent to which other firms in the market could afford to meet those costs, and therefore the implication for other financial services firms if cross-subsidies from firms doing other activities became necessary.

**7.43** Taking these factors into account, we will not be proposing to extend FSCS cover to regulated stablecoin issuers or custodians. We will keep this position under review as the market develops. However, that will not affect the existing position that FSCS protection already applies in the indirect circumstance of a secondary pooling event (Chapter 9) where a UK bank or an authorised custodian holding the backing assets of a regulated stablecoin issuer fails. In these circumstances, those service providers (the authorised deposit-taking business or authorised custodian) will be undertaking traditional financial services and will fall outside the scope of the proposed fiat-backed stablecoin regime. FSCS cover already applies in these circumstances.

**Q30: Do you agree that the FCA should not be proposing to extend FSCS cover to the regulated activities of issuing and custody of fiat-backed stablecoins? If you do not agree, please explain the circumstances in which you believe FSCS protection should be available.**

## Chapter 8

# Prudential requirements

## A new prudential sourcebook

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- 8.1** In this chapter we discuss our thinking on the prudential requirements for regulated stablecoin issuers and custodians. These prudential requirements will seek to ensure that regulated stablecoin issuers and custodians have adequate financial resources. They are in addition to the requirements to safeguard backing assets discussed in Chapter 3.
- 8.2** We are considering a dedicated new prudential sourcebook for regulated stablecoin issuers and custodians – and, in time, other cryptoasset firms. In this chapter, we draw on concepts from our Investment Firms Prudential Regime (IFPR) as a starting point for how we anticipate designing a prudential regime for regulated stablecoin issuers and custodians. We are seeking views on how we could apply and tailor these concepts to capture the risks associated with regulated stablecoin issuers and custodians, as well as the wider cryptoasset ecosystem. We cover the potential scope of the new requirements, the sorts of capital and liquidity requirements that may be appropriate and the need for regulatory reporting of prudential matters. Sound prudential standards for firms undertaking regulated activities in stablecoins should help to provide additional confidence to consumers and the market in engaging with the relevant stablecoin.
- 8.3** In this chapter, we refer to the new prudential sourcebook using a placeholder title 'CRYPTOPRU'.

## Why do we need prudential requirements?

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- 8.4** There is a requirement under FSMA for every authorised firm to have appropriate resources. This includes maintaining appropriate financial resources, which may help to achieve the following outcomes for consumers and markets:
- enable firms to remain financially viable and to provide services through an economic cycle
  - enable a firm to be able to afford to put right any harm that it causes
  - enable an orderly wind-down without causing undue economic harm to consumers or to the integrity of the UK financial system
- 8.5** As discussed earlier in this DP, there have been some notable failures of cryptoasset firms in recent years (including Terra/Luna and FTX). A lack of financial resources are not the only reasons firms fail – other factors such as governance and conduct issues that lead to harm are also important – and this is as true in the cryptoasset sector as in traditional financial services. However, maintaining adequate levels of financial resources (such as capital) gives firms a greater ability to absorb unexpected losses where these occur and helps in meeting the above outcomes.

- 8.6** An appropriate prudential framework is not a substitute for good governance and conduct, but complements them. Appropriate prudential requirements can ensure that firms are incentivised towards prudent management of their business, aligning the interests of the firm with those of its stakeholders.
- 8.7** In the case of regulated stablecoin issuers and custodians, an appropriately robust prudential regime can also help to maintain confidence in the regulated stablecoin market. A lack of financial prudence, on the other hand, could have the opposite effect and may also increase conduct risk. For example, poor financial management can lead to prioritising short-term revenue generation over consumers' interests. Over time, this could lead to a firm's failure and result in harm to consumers and financial markets.
- 8.8** In general, it is helpful to have rules that are self-contained within a single prudential sourcebook for any given regulated activity, but when we come to consult on proposed rules, it is possible that we may find it necessary to refer to other relevant rules or legislation.
- 8.9** We do not operate a zero failure regime. But we believe that introducing prudential requirements for regulated stablecoin issuers and custodians will help reduce the risk of firm failure. This will also reduce the degree of harm by helping to ensure that where failure does occur, it will result in a more orderly failure (with less market disruption and reduced impact on consumers). Firms will also face reduced incentives to engage in poor conduct to drive returns. These requirements will also increase the likelihood of restoring consumers back into the position they should have been in before harm occurred, using the firm's own funds. So prudential requirements are important to help address the cost of potential harm that may occur from a firm's ongoing activities.
- 8.10** By setting out clear prudential rules and expectations for regulated stablecoin issuers and custodians, we reduce regulatory uncertainty. This may encourage firms to enter the market with a resultant increase in competition, lowering prices consumers pay. Notwithstanding the ongoing risks noted above and in other chapters, the existence of a robust prudential regime, alongside the other measures set out in this DP, may give confidence to individuals and firms to participate in the regulated stablecoin market.

## Application and interaction with other prudential sourcebooks

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- 8.11** As outlined in Chapter 1, cryptoasset regulation will be introduced in phases. Initially, we will consult on requirements for regulated stablecoin issuers and custodians. A new prudential sourcebook should be capable, over time, of expanding to cover firms undertaking additional cryptoasset activities as they are brought into the regulatory perimeter.
- 8.12** There may be instances where a firm finds itself subject to more than one prudential sourcebook due to the firm being authorised and regulated for multiple activities. For example, a firm conducting designated investment business might be subject to the prudential sourcebook for MiFID investment firms (MIFIDPRU). That firm may choose to apply for permission to undertake regulated stablecoin activities. Where this is the case,

we believe that any activity-based prudential requirements under [CRYPTOPRU] are best applied cumulatively with other activity-based prudential requirements. In this way, the potential for harm for each relevant regulated activity is captured in total.

- 8.13** Where other prudential requirements are based upon the firm as a whole and are not specific to particular regulated activities (for example, the fixed overheads requirement – see paragraphs below), it is more natural that firms should apply these in parallel. For any requirements where it may be less clear whether they would operate either cumulatively or in parallel, we will specify how these interactions will work in practice when we consult on requirements in the future.

## Capital requirements

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- 8.14** Prudential regimes typically impose minimum capital requirements made up of various components, each of which aims to address a specific purpose. The overall capital requirement of a firm is then often determined by whichever component is the highest. These requirements may, for example, be based on the permissions that a firm has, its reoccurring expenditure, or the amount of its regulated business. Our current thinking is that such an approach would be suitable for cryptoasset firms, and the components of their capital requirements consist of a permanent minimum requirement (PMR), a fixed overhead requirement (FOR), and an activity-based 'K-factor' requirement (KFR).

### Permanent minimum requirement (PMR)

- 8.15** A PMR would set a flat minimum for all firms based on which cryptoasset activities they undertake. Where a firm is conducting multiple activities (eg both regulated stablecoin issuance and custody) it would be appropriate for it to hold capital in line with the highest requirement.
- 8.16** A PMR would provide minimum on-going financial substance for smaller entrants into the market. It would also be the minimum amount of capital required at the point of authorisation. As a firm grows and its expenditure or business activity increases, it is expected that the other components would then exceed the PMR to instead become the main driver of the firm's capital requirement.

### Fixed overhead requirement (FOR)

- 8.17** A FOR would ensure that a firm has a minimum amount of capital available if it needs to wind-down or exit the market. A FOR is generally an amount equal to a proportion of a firm's relevant expenditure in the previous year. The purpose of a FOR is to ensure that a firm has sufficient resources to pay ongoing expenses (eg key staff salaries) while it winds down and exits the market, minimising disruption to consumers and markets in the process.
- 8.18** A FOR would likely operate by considering annual total expenditure and then allowing a firm to make certain deductions of a 'variable' or non-recurring nature (eg discretionary bonus payments). The resulting amount will then reflect items that are more 'fixed' or

recurring in nature (eg payment of rent, salaries), which will need to be paid to keep the firm going while it runs down its business. The formation of a list of any such deductions allowable under the new CRYPTOPRU sourcebook will also need to consider whether there are any items specific to cryptoasset business models. For example, if a firm was to wind-down or exit the market, it would be unlikely that it would continue to be minting further regulated stablecoins. If this is the case, it would be disproportionate to expect it to include the variable cost it incurs in minting regulated stablecoins within its FOR calculation.

## **K-factor requirement (KFR)**

- 8.19** A variable or 'K-factor' capital requirement (KFR) would help address the potential for harm arising from a firm's on-going operations when carrying out regulated cryptoasset related activities, with the amount of the requirement growing with the scale of business undertaken. In the future, we would foresee that where a firm conducts multiple regulated cryptoasset activities, the overall KFR would be the total amount calculated from applying a specific element or 'K-factor' for each relevant cryptoasset activity undertaken by the firm. To be proportionate and easy to calculate, these different elements should be based on simple, observable, metrics according to the type of regulated activity undertaken.
- 8.20** To illustrate this, in phase one, the following K-factors may be applicable for regulated stablecoin issuers and custodians:
- K-CUC – Cryptoassets (including regulated stablecoins) under custody
- 8.21** K-CUC would be the K-factor requirement for the amount of capital firms would be required to hold against risks associated with safeguarding or safeguarding and administering cyptoassets for clients (ie when acting as custodians). The definition of cryptoassets under custody (CUC) would initially capture only regulated stablecoins and security tokens. This could potentially be expanded as more activities are brought into the regulatory perimeter.
- 8.22** As referenced in Chapter 5, the custodian activity has several operational risks associated with it, that have the potential to cause harm. As a firm grows and takes on the responsibility of safeguarding or safeguarding and administering cryptoassets for more sizeable amounts of cryptoassets, the potential for harm increases.
- 8.23** We are likely to suggest that the K-factor for firms conducting this activity would look to measure the amount of CUC periodically (eg daily, weekly or monthly) over a period of time and hold capital against the average of observations recorded over that period. Averaging the amounts aims to provide an element of smoothing. We are likely to also suggest that the observations used may be 'lagged' by a suitable time period (ie set aside the most recent daily, weekly or monthly amounts when calculating the average). This smoothing and lagging would allow firms time to plan for changes in capital requirements from more recent changes in the level of their business activity and would help avoid a disproportionate impact from outlying amounts. It would be likely that this approach would also be used for other K-factors in [CRYPTOPRU] (as we do currently when using activity-based K-factors for the IFPR as a comparison).

- K-CII – Cryptoassets in issuance

**8.24** K-CII would be the K-factor requirement for the amount of capital firms would be required to hold against risks associated with issuing a regulated stablecoin.

**8.25** As referenced in Chapter 3, there are several operational risks associated with issuing regulated stablecoins that may lead to losses. As a regulated stablecoin issuer scales its business operations, the increased volume of the regulated stablecoins in issuance inherently increases the potential amount of harm that may be caused to markets and consumers if a risk materialises.

**8.26** The K-factor for issuance activity K-CII would be measured and calculated in a similar way as the requirement for K-CUC (ie with averaging), with the most relevant metric being the volume of regulated stablecoins in issuance. We believe that the periods of time for these requirements will depend on the characteristics of the metric (eg how much they may fluctuate and how proportionate it may be to gather that data). For example, while using more observations or over a longer period may be less proportionate, it should lead to reduced volatility when calculating the relevant K-factor. Whereas using fewer observations or over a shorter period may introduce greater volatility in capital requirements.

### Illustrated examples of minimum requirements

**8.27** To help illustrate how the PMR, FOR and KFR interact for an individual firm, we have provided 3 distinct scenarios using different sized firms. The red bars in the figures below represent a firm's capital requirements, the pink bar represents a firm's potential capital resources, and the dotted line represents the binding capital resources requirement. As referenced above, the overall capital resources requirement will be the highest of the 3 components (ie PMR, FOR or KFR).

**8.28** Figure 1 below envisages a small stablecoin firm (firm A) that currently has limited business and regulatory operations (eg firm A may be newly authorised or have a very small market share). In this example, the PMR is likely to be the binding capital requirement as firm A will have limited expenditure and business volume.

**Figure 1**

**Key:**

Capital resources requirement - - - - -

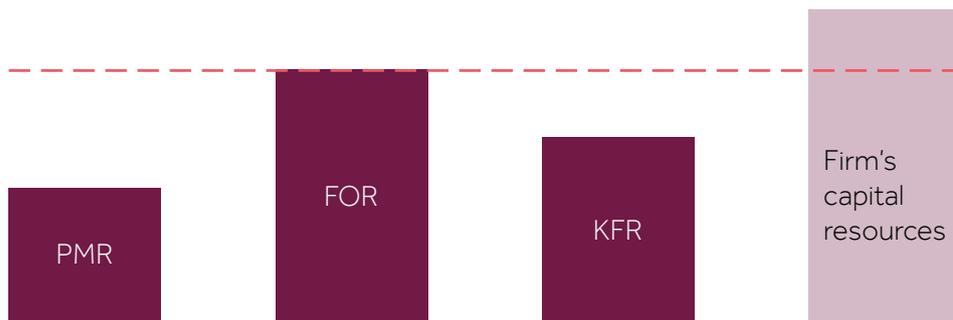


**8.29** Figure 2 below envisages a scenario where a firm (firm B) has expanded its operations, resulting in increased expenditure (eg hiring more staff). For firm B the FOR becomes the binding requirement due to this growth (ie the FOR is now higher than the PMR and KFR).

**Figure 2**

**Key:**

Capital resources requirement - - - - -

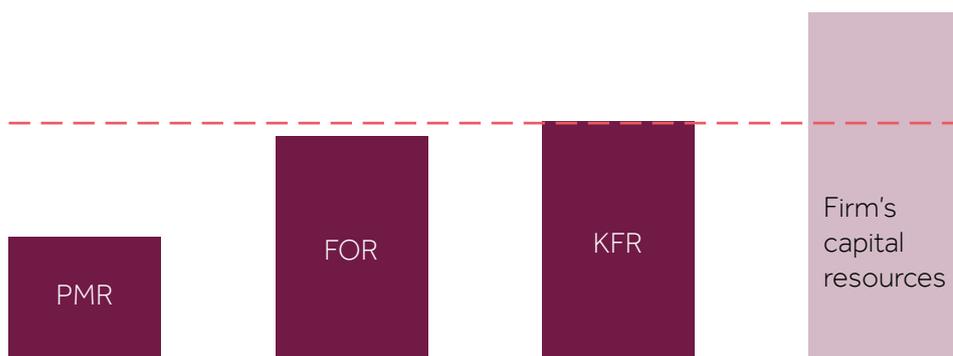


**8.30** Figure 3 below envisages a scenario where a firm (firm C) has fairly stable fixed expenditure, however its regulatory activities have grown as firm C attracts more business (eg firm C's issued regulated stablecoins may have increased over time). As a result, the KFR becomes the binding requirement (ie being higher than its PMR and FOR).

**Figure 3**

**Key:**

Capital resources requirement - - - - -



## Definition and types of capital that are eligible as regulatory capital

**8.31** The quality of what is allowed to count for inclusion as capital, to meet any regulatory capital requirements, will help to determine the ability of firms to remain financially resilient in the event of unexpected losses. Regulatory capital should be of sufficient quality to absorb losses when required (so that the firm can continue to operate as a

going-concern). The IFPR provides a useful comprehensive benchmark for the definition and quality of regulatory capital which we believe is equally relevant to firms subject to [CRYPTOPRU]. It allows different types of capital, with a minimum proportion to be of the highest quality (such as share capital) while allowing other types (subordinated debt) to make up the total.

**8.32** In the IFPR, regulatory capital is determined by its:

- permanence (capital that is not meant to be paid back)
- level of subordination and its ability to absorb losses, (eg whether the capital absorbs losses on a going concern basis without interrupting normal business operations)

**8.33** Regulatory capital generally falls under the following categories:

- **Common Equity Tier 1 (CET1)** is the highest quality of capital for regulatory purposes. It has the highest degree of permanence, subordination, and ability to absorb losses immediately when they occur.
- **Additional Tier 1 (AT1)** also absorbs losses, but AT1 capital is less subordinated than CET1 capital. To absorb losses while the firm is still a going-concern, AT1 instruments must be capable of either being written down or converted into CET1 instruments when a trigger event occurs (eg when the CET1 of the firm falls below a specified level).
- **Tier 2 (T2)** capital is generally not permanent (eg subordinated debt with an initial maturity of at least 5 years). T2 capital is subordinated to the claims of other creditors, but only absorbs losses if a firm enters an insolvency process (rather than doing so on a 'going concern' basis).

**8.34** Prudential regimes also tend to apply regulatory adjustments to the amount of capital that is available to meet a firm's capital requirements. For example, goodwill and other intangible assets are deducted from capital, as they are generally treated as having no value for regulatory purposes. Our current view is that the same principle should apply when calculating regulatory capital for firms subject to [CRYPTOPRU].

## Group risk

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**8.35** We assess a firm's membership of a group at the point of authorisation and on an ongoing basis. Group membership is relevant to the assessment of the threshold conditions. For example, when we assess whether a firm has appropriate financial resources, we must have regard to how other group members make provision for any liabilities, and how risk is managed in connection with the firm's business. When we assess whether a firm is capable of being effectively supervised, we have regard to whether membership of the group and close links to other parties are likely to be consistent with effective supervision of the firm.

**8.36** We are currently of the view that applying requirements to address group risk should be a relevant feature of a prudential regime for firms. Typically, we use the tool of prudential consolidation to address group risk. Under a prudential consolidation a group is treated

as if it was a single enlarged firm and the relevant prudential rules that apply to that firm are also applied to the whole group. Under the IFPR, we also introduced the Group Capital Test (GCT), which is another tool to address group risk. The purpose of both alternative tools is to help ensure that regulated firms in a group are not exposed to unnecessary financial strain due to their membership of that group.

**8.37** It is our view that initially the regulatory tool of traditional prudential consolidation would not be appropriate for cryptoasset firms. This is because the methods of prudential consolidation are derived from and entrenched in years of complex regulation, with key definitions and concepts that are specific to the banking and investment firm sectors. Given that cryptoasset regulation is still in its infancy, we believe it may not be practical to develop prudential consolidation rules as a standard requirement until such a time that the full regulatory perimeter is clearly defined. Effective prudential consolidation depends on clearly defining the scope of each type of relevant undertaking that would form part of a consolidation group.

**8.38** We are currently minded to propose the creation of a simple regime for regulated stablecoin issuers and custodians, using the concept of a GCT (rather than prudential consolidation). It aims to reduce the risk that being part of a group may lead to potential sources of harm, without needing to apply all the relevant detailed provisions of a prudential consolidation. The GCT would seek to ensure stable group structures, by addressing the situation where a firm or other group undertakings may appear to have sufficient capital at an individual level, but the parent entity is leveraged and has funded the capital instruments of a subsidiary with debt. Under a GCT each parent entity must hold sufficient capital to support its investment in its subsidiaries.

## Concentration risk

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**8.39** The IFPR introduces an obligation for investment firms to monitor and control concentration risk. Concentration risk is the potential for loss that may occur from a firm being overly exposed to one or more counterparties or type of asset. We are considering the extent to which this risk is relevant to firms subject to [CRYPTOPRU] and our current thinking is that it would be just as relevant.

### General obligation to monitor concentration

**8.40** To mitigate the potential for harm that can arise from different types of concentrated exposures or relationships, it is prudent that firms should monitor and control all their relevant sources of concentration risk, including:

- assets (for example, trade debts)
- off-balance sheet items
- the location of client money and custody assets
- the location of the firm's own cash deposits
- the sources of earnings

**8.41** When we refer to the location of client money, custody assets or cash, we envisage that firms should monitor and control the extent to which these assets are concentrated

at particular banks, investment firms and other entities including sub-custodians (see Chapter 5). It is prudent that firms should be able to identify not just individual clients but also groups of connected clients who may constitute a single risk because of their interconnectedness.

- 8.42** As discussed in Chapter 3, regulated stablecoin issuers may be required to ensure that the backing assets are held in a prescribed form. Given that the regulated stablecoin's value is determined by backing assets, good risk management would suggest that issuers ensure that their backing assets are not overly exposed to one or more institutions. A recent example of this was the impact that the collapse of Silicon Valley Bank in the US had on Circle, where a reported 9% of the backing assets were caught up in the bank's failure. This had a subsequent knock-on impact on the secondary market price of Circle's stablecoin (USDC).
- 8.43** Depending on the size of the regulated stablecoin issuer, following the same example, 9% of backing assets held with a single counterparty may not constitute a major concentration risk. Our current thinking is that smaller regulated stablecoin issuers may require greater proportionality given the smaller absolute size of their exposures. We currently envisage that the concentration risk requirements would be dynamic in nature, and it will be the firm's responsibility to conduct an appropriate risk assessment for its exposures. It is expected that this would form part of the internal capital adequacy and risk assessment (ICARA) process (see paragraph 8.49).

## Liquidity

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- 8.44** It is important for a firm to maintain appropriate levels of its own liquidity (readily available assets, eg cash) at all times to ensure that the firm can meet all liabilities as they fall due. Some prudential regimes impose an obligation on regulated firms to maintain sufficient levels of liquid assets to help ensure this. We initially envisage that a basic liquidity requirement would help achieve this outcome for firms.
- 8.45** Our intention is that, by basing a minimum liquidity requirement on a proportion of the fixed overhead requirement, a firm should be able to meet its relevant overheads for at least a set period by using such liquidity, if other sources of cash-flow are unavailable.
- 8.46** Below we have included a list of the types of core liquid assets that we believe may be most suitable for firms to use to meet a basic liquid assets requirement. These are the straightforward liquid assets that firms commonly hold and do not require any reduction (or 'haircut') given their certainty of value. Any amount of the following may be used:
- coins and banknotes
  - short-term deposits at a UK bank
  - assets representing claims on or guaranteed by the UK Government or the Bank of England (for example UK gilts and Treasury bonds)
  - units or shares in a short-term regulated money market fund, or in a comparable third country fund

## Requirements for regulated stablecoin issuers

**8.47** A regulated stablecoin issuer may have additional need for liquidity due to the way in which their business model operates. For example, as stablecoin holders make constant requests for stablecoins to be minted or destroyed, there could be expected large cash inflows and outflows in the backing assets. Under the proposed approach in Chapter 3 regulated stablecoin issuers will be subject to 'top up' requirements where there is a shortfall in the backing assets. Where a shortfall does occur, this may cause a strain on the liquidity of the regulated stablecoin and they may not be able to meet the safeguarding requirements imposed on them. So, by holding a small amount of liquid assets in proportion to the size of the coins in issuance, a buffer can be created in the firm's own resources which the regulated stablecoin issuer can use if they need to top up the backing assets with their own resources. We will consider whether this additional liquidity component should be held in a narrower range of assets (ie those permitted to be held as backing assets as referenced in Chapter 3). Alternatively, whether the full range of core liquid assets used to meet the basic liquid asset requirement may be sufficient for the purposes of topping up the backing pool.

## Internal capital adequacy and risk assessment

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- 8.48** The requirements discussed above would typically make up the minimum standards within a prudential regime. The financial resources an individual firm would require may be greater than these minimum standards based on the complexities of its business model.
- 8.49** We are exploring if it is appropriate to place an obligation upon firms to conduct an individual capital adequacy and risk assessment (ICARA) process on an ongoing basis, similar to the one set out in Chapter 7 of the MIFIDPRU Prudential sourcebook for MiFID investment firms, but with appropriate guidance for cryptoasset activities.
- 8.50** Our proposed approach is underpinned by the following key principles:
- The expectation that firms consider and account for the potential harm they could cause to consumers and markets, as well as risks to their own safety and soundness. They must assess the degree to which the activities they undertake pose harm to others, and account for this appropriately. This includes credible and costed wind-down planning, which we consider a critical feature of firms' internal risk assessment process under our new framework.
  - The ICARA process should be central to firms' risk management processes. Under our proposals it will cover:
    - identification, monitoring and mitigation of harms
    - business model planning and forecasting
    - recovery and wind-down planning
    - assessing the adequacy of financial resources.
  - Senior management is responsible for ensuring the appropriateness of their firm's governance and risk management. Our expectation is that it is the responsibility

of a firm to recognise, monitor, control and mitigate the risks to which they are exposed, and potential for harm their activities pose to consumers and markets.

- We will intervene if firms fail to act appropriately or their actions appear unsuccessful. We propose that firms must notify us where their level of capital and/or liquid assets fall below specified intervention points (these are typically a percentage above the capital and liquidity requirements).
- Our expectations on firms are proportionate to the risk of harm posed and contain core requirements for all firms.

## Public disclosure of prudential information

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- 8.51** As part of our existing requirements, some regulated firms are currently required to periodically disclose some basic information on their prudential requirements.
- 8.52** Poorly run firms pose a greater potential risk of harm to markets and consumers. By disclosing appropriate and relevant information about its financial resilience, risk management policies and other control systems, a firm helps stakeholders (especially investors, potential investors, and counterparties) to make informed decisions about their relationship with the firm on the basis of the harm that it may pose to customers and/ or markets.
- 8.53** In this way, public disclosures support effective market discipline and facilitate constructive engagement by all stakeholders.
- 8.54** For disclosures to fulfil this role effectively, they need to be easily accessible and understandable by stakeholders. So, we envisage that regulated stablecoin issuers and custodians will need to publish their prudential disclosures on a dedicated part of their website which is easily accessible. For example, it appears when the website is searched, via a search engine or is clearly sign-posted. Regulated stablecoin issuers and custodians that do not have websites would still need to make their disclosures freely available. This might be in other material that they publish or provide to investors, such as an annual report or investor brochure.

**Q31: Do you agree with our proposed prudential requirements for regulated stablecoin issuers and custodians? In particular, do you agree with our proposals on any of the following areas:**

- i. Capital requirements and quality of capital
- ii. Liquidity requirements and eligible liquid assets
- iii. Group risk
- iv. Concentration risk
- v. Internal risk management

## Chapter 9

# Managing regulated stablecoin issuers and custodian firm failures

- 9.1** This chapter focuses on some of the issues that may arise if a regulated stablecoin issuer, custodian or other third party that provides services to these entities fails (eg enters an insolvency process). Firms will always carry a risk of failing (which may be due to not having adequate financial resources), as highlighted in Chapter 8. While we cannot stop firms from failing, we seek to ensure that when firms do fail, they can wind down in an orderly manner or enter insolvency in a way that minimises harm to consumers and the market.

## Failure of a regulated stablecoin issuer or other firm holding backing assets

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- 9.2** As noted in Chapter 3, we are seeking to apply our Client Assets (CASS) regime to the safeguarding of regulated stablecoin backing assets. This includes considering how backing assets should be returned if a firm fails. The approach to return backing assets would fall under 3 scenarios upon:
- the failure of the issuer;
  - the failure of the firm responsible for safeguarding the backing assets if not the issuer and;
  - the failure of the bank/custodian holding the backing assets for either the issuer or the firm responsible for safeguarding the backing assets if not the issuer.

## Pooling events

- 9.3** The CASS rules currently describe 2 different types of pooling events for client money, depending on the type of firm that has failed:
- a. A primary pooling event (PPE)** occurs, among other instances, on the failure of a safeguarding firm. All client money held by the firm is notionally pooled, forming a client money pool. Custody assets would either be returned in specie to clients or, generally as a last resort, liquidated. If liquidated, the liquidation proceeds would be included in the pool. The pool is then distributed to clients on a pro-rated basis according to their entitlements, following the deduction of distribution costs.
  - b. A secondary pooling event (SPE)** occurs when a bank or third-party holding client money on behalf of a safeguarding firm fails. If the firm does not choose to make good a shortfall that results from this event, the firm is required to ensure any shortfall resulting from the third-party failure is shared rateably among the firm's clients, in line with their entitlements. The firm would need to calculate new entitlements for clients reflecting any shortfall and update the firm's records to reflect any new entitlements, and actions taken by the firm to address the shortfall.

- 9.4** We are considering applying (and adapting as necessary) the above pooling events to stablecoin backing assets. These pooling events would be triggered depending on which party fails (the failure of an issuer would result in a different course of action in comparison to the failure of a third-party firm holding backing assets for the issuer). For example, the failure of an issuer holding regulated stablecoin backing assets could result in a PPE. The failure of a bank used by the issuer to hold backing assets could result in a SPE.
- 9.5** We are also considering including rules on triggering a PPE when there is a critical failure of the technology underpinning the regulated stablecoin (for example, a blockchain or another distributed ledger). Given the range of consequences in this scenario, we are exploring whether this should occur in all instances of a technological failure or certain circumstances. We would welcome feedback on the circumstances where this would be appropriate in Question 32.
- 9.6** In addition, there are differences to consider when applying traditional CASS pooling events to the regulated stablecoin backing assets, particularly where a third party holding the backing assets fails (i.e. SPE). Differences may include:
- Where a shortfall in backing assets arises, the issuer must top up the shortfall in the next reconciliation. This enables consumers to continue to be able to redeem at par value within 1 business day and protect the stability of the stablecoin (see Chapter 3). This means, as highlighted in Chapter 8, the firm will need to make good any shortfall in the event of a third-party failure. In such circumstances, Financial Services Compensation Scheme (FSCS) coverage may apply as highlighted in Chapter 7.
  - In traditional finance, where a shortfall arises following a SPE, consumers may be eligible for 'look-through' compensation where the failed third-party institution (eg a credit institution) is covered by the FSCS. For regulated stablecoins, we are exploring if similar provisions could be available for consumers in the event of a SPE, and if so, how. We recognise that due to the potential pseudoanonymity of stablecoins, identifying underlying holders of a stablecoin could potentially be very difficult for issuers.

**Q32: Do you agree with applying existing CASS rules on post-failure treatment of custody assets to regulated stablecoin issuers and other firms holding backing assets for regulated stablecoins, as well as CASS pooling events? If not, why not? Are there any alternative approaches that should be considered? If so, please explain.**

### **Distribution (or transfer) of the backing assets**

- 9.7** When a firm holding client money fails, the CASS rules require the firm (or an insolvency practitioner (IP) appointed over the firm), as soon as reasonably practicable, to distribute the client money to each consumer who is a beneficiary to the client money pool, which is rateable to their entitlement. The rules also permit a firm to transfer client money (and custody assets) to another entity providing certain conditions in CASS are met.

- 9.8** For custody assets, if not transferred to another entity, a firm may either return the assets in specie to consumers, or generally as a last resort liquidate and return the proceeds to consumers. The CASS rules require costs relating to the distribution of client money to be borne by the firm. In instances where a firm seeks to divest itself from custody assets, costs should be paid from the firm's own funds.
- 9.9** We are considering applying similar distribution (and transfer) provisions to regulated stablecoin backing assets in the event of firm failure. However, the tradeable nature of regulated stablecoins makes distribution particularly challenging.
- 9.10** In traditional finance models, the firm generally has a list of beneficial owners of the client money and custody assets (including the means of contacting them). In contrast, a regulated stablecoin issuer will likely not know, or have access to records that identify, all the current holders of the coin – only the wallet address that the coin is stored in. So, our rules seek to strike a balance between the interests of consumers who come forward for distribution in receiving their funds quickly and giving other consumers a fair opportunity to come forward.
- 9.11** To achieve this, we are considering the following distribution process for regulated stablecoin backing assets to be pursued by a firm if a PPE is triggered:
- **Provide an estimated distribution entitlement if all consumers came forward** – consumers should know what they can expect to be returned as soon as possible. We think this should reflect the value of the backing assets and any estimated costs of distribution.
  - **Advertise the first point of distribution, including estimated return and date of first distribution** – our aim is for this to reach as many consumers as possible and for firms to make the first distribution notice promptly after the decision to distribute. The distribution could initially be a partial distribution, rather than all the backing assets. Firms will need to consider appropriate advertising channels. We are considering requiring advertising through relevant trade press and social media, as well as through exchanges, and to custodians as minimum requirements. Additional methods may be necessary depending on the nature and use of the regulated stablecoin. We are also exploring whether the DLT could be used to send electronic notifications directly to wallet holders. We understand that technology enabling this is currently being developed and trialled in industry, which will allow customers to send and receive messages through their wallet.
  - **Make the distribution or initial distribution out of backing assets at the advertised rate** – any distributions would need to be in line with relevant legislation and regulatory requirements including Know Your Client (KYC) requirements. These mean consumers must provide the necessary documents to enable the firm to complete any relevant anti-money laundering checks.
  - **Subsequent and final distributions** – following the triggering of a PPE, firms must advertise subsequent and final distribution dates (following a similar process as above), after which the trust over the backing assets would end. We welcome views in Question 33 on how an issuer can distribute stablecoin backing assets and end the trust over these assets with sufficient safeguards for consumers, considering the challenges of knowing the underlying holders of regulated stablecoins.

**9.12** We are also considering whether firms should follow this process for a solvent wind-down of the regulated stablecoin issuer. This would be relevant where the issuer decides to require consumers to redeem their regulated stablecoins. In a solvent wind-down, all coins can be redeemed in full as there would not be any requirement for the firm to deduct distribution costs (as there would if a firm enters an insolvency process). We are also exploring how any unclaimed regulated stablecoin backing assets should be treated in a solvent wind-down, as well as in the event of insolvency.

**Q33: Do you agree with our thinking on how the CASS rules can be adapted for returning regulated stablecoin backing assets in the event of a firm failure or solvent wind-down? If not, why not? Do you foresee the need for additional protections to ensure prompt return of backing assets to consumers or otherwise reduce harm in firm failure (eg strengthening wind-down arrangements, a bespoke resolution regime)? If so, please explain.**

### Post-failure trading

**9.13** Stablecoins are exchanged on secondary markets both 'on-chain' through transfers between wallets, and 'off-chain'. If a regulated stablecoin issuer fails, secondary trade could cause harm as the coin may fall below its original value and new consumers may not understand their rights in the backing asset distribution. However, the secondary market could also be a helpful mechanism for quickly realising value that would otherwise be tied up until a distribution can occur. It may also be easier to access for consumers who have already been participating in it. This speed and ease of access could outweigh any reduction in value realised relative to participating in the distribution.

**9.14** We considered the implications of stopping secondary trading. It may technically be possible to code a 'hard stop' to prevent on-chain trades that could be triggered when required. For example, when the firm enters insolvency proceedings, or the proposed distribution is advertised. However, this would not prevent off-chain trading and could fragment markets (as no trading could take place between exchanges). This in turn could lead to unfair outcomes, with some consumers unable to participate in secondary trading at all if their coins are, for example, held in self-custody.

**9.15** Overall, we do not consider it appropriate to prevent secondary trading. Instead, we intend to focus on making sure the market is given clear information on the state of the backing assets and any plans for distribution. We may consider this further as part of issuance and disclosure requirements in the future regulated cryptoasset regime.

**Q34: Do you agree with the proposed overall approach for post-failure trading? If not, is there anything else that should be considered to make the approach more effective? If so, please explain. Are there any arrangements that could avoid distribution of backing assets in the event an issuer fails and enters insolvency proceedings?**

## Failure of a custodian of a regulated stablecoin

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- 9.16** As detailed in Chapter 5, we aim to use the CASS regime to protect customers' rights to their regulated stablecoins when they are held by a custodian. This includes considering how coins (including the means of access to the coins such as cryptographic private keys) should be treated if a custodian fails.
- 9.17** In traditional finance models, the CASS rules prescribe safeguarding measures for consumers that the firm (or IP appointed over the firm) must adhere to when transferring custody assets to a solvent firm, or before closing the client estate. Separately, custodians may be eligible to be placed in the Investment Bank Special Administration regime (a bespoke insolvency regime for investment banks), which gives an IP additional tools to enable the prompt return of client assets.
- 9.18** We are considering requirements for regulated stablecoin custodians that will broadly follow the approach taken in traditional finance in CASS. In other words, we intend to develop safeguarding measures for consumers by requiring the firm (or an IP appointed over the firm) to ensure that consumers have sufficient opportunity to claim their stablecoins. We are also exploring how to treat regulated stablecoins held by a custodian that consumers do not claim during an insolvency process.
- 9.19** Owing to the different underpinning technology of regulated stablecoins, we anticipate our existing approach to the treatment of custody assets post-failure should be applicable. This includes the tracing requirements on custodian firms and the considerations around transfer of the regulated stablecoin to another custodian. We are also considering whether this process should be followed for a solvent wind-down of a custodian of regulated stablecoins and if additional protections should be in place for consumers in this scenario, such as developing plans for how the firm wind downs on an orderly basis (known as 'wind-down plans').

**Q35: What challenges arise when stablecoins are returned to consumers, particularly with respect to their entitlements? Do you foresee the need for additional protections to facilitate the prompt return of regulated stablecoins to consumers or otherwise reduce harm in firm failure (eg introducing distribution rules within CASS for cryptoassets, strengthening wind-down arrangements, or a bespoke resolution regime)? If so, please explain.**

## Chapter 10

# Regulating payments using stablecoins

- 10.1** Stablecoins have the potential to be used as payment instruments, and the Treasury is looking to amend payments legislation to enable this. There are some potential benefits of using stablecoins in this way, for example the speed, accuracy and cost of making the payment. Most of the requirements currently applicable to payments do not sit within our Handbook, but firms must comply with the regulations contained within the Payment Services Regulations 2017 (PSRs) and the Electronic Money Regulations 2011 (EMRs).
- 10.2** The PSRs work by regulating the transfers of 'funds', including transfers of non-cash and electronic money. However, the PSRs do not capture transfers of value through other assets, including cryptoassets such as stablecoins, unless they fall within the definition of electronic money.
- 10.3** We have already seen the emergence of hybrid business models, in the UK and elsewhere, which seek to integrate traditional payment services involving the transfer of 'conventional' funds with the use of stablecoins to convert cryptoassets back into fiat currency. The payment processing itself is regulated as a payment service under the PSRs, but the 'add-on' functionality of linking this to a purchase or sale of cryptoassets including stablecoins is not.
- 10.4** Stablecoins are also commonly used to enable buying or selling cryptoassets within exchanges in what is commonly known as a 'trading pair'. We have not yet seen stablecoins being used in UK payment for goods and services in the real economy. 'Buying' goods or services with cryptoassets certainly happens, but it does so largely on an ad hoc basis, without the involvement of intermediaries providing services similar to those offered by conventional payment service providers.
- 10.5** As set out in Chapter 2, the Treasury propose to regulate the use of fiat-backed stablecoins to make payments in the UK. This framework, and our guidance and rules under it, will aim to achieve the following for payments made with stablecoins:
- secure good outcomes for consumers choosing to use stablecoins to make or receive payments that are broadly equivalent to outcomes under the existing payments regulatory framework
  - ensure that firms developing and offering stablecoin payment services do so in a way that is safe and compatible with these good consumer outcomes
  - provide a clear and level playing field enabling competition to drive innovation and develop propositions using the potential advantages of stablecoins in speed, accuracy and cost of settlement in consumers' interests.

## Proposed regulatory approach

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- 10.6** The PSRs currently set out, among other things, the range of payment services in scope and a list of exclusions, the standards that must be met by payment service providers

for authorisation or registration to be granted, capital requirements and safeguarding requirements, conduct of business requirements applicable to payment services, and our powers and functions for supervision and enforcement in this area.

- 10.7** The Treasury have proposed extending the scope of the PSRs to fully capture two possible models for stablecoins used for payment.
- **The hybrid model** – this envisages that a stablecoin would be used at the entrance or exit of an existing fiat payment chain, but the actual transfer of value would be in fiat by way of a traditional payment service. For example, services where a consumer uses stablecoin to make a payment for goods or services, and the Payment Services Provider (PSP) performs a conversion from stablecoin to fiat to enable the payment to be made.
  - **The pure stablecoin model** – this envisages that both the payer and payee transact in stablecoin, and the transfer of stablecoins between them occurs 'on-chain'.
- 10.8** The Treasury propose that the payment models noted above will be regulated where they involve a regulated stablecoin. They are also exploring regulating these payment models when they involve a stablecoin issued by an overseas entity (referred to in this DP as 'overseas stablecoins'). The Treasury are exploring whether firms offering these payment services will need new permissions under the PSRs for one or more of the new payment models noted above. We refer to firms providing these services as payment arrangers.
- 10.9** The Treasury have also stated that the scope of regulation will not include peer-to-peer stablecoin transfers where the payment service underpinning or facilitating the transfer is not offered on a commercial basis.
- 10.10** As outlined further in Chapter 11, the Treasury are considering only permitting firms to use overseas stablecoins in their payment services if these had been approved against standards we set. To undertake this assessment, firms would need a further permission under the PSRs.
- 10.11** Transactions involving other types of cryptoasset would, for the moment, remain unregulated (in the case of the pure stablecoin model) or partially regulated where the transaction included fiat currency. That is, regulation would apply once a stablecoin has been converted into fiat and that fiat is used to make a payment.

## The hybrid model

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- 10.12** This way of making payments includes a number of steps, most of which the consumer does not see. The key element of this model is that the actual payment being made is a payment transaction as currently set out in the PSRs. Different entities may be involved in the different steps forming part of the hybrid model.

#### Model A:

- 1. Crypto on-ramp:** A payer must have a holding of stablecoin.
- 2. Payment initiation:** The payer will seek to buy goods or services priced in fiat and instruct a stablecoin Payment Service Provider through a payment interface to make payment to the merchant using the stablecoin.
- 3. Stablecoin exchange:** The PSP will then initiate the exchange of stablecoin for fiat for the consumer. This may involve the transfer of the stablecoin from the consumer's wallet to one belonging to the PSP, or the initiation of an exchange through someone else.
- 4. Value transfer:** The PSP will then initiate the transfer of funds through existing payment mechanisms to the merchant.

#### Model B:

- 1. Merchant makes arrangements to receive payments in stablecoin:** The merchant will price goods or services in stablecoin. They will make arrangements with an acquirer, a type of intermediary PSP that allows the merchant to receive payments through payment systems for (a) goods or services with prices set in stablecoin to be converted to fiat, and (b) incoming payments to be converted to stablecoin. These arrangements may also include providing a custodial wallet to the merchant, or the merchant may use an existing or dedicated non-custodial wallet.
- 2. Payment initiation:** The consumer will seek to buy these goods and services and instruct a PSP (consumer's PSP) through a payment interface to pay the merchant.
- 3. Value transfer:** The consumer's PSP will initiate the transfer of funds through existing payment mechanisms to the merchant's acquirer.
- 4. Conversion to stablecoin:** The merchant's acquirer will convert fiat into stablecoin equivalent.
- 5. Stablecoin transfer to merchant:** The merchant's acquirer will transfer stablecoins to the merchant's individual wallet.

**10.13** Model A arrangements currently exist both in the UK and overseas, making use of both existing 'stablecoin' type products and wider unbacked cryptoassets.

**10.14** We do not know of any firms offering Model B types of arrangements in the UK. This may be because relatively few merchants would actively prefer to receive payments in crypto. However, those that offer Model B probably operate in an environment where both parties are comfortable with the use of cryptoassets, and the consumer is willing to make the payment in crypto. However, as take-up of stablecoins increases, merchants whose supply chain operates using payments made in cryptoassets may prefer to receive payments from consumers in stablecoin, regardless of whether those consumers want to pay this way.

- 10.15** In both models, some parts of these activities would fall within the existing scope of the PSRs if carried out in the UK. For instance, the 'payment interface' would be likely to fall within the definition of 'payment instrument'. In both models, the consumer's PSP would execute payment transactions by transferring funds to the merchant's PSP – falling within the scope of the PSRs. This is because at the centre of the service being provided is a set of procedures that enables the consumer to initiate a payment transaction. It is this set of procedures with a payment transaction that is currently defined in the PSRs.
- 10.16** This is similar to the way foreign exchange services are regulated. Under the PSRs, providing foreign exchange services is not itself a payment service. However, the onward payment by a PSP or foreign exchange services provider, on behalf of a consumer to a third party of currency bought in a foreign exchange transaction, often is.
- 10.17** At present, the full payment transaction in stablecoins is not regulated end-to-end. The unregulated elements of the service include the custody or control of stablecoins belonging to the consumer, and in providing services that include the exchange of stablecoin to fiat and vice versa. In this model, as a result of the use of stablecoins, both consumers and merchants are exposed to additional risks compared with conventional payment methods.
- 10.18** The Treasury propose to bring ancillary crypto-related activities (such as the exchange of stablecoin to fiat described above in Models A and B) into scope of the PSRs as payment services. We refer to these new payment services as 'ancillary stablecoin payment services'.

## The pure stablecoin model

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- 10.19** A purely stablecoin model is where the consumer pays for a good or service using stablecoin and the merchant receives the value of the goods in stablecoins. In this model, no part of the transaction would be processed using conventional payment systems. This could fully realise some of the key potential advantages of DLT, such as the possibility of payments not being reliant on trusted intermediaries – due to the greater transparency and reliability offered by the technology in the transfer of value or rights between users. This could increase efficiency, speed and reliability, while reducing the total costs as the number of parties involved in completing a payment transaction falls.
- 10.20** The cryptographic model may take 2 broad forms. The first may be viewed as a direct 'on-chain' model. This is where the transfer of the stablecoin from the buyer's wallet to the seller's wallet takes place simultaneously or near simultaneously, with the consumer making their purchase / authorising the payment.
- 10.21** A second model is more complex and involves the payment arranger 'batching' and/or netting off transactions initiated through its payment interface. This involves the arranger holding stablecoins that have been earmarked for transfer for a period of time, before initiating fewer, and potentially larger transactions, on the blockchain in stages.
- 10.22** The direct 'on-chain' model has advantages such as greater speed in transaction and improved certainty. However, it may lead to inefficiencies, particularly when the

volume of transactions requiring authentication on the blockchain grows. The pure stablecoin model, whereby stablecoin transactions are batched, also carries additional risks due to the delay between payment initiation and actual transfer of the stablecoin. Stablecoin transactions which are held before transfers take place must be managed through appropriate custody/ safeguarding regulation. However, like large scale net settlement systems, it may prove to be cheaper and more efficient than processing each transaction individually.

- 10.23** We have yet to see significant uptake of direct payment by stablecoin for real-world retail payments of either type of model. Outside of cryptoasset exchanges where stablecoins are regularly used in trading pairs, crypto lending and staking services, and relatively specialist markets for digital goods; few merchants are willing to accept payment in stablecoin, and few consumers routinely hold it for the purpose of paying for goods and services.
- 10.24** The Treasury's proposed framework for regulating fiat-backed stablecoin UK payment services, alongside our regulation of issuance and custody of regulated stablecoins, will help to provide a framework to enable this to grow.

## Conduct requirements

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- 10.25** We consider that, in general, the existing conduct rules for payment service providers in the PSRs should apply for both the new pure stablecoin payments activities, and to the ancillary stablecoin payment service activities being brought into the scope of the PSRs for hybrid payment models.
- 10.26** These include information requirements which are set out in Part 6 of the PSRs, and rights and obligations for the provision of payment services set out in Part 7 of the PSRs. We explain our expectations of firms for these requirements in our guidance to firms in chapter 8 of Payments and Electronic Money – Our Approach ('our Approach Document').
- 10.27** This would give consumers using stablecoins for payments the same rights as current users of regulated payment services. For example:
- information about how payment instructions can be given, how the consumer can communicate with the PSP if they have any questions about the service, fees and charges, and variation and termination of the contract
  - information about individual payment transactions processed, including transaction amounts, charges and value dates
  - consumer rights involving execution of transactions such as maximum regulatory time limits for executing a payment order
  - consumers where a transaction is executed defectively or is unauthorised, and complaints-handling requirements.

- 10.28** As with existing PSPs, we consider that payment arrangers should be subject to our Principles, including the Consumer Duty where applicable. Many of the issues around the Principles and Consumer Duty discussed in Chapter 8 (conduct of business requirements) of our Approach Document would also apply to payment arrangers.
- 10.29** The Treasury is currently progressing the repeal and restatement of the PSRs as part of the Smarter Regulatory Framework. We expect many firm facing requirements currently found in the PSRs to move into our rulebook. So, some or all of the requirements referred to in this section may be found in our rulebook in future. In the meantime, we may issue guidance on how the provisions in the PSRs will apply to payment arrangers.

## Custody and safeguarding in hybrid and pure stablecoin payment services

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- 10.30** The PSRs require payment institutions to safeguard funds they receive from customers for execution of a payment transaction. Payment firms are required to safeguard as soon as they receive the funds. The safeguarding obligation generally remains in place until the value of the funds is paid out to the payee or the payee's PSP. As set out in Chapter 5, we have identified a series of requirements we are considering for custody activities for firms that hold regulated stablecoins on behalf of consumers.
- 10.31** Custody arrangements are likely to arise in hybrid payment services, and may also arise in pure stablecoin payment services where payment firms intermediate payments in stablecoins. Where this occurs, we expect that the same requirements set out in Chapter 5 will apply to them.
- 10.32** It is important to ensure consumer funds and any stablecoin involved in a hybrid transaction are seamlessly protected. To achieve this, we expect that:

**In model A:** custody requirements would apply to the stablecoin while under the PSP's control. These might be in the consumer's own individually segregated wallet, or in an omnibus custodial wallet operated on behalf of all consumers. This would apply until such time as the corresponding amount of fiat currency had been safeguarded, or the payment transaction completed if the firm was pre-funding the payment transaction.

**In model B:** safeguarding requirements would apply to funds received through the payment system. These requirements would continue until such time as a PSP held the corresponding stablecoin in custody for the merchant, or had procured the corresponding stablecoin to be transferred directly to the merchant's self-custody wallet.

- 10.33** In pure stablecoin payment arrangements, we do not expect safeguarding requirements to apply, as the payment service provider would not be holding funds in respect of a payment transaction. However, where the payment arranger takes custody of the consumer's stablecoin when providing these services, our requirements on stablecoin custody would apply to that activity. The payer's PSP would have to meet these until it initiated a blockchain transfer to the recipient or the recipient's PSP. A recipient's PSP would have to meet our requirements from the time the stablecoin came into its custody.

- Q36:** Do you agree that this approach to integrating PSR safeguarding requirements and custody requirements will secure an adequate degree of protection for users of stablecoin payment services?
- Q37:** Do you agree that the custody requirements set out in chapter 5 should apply to custody services which may be provided by payment arrangers as part of pure stablecoin payment services?

## Money Laundering Regulations (MLRs)

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- 10.34** The MLRs apply to payment services regulated under the Payment Services Regulations 2017 (PSRs) and are likely to apply to pure and hybrid stablecoin payment services.

## Operational Resilience

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- 10.35** Due to the important role of payment services for consumers, we note the significance of ensuring payment arrangers maintain operational and prudential resilience. We would expect similar requirements as those discussed in Chapters 6 (organisational requirements) and 8 (prudential) to apply to payment arrangers. Disruption to a firm that facilitates payments by way of stablecoin, which may have become systemically important, could potentially lead to systemic disruption of the wider payment network. Having a robust resilience framework ensures all payment firms have greater ability to withstand operational and economic disruption, deliver critical operations and minimise consumer harm.

## Redress and FSCS

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- 10.36** The FCA's dispute resolution sourcebook (DISP) applies to payment service providers authorised under the PSRs. It sets out how firms should manage complaints from consumers and allows for consumers to access the Ombudsman Service if a consumers' complaint is not satisfactorily resolved. We are proposing that PSPs coming into scope of the new ancillary and pure stablecoin payment service activities would need to comply with DISP and consumers of payment arrangers would have access to the Ombudsman Service.
- 10.37** Non-bank payment providers are not within the scope of protection of the Financial Services Compensation Scheme (FSCS) if they fail. As set out in Chapter 7, we cannot extend FSCS protection to activities that are not in the Regulated Activities Order. This

includes activities related to electronic money issuance and payment services, which are regulated outside FSMA under the Electronic Money Regulations and the Payment Services Regulations. This means FSCS cover could not be applied to payments using stablecoins.

**Q38: Are there additional risks or opportunities, not considered above, of different stablecoin payment models that our regulation of payment arrangers should seek to tackle or harness?**

## Chapter 11

# Overseas stablecoins used for payment in the UK

- 11.1** As discussed in Chapter 10, the Treasury is considering making changes to the payments legislation to enable retail payments for goods and services to be made using fiat-backed stablecoins. This proposal would enable payments to be made with regulated stablecoins and, in line with the options HMT are exploring, certain stablecoins which are issued outside of the UK (overseas stablecoins).
- 11.2** The Treasury's consideration to allow overseas stablecoins to be used for payments in the UK may bring benefits of greater consumer choice. However, it does carry various practical issues for implementation, and creates risks to consumers, competition and market integrity, which we have outlined below. We are keen to hear views from industry on the viability of the Treasury's idea for consideration and whether alternative options may be appropriate.
- 11.3** Under this consideration, any fiat-backed stablecoins used for payment in the UK must meet certain standards. In the case of regulated stablecoins, our Handbook will set out these standards and we discuss our proposals in Chapters 3 – 9 of this DP. We propose that each overseas stablecoin would need to meet equivalent standards. This would ensure that consumers will continue to have an appropriate degree of protection in place, and that the integrity of the UK's financial system remains secure.

## Route for overseas stablecoins to enter the UK payment chain

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- 11.4** To ensure that an overseas fiat-backed stablecoin used for payment in the UK meets required standards, the stablecoin, including consideration of its issuer, must first be assessed and approved. The Treasury are therefore exploring whether to create a new activity of acting as a 'payment arranger' and should be subject to separate authorisation or registration under the PSRs. In this scenario, the payment arranger would have to assess and approve any overseas stablecoin to be used as a means of payment in the UK before the overseas stablecoin can be used in UK payment chains.

## Role of payment arrangers

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- 11.5** As outlined in Chapter 10, to conduct the assessment and approval of overseas stablecoins, the Treasury are considering whether payment arrangers would need to be authorised under the Payment Services Regulations 2017 (PSRs). This would be in addition to any authorisation they require to carry on any other regulated activities, including other stablecoin-related payment services in the UK, for example, operating a payment account or execution of payment transaction.

- 11.6** All payment arrangers will need to meet all standards set out in the PSRs. They will also need to have the skills, expertise, knowledge and relevant experience to assess and approve overseas stablecoins in line with all the requirements set out in FCA standards as discussed in this chapter, among other things, before we could authorise them to act in this capacity.

## Standards for overseas stablecoins

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- 11.7** As set out above, to support the Treasury's consideration, we propose that payment arrangers would have to assess overseas stablecoins against standards which are equivalent to those required for regulated stablecoins as set out in this DP.
- 11.8** We understand that assessing an issuer as well as the overseas stablecoin itself against these standards will be complex. It will involve the payment arranger making arrangements with the relevant overseas stablecoin issuer for access to relevant information and agreements. We do not think that a payment arranger will be able to get enough information to assess and approve an overseas stablecoin by relying on publicly available information alone. We consider that overseas issuers will therefore have to provide all relevant information to payment arrangers, on an ongoing basis, for their stablecoins to be used for payments in the UK without being established and authorised in the UK as an issuer. Similar to the requirements in Chapter 4, we would also expect these issuers to publish, and regularly update, key information about their stablecoin. The payment arranger would need to take account of this during their assessment.
- 11.9** As part of the assessment and approval process, we propose that payment arrangers will be required to appoint an independent third party (such as an auditor) to verify certain elements of their assessment. For example, the adequacy of the overseas stablecoin's backing assets and arrangements for maintaining and managing them. We would expect these independent third-party assessments to be made on a regular basis to ensure the overseas stablecoin continues to meet the highest standards. By introducing a third party into the approval process we hope this will reduce the likelihood that 'lower standard' stablecoins, or those with diverging standards, are introduced to the UK payment network. The Ombudsman Service would also be available in circumstances whereby a payment arranger did not conduct adequate due diligence in relation to an overseas stablecoin. However, we do not anticipate that redress from the payment arranger would be available to consumers if the overseas stablecoin destabilises, or its issuer fails, provided that the payment arranger has complied with our rules.
- 11.10** Overseas stablecoins which the payment arranger determines meet our standards would then be permitted to be used as part of regulated payment services in the UK. Overseas stablecoins introduced to the UK payment chain would need to be monitored by the payment arranger on a weekly basis to ensure they remain compliant with our standards. We are considering whether any further requirements, eg reporting and disclosures, should be made to ensure the smooth functioning of approved overseas stablecoins in the UK payment network. For example, this may include informing consumers that overseas stablecoin issuers or custodians are not directly regulated by the FCA and recourse may be problematic or may not exist should the overseas issuer fail.

- 11.11** To ensure good consumer outcomes and to protect the UK payments network we are considering how to manage risks when an approved stablecoin ceases to be compliant with relevant FCA standards. For example, we may require payment arrangers to communicate directly with the issuer, and their customers, the users of the payment service using the stablecoin, without undue delay, if an approved overseas stablecoin is no longer compliant. In this scenario the facilitation of payments in the UK by the payment arranger must cease immediately. They must also notify us so that we can update our systems to reflect this.
- 11.12** It is important that the standards and expectations are equivalent to enable fair competition between regulated stablecoins and overseas stablecoins. This proposal is also aligned to our international growth and competitiveness objective by avoiding creating incentives for firms to locate outside the UK.

## Risks, harms and benefits

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- 11.13** We understand there are various risks and benefits associated with the Treasury's proposal and have set out a short overview below:
- There may be different levels of consumer protection available, as FCA rules would not be directly applicable to overseas issuers themselves.
  - There may be significant conflicts of interest between the payment arranger and the overseas issuer. For example, due to approval being linked to remuneration, or the issuer and payment arranger being part of the same group.
  - Consumers will be able to use a greater number of fiat-backed stablecoins as a means of payment in the UK, potentially leading to increased competition.
  - There may be competition concerns, as it is unclear whether a payment arranger would be willing to approve an overseas stablecoin which competes with any stablecoin issued by its own group. There may also be competition law risks to the ability of the overseas stablecoin issuer and any payment arranger sharing confidential information, where the respective groups both compete (actually or potentially) in the same markets.
  - The payment arranger may not have access to sufficient or trustworthy information of the overseas issuer to enable it to properly consider the overseas stablecoin.
  - The backing assets of overseas stablecoins may not be safeguarded in the same way as regulated stablecoins and so may not be available to consumers should the overseas issuer fail.
  - Insolvency proceedings involving overseas stablecoin issuers may not consider the underlying consumers in a similar way as UK insolvency proceedings.
  - Payment arrangers may reach different conclusions after assessing the same overseas stablecoin, leading to diverging standards, as well as regulatory and competition issues.
  - Consumers are likely to get confused between regulated stablecoins, approved overseas stablecoins and other so-called stablecoins used on trading venues.

## Gateway requirements and role of FCA

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- 11.14** Under the Treasury's consideration, payment arrangers would be authorised under the PSRs and require FCA approval before being able to assess and approve overseas stablecoins. As with other crypto applications, we intend to maintain strong standards at the gateway. As part of the authorisation process, we would therefore require payment arrangers to provide us with all the relevant evidence to satisfy us they are able to assess and approve overseas stablecoins to our standards. We would expect payment arrangers to provide information about their approval process and how they may formally get information from overseas stablecoin issuers and the independent third-party assessors whom they propose to use.
- 11.15** We would not be responsible for the approval of any overseas stablecoin or confirm whether a specific stablecoin meets our standards before going to market, and would have no remit over the overseas stablecoin issuer itself.

## Liability of payment arrangers

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- 11.16** We recognise that even assessment against high standards will not prevent things from going wrong. The PSRs include liability requirements for misdirected or failed payment transactions, which we anticipate would apply where the reason for failure is outside the control of the payment arranger and rests with the issuer of an overseas stablecoin (eg failure to redeem at par).
- 11.17** However, we would not hold payment arrangers responsible for the approved stablecoin failing to maintain its peg, provided they complied with our assessment requirements. In those circumstances, payment service users would not have a claim against the payment arranger for loss of value of the relevant stablecoin during the payment transaction (or while it was held in custody with the payment service provider for the purposes of executing payment transactions). As requirements on the standards payment arrangers would have to assess against are high, such occasions of devaluation of properly assessed stablecoins should be rare. In that eventuality consumers' only claim, if any, would be against the overseas issuer. Our standards would include ensuring the availability of a claim to redeem at par against the issuer. This should give some security for users of properly approved stablecoins. However, we recognise these rights may not be as readily enforceable as those enjoyed by users of UK issued regulated stablecoins. This is particularly the case if the issuer enters overseas insolvency proceedings where specific powers to protect consumers in these proceedings would not apply.

**Q39: What are the potential risks and benefits of the Treasury's proposal to allow overseas stablecoins to be used for payments in the UK? What are the costs for payment arrangers and is the business model viable?**

**Q40:** What are the barriers to assessing overseas stablecoins to equivalent standards as regulated stablecoins?  
Under what circumstances should payment arrangers be liable for overseas stablecoins that fail to meet the FCA standards after approval, or in the case where the approval was based on false or incomplete information provided by the issuer or a third party?

## Chapter 12

# Conclusion

- 12.1** This Discussion Paper sets out our thinking on how to design a regulatory regime for issuers and custodians of regulated stablecoins and fiat-backed stablecoins that can be used as a form of payment in the UK. Our aim is to reduce the serious risks and harms that we have seen in the market (as outlined in Chapters 1 and 2), ensure that consumers have appropriate protections when using this money-like instrument and that market integrity is upheld in line with our objectives.
- 12.2** We would like feedback from a wide range of stakeholders, including consumers and those representing them. We want to get a clear understanding of the impact our proposals could have on current business models and the market – including any relevant costs. We also want to understand if there are relevant market developments that we have not considered, or unintended consequences that could arise if we take any of the approaches suggested in this paper.
- 12.3** Alongside this DP, we plan to engage with a wide range of stakeholders in forums and roundtables as well as individual meetings. As we develop specific policy proposals, we may also convene groups or run policy sprints to help us consider potential options and understand the consequences of different approaches.
- 12.4** Our next steps following consideration of the responses will be to draft appropriate new Handbook rules for consultation. We will also consider whether there are other aspects of our existing rules that may need changing – and should issues arise that are beyond our powers, we will raise them with the Treasury and other stakeholders, as appropriate.

## Annex 1

# List of questions

### Chapter 2: A new stablecoin regime

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- Q1:** Should the proposed regime differentiate between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes? If so, please explain how.
- Q2:** Do you agree with our assessment of the type of costs (both direct and indirect) which may materialise as a result of our proposed regime? Are there other types of costs we should consider?
- Q3:** Do you agree with our assessment above, and throughout this DP, that benefits, including cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, increased competition, could materialise from regulating fiat-backed stablecoins as a means of payment? Are there other benefits which we have not identified?

### Chapter 3: Backing assets and redemption

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- Q4:** Do you agree with our proposed approach to regulating stablecoin backing assets? In particular do you agree with limiting acceptable backing assets to government treasury debt instruments (with maturities of one year or less) and short-term cash deposits? If not, why not? Do you envision significant costs from the proposal? If so, please explain.
- Q5:** Do you consider that a regulated issuer's backing assets should only be held in the same currency as the denomination of the underlying regulated stablecoin, or are there benefits to allowing partial backing in another currency? What risks may be presented in both business-as-usual or firm failure scenarios if multiple currencies are used?
- Q6:** Do you agree that regulated stablecoin issuers should be able to retain, for their own benefit, the revenue derived from interest and returns from the backing assets. If not, why not?

- Q7: Do you agree with how the CASS regime could be applied and adapted for safeguarding regulated stablecoin backing assets? If not, why not? In particular:**
- i. Are there any practical, technological or legal obstacles to this approach?
  - ii. Are there any additional controls that need to be considered?
  - iii. Do you agree that once a regulated stablecoin issuer is authorised under our regime, they should back any regulated stablecoins that they mint and own? If not, why not? Are there operational or legal challenges with this approach?

- Q8: We have outlined two models that we are aware of for how the backing assets of a regulated stablecoin are safeguarded. Please could you explain your thoughts on the following:**

- i. Should regulated stablecoin issuers be required to appoint an independent custodian to safeguard backing assets?
- ii. What are the benefits and risks of this model?
- iii. Are there alternative ways outside of the two models that could create the same, or increased, levels of consumer protection?

- Q9: Do you agree with our proposed approach towards the redemption of regulated stablecoins? In particular:**

- i. Do you foresee any operational challenges to providing redemption to any and all holders of regulated stablecoins by the end of the next UK business day? Can you give any examples of situations where this might be difficult to deliver?
- ii. Should a regulated issuer be able to outsource, or involve a third party in delivering, any aspect of redemption? If so, please elaborate.
- iii. Are there any restrictions to redemption, beyond cost-reflective fees, that we should consider allowing? If so, please explain.
- iv. What costs associated with our proposed redemption policy do you anticipate?

- Q10: What proof of identity, and ownership, requirements should a regulated stablecoin issuer be gathering before executing a redemption request?**

## Chapter 4: Other key expectations of stablecoin issuers

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- Q11: Do you agree with our approach to the Consumer Duty applying to regulated stablecoin issuers and custodians. Please explain why.**

- Q12:** Do you consider that regulated stablecoins should remain as part of the category of 'restricted mass marketed investments' or should they be captured in a tailored category specifically for the purpose of cryptoasset financial promotions? Please explain why.

## Chapter 5: Custody requirements

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- Q13:** Should individual client wallet structures be mandated for certain situations or activities (compared to omnibus wallet structures)? Please explain why.
- Q14:** Are there additional protections, such as client disclosures, which should be put in place for firms that use omnibus wallet structures? Are different models of wallet structure more or less cost efficient in business-as-usual and firm failure scenarios? Please give details about the cost efficiency in each scenario.
- Q15:** Do you foresee clients' cryptoassets held under custody being used for other purposes? Do you consider that we should permit such uses? If so, please give examples of under what circumstances, and on what terms they should be permitted. For example, should we distinguish between entities, activities, or client types in permitting the use of clients' cryptoassets?
- Q16:** Do you agree with our proposals on minimising the risk of loss or diminution of clients' cryptoassets? If not, please explain why not? What additional controls would you propose? Do you agree with our proposals on accurate books and records? If not, please explain why not.
- Q17:** Do you agree with our proposals on reconciliation? If not, please explain why not? What technology, systems and controls are needed to ensure compliance with our proposed requirements?
- Q18:** Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.
- Q19:** Do you agree with our proposals on adequate governance and control? If not, please explain why not? What (if any) additional controls are needed to achieve our desired outcomes? What challenges arise and what mitigants would you propose?

- Q20:** Should cryptoasset custodians undertaking multiple services (eg brokers, intermediaries) be required to separate custody and other functions into separate legal entities?
- Q21:** Are there any practical issues posed by requiring cryptoasset exchanges to operate a separate legal entity for custody-like activities? Specifically, please could you explain your thoughts on the following:
- i.** Would these issues differ between institutional and retail clients?
  - ii.** What would be the operational and cost impact?
  - iii.** What are the benefits to clients of cryptoasset exchanges prefunding trades? Can these be achieved if there is legal separation of entities?
  - iv.** Would separating custody and exchange functions impact the way clients' accounts are managed and structured (in omnibus and individual client wallets)?
  - v.** Do you agree that the conflicts of interest we have identified exist? Are there other conflicts of interest we should consider?
  - vi.** Are there alternative ways to ensure the same level of consumer protection?
- Q22:** What role do you consider that custodians should have in safeguarding client money and redemption? What specific safeguards should be considered?

## Chapter 6: Organisational requirements

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- Q23:** Do you agree that our existing high-level systems and controls requirements (in SYSC) should apply to the stablecoin sector? Are there any areas where more specific rules or guidance would be appropriate?
- Q24:** Do you agree with our proposal to apply our operational resilience requirements (SYSC 15A) to regulated stablecoin issuers and custodians? In particular:
- i.** Can you see how you might apply the operational resilience framework described to your existing business (eg considering your important business services and managing continuity)? Please set out any difficulties with doing this.
  - ii.** What approach do you take when assessing third party-providers for your own internal risk management (such as responding to, testing and managing potential disruption)?
  - iii.** Are there any minimum standards for cyber security that firms should be encouraged to adopt? Please explain why.

- Q25:** Do you agree with our proposal to use our existing financial crime framework for regulated stablecoin issuers and custodians? Do you think we should consider any additional requirements? If so, please explain why.
- Q26:** Do you agree with our proposal to apply our existing Senior Managers and Certification Regime to regulated stablecoin issuers and custodians? In particular:
- i.** Should we apply the current SMR and requirements to issuers and custodians of regulated stablecoins? Are there additional SMFs or requirements needed to capture the nature of regulated stablecoin business services?
  - ii.** Should we create additional criteria to determine when the 'enhanced category' of the regime should apply to regulated stablecoin issuers and custodians?
  - iii.** Should we apply the current certification functions and requirements to regulated stablecoin issuers and custodians? Are there any additional functions needed to capture the nature of regulated stablecoin issuers and custodians business services?
  - iv.** Do you agree that we should apply the existing Conduct Rules to regulated stablecoin issuers and custodians?

## Chapter 7: Conduct of business and consumer redress

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- Q27:** Do you agree with our consideration to apply our Principles for Businesses and other high-level standards to regulated stablecoin issuers and custodians? Are there any particular areas you think we should apply detailed rules regarding information to (other than those for backing assets set out in Chapter 3)?
- Q28:** Do you consider that we should design more specific conduct of business rules to regulated stablecoins issuers and custodians? In particular what approach should we take to applying rules on inducements and conflicts of interest management to regulated stablecoin issuers and custodians?
- Q29:** Do you agree that the dispute resolution mechanisms provided in traditional financial services (ie the application of the DISP sourcebook and access to the Ombudsman Service) should be applied to the business of regulated stablecoin issuers and custodians? Have you identified any gaps or issues in relation to dispute resolution? Please explain.

- Q30:** Do you agree that the FCA should not be proposing to extend FSCS cover to the regulated activities of issuing and custody of fiat-backed stablecoins? If you do not agree, please explain the circumstances in which you believe FSCS protection should be available.

## Chapter 8: Prudential requirements

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- Q31:** Do you agree with our proposed prudential requirements for regulated stablecoin issuers and custodians? In particular, do you agree with our proposals on any of the following areas:
- i.** Capital requirements and quality of capital
  - ii.** Liquidity requirements and eligible liquid assets
  - iii.** Group risk
  - iv.** Concentration risk
  - v.** Internal risk management

## Chapter 9: Managing stablecoin firm failure

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- Q32:** Do you agree with applying the existing CASS rules on post-failure treatment of custody assets to regulated stablecoin issuers and other firms holding backing assets for regulated stablecoins, as well as CASS pooling events? If not, why not? Are there any alternative approaches that should be considered? If so, please explain.
- Q33:** Do you agree with our thinking on how the CASS rules can be adapted for returning regulated stablecoin backing assets in the event of a firm failure or solvent wind-down? If not, why not? Do you foresee the need for additional protections to ensure prompt return of backing assets to consumers or otherwise reduce harm in firm failure (eg strengthening wind-down arrangements, a bespoke resolution regime)? If so, please explain.
- Q34:** Do you agree with the proposed overall approach for post-failure trading? If not, is there anything else that should be considered to make the approach more effective? If so, please explain. Are there any arrangements that could avoid distribution of backing assets in the event an issuer fails and enters insolvency proceedings?

- Q35:** What challenges arise when stablecoins are returned to consumers, particularly with respect to their entitlements? Do you foresee the need for additional protections to facilitate the prompt return of regulated stablecoins to consumers or otherwise reduce harm in firm failure (eg introducing distribution rules within CASS for cryptoassets, strengthening wind-down arrangements, or a bespoke resolution regime)? If so, please explain.

## Chapter 10: Regulating payments using stablecoins

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- Q36:** Do you agree that this approach to integrating PSR safeguarding requirements and custody requirements will secure an adequate degree of protection for users of stablecoin payment services?
- Q37:** Do you agree that the custody requirements set out in chapter 5 should apply to custody services which may be provided by payment arrangers as part of pure stablecoin payment services?
- Q38:** Are there additional risks or opportunities, not considered above, of different stablecoin payment models that our regulation of payment arrangers should seek to tackle or harness?

## Chapter 11: Overseas stablecoins used for payment in the UK

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- Q39:** What are the potential risks and benefits of the Treasury's proposal to allow overseas stablecoins to be used for payments in the UK? What are the costs for payment arrangers and is the business model viable?
- Q40:** What are the barriers to assessing overseas stablecoins to equivalent standards as regulated stablecoins? Under what circumstances should payment arrangers be liable for overseas stablecoins that fail to meet the FCA standards after approval, or in the case where the approval was based on false or incomplete information provided by the issuer or a third party?

## Annex 2

# Abbreviations used in this paper

Abbreviation	Description
<b>AML</b>	Anti-Money Laundering
<b>AT1</b>	Additional Tier 1
<b>BCOBS</b>	Banking: Conduct of Business Sourcebook
<b>CASS</b>	Client Assets Sourcebook
<b>CDs</b>	Certificate of Deposits
<b>CET1</b>	Common Equity Tier 1
<b>CMAR</b>	Client Money and Assets Return
<b>COBS</b>	Conduct of Business Sourcebook
<b>COCON</b>	Code of Conduct Sourcebook
<b>COMP</b>	<u>Compensation Sourcebook</u>
<b>CPs</b>	Commercial Papers
<b>CTF</b>	Counter-Terrorist Financing
<b>CUC</b>	Cryptoassets under custody
<b>DeFI</b>	Decentralised Finance
<b>DISP</b>	Dispute resolution: Complaints Sourcebook
<b>DLT</b>	Distributed Ledger Technology
<b>DP</b>	Discussion Paper
<b>DvP</b>	Delivery vs Payment
<b>EMRs</b>	Electronic Money Regulations
<b>FCA</b>	Financial Conduct Authority
<b>FED</b>	Federal Reserve System
<b>FEES</b>	Fees Manual
<b>FOR</b>	Fixed Overhead Requirement
<b>FRC</b>	Financial Reporting Council
<b>FSB</b>	Financial Stability Board
<b>FSCS</b>	Financial Services Compensation Scheme
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>GBP</b>	Great British Pound
<b>GCT</b>	Group Capital Test
<b>GEN</b>	General Provisions
<b>ICARA</b>	Internal Capital Adequacy and Risk Assessment

<b>Abbreviation</b>	<b>Description</b>
<b>IFPR</b>	Investment Firms Prudential Regime
<b>IMF</b>	International Monetary Fund
<b>IOSCO</b>	International Organization of Securities Commissions
<b>IP</b>	Insolvency Practitioner
<b>JMLSG</b>	Joint Money Laundering Steering Group
<b>K-CUC</b>	Cryptoassets (including regulated stablecoins) under custody
<b>K-CII</b>	Cryptoassets in issuance
<b>KFR</b>	K-Factor Requirement
<b>KYC</b>	Know Your Customer
<b>MIFID</b>	Markets in Financial Instruments Directive
<b>MLRO</b>	Money Laundering Reporting Officer
<b>MLRs</b>	Money Laundering Regulations
<b>MMF</b>	Money Market Fund
<b>MPC</b>	Multi-party computation
<b>NCA</b>	National Crime Agency
<b>PA</b>	Payment arranger
<b>PMR</b>	Permanent Minimum Requirement
<b>PoR</b>	Proof of Reserves
<b>PPE</b>	Primary Pooling Event
<b>PR</b>	Prescribed Responsibilities
<b>PRA</b>	Prudential Regulation Authority
<b>PRIN</b>	Principles of Business
<b>PSP</b>	Payment Service Provider
<b>PSRs</b>	<u>Payment Services Regulations 2017</u>
<b>RAO</b>	<u>Financial Services and Markets Act 2000 (Regulated Activities) Order 2001</u>
<b>Repo's</b>	High Rating Corporate Bonds and Repurchase Agreements
<b>SM&amp;CR</b>	Senior Managers and Certification Function
<b>SMF</b>	Senior Management Functions
<b>SMR</b>	Senior Managers Regime

<b>Abbreviation</b>	<b>Description</b>
<b>SoR</b>	Statement of Responsibilities
<b>SPE</b>	Secondary Pooling Event
<b>SYSC</b>	Senior Management Arrangements, Systems and Controls
<b>USDC</b>	United States Dollar Coin
<b>USDT</b>	United States Dollar Tether

## Annex 3

# Glossary

Term	Definition
Blockchain	A type of distributed ledger which records transaction information in 'blocks', distributed amongst a network of nodes that work together to reach consensus on updates to the shared ledger, creating an auditable 'chain' of transactions.
Burning	Sending cryptoassets to a wallet that has no access key, for the purpose of taking them permanently out of circulation.
Cross-chain bridge	A messaging protocol that enables interoperability between blockchains by holding or storing cryptoassets and creating token representations of the same value on another blockchain, allowing for cross-chain transactions.
Decentralised Finance (DeFi)	DeFi is a segment of the crypto ecosystem, which utilises blockchain networks and smart contract technology to provide a range of financial service activities without an intermediary.
Delivery vs. Payment (DvP)	A securities settlement mechanism that links a securities transfer and a funds transfer in such a way as to ensure that delivery occurs if and only if the corresponding payment occurs.
De-peg	A period in which a stablecoin loses its value relative to the underlying asset. During this period, the stablecoin will usually be traded at a discount on the secondary market.
Distributed Ledger Technology (DLT)	A type of technology that enables the sharing and updating of records in a distributed way.
Electronic Money	Electronic money is stored monetary (including magnetically) value as represented by a claim on the electronic money issuer which is issued on receipt of funds for the purpose of making payment transactions and is accepted as a means of payment by third parties other than the issuer.
Fiat currency	A government-issued currency that is not backed by a physical commodity, such as gold or silver.
Fungible	The state of being interchangeable with and indistinguishable from another.
Freezing	A functionality that disables the transfer of a stablecoin, so that they can no longer be used for economic activity.
Immutable	This means that information or transaction history held on the blockchain cannot be modified or altered once created.
Liquidity pools	A smart contract arrangement in DeFi that holds two or more cryptoassets to enable financial activity to take place, such as trading or lending.

Term	Definition
Merchant acquirer	Acquiring of payment transactions is defined in regulation 2 of the PSRs as “a payment service provided with a payment service provider contracting with a payee to accept and process payment transactions which result in a transfer of funds to the payee.” This includes traditional ‘merchant acquiring’ services enabling suppliers of goods, services, accommodation or facilities to be paid for purchases arising from card scheme transactions.
Minting	Creating new digital coins or tokens on a blockchain network.
Money Market Funds (MMFs)	MMFs are a type of open-ended investment fund used in many jurisdictions, that gives investors a way to diversify credit risk and a place to hold rather than grow their assets.
Multi-party computation (MPC)	Multi-party computation is a cryptographic method used to increase the security of asset storage and transactions on the blockchain. It works by securely distributing the private data required to validate transactions in such a way that the data held by one user is kept secret to the other users taking part in the protocol.
Net settlement	A system which aggregates and offsets multiple payments between banks.
Node	A computational device operated by blockchain network participants to store a copy of all transactional data, check the validity of new blocks and broadcast information to other nodes in the network.
Off-ramp	The process of exchanging cryptoassets for fiat currency.
On-ramp	The process of exchanging fiat currency (such as US dollars) for cryptoassets.
Payment chain	A system which allows the transfer of value between different parties through a payment scheme. Commonly initiated by the merchant to issuing and acquiring bank.
Payment instrument	Any personalised device or personalised set of procedures agreed between a customer and the payment service provider (such as a bank) used by the customer to initiate payments. This includes debit and credit cards as well as payments made online and through mobile applications.
Payment interface	The interface as referred to in Article 30 of the Regulatory Technical Standards on Strong Customer Authentication. Interface enables secure communication with account information service providers, payment initiation service providers and payment service providers issuing card-based payment instruments.
Payment Order	A ‘payment order’ is, in summary, an instruction to a PSP to fall within the definition of ‘payment instrument’. It is a set of procedures that enables the consumer to instruct a payment initiator to transfer funds to a merchant
Payment service provider	A natural or legal person permitted under the Payment Services Regulations 2017 (PSRs) to provide payment services in the UK, including those authorised or registered under the PSRs, credit institutions, agents, governmental departments, and local authorities.

Term	Definition
Payment services	Payment services are listed in Schedule 1 Part 1 to the PSRs 2017. This includes but is not limited to services such as the execution of payment transactions, including transfers of funds on a payment account with the user's payment service provider or with another payment service provider; issuing payment instruments or acquiring payment transactions; money remittance; payment initiation services and account information services.
Payment Services Regulations 2017 (PSR)	The PSRs 2017 govern the authorisation and associated requirements for authorised or registered payment institutions (PIs). They also set the conduct of business rules for providing payment services.
Payment transaction	The process of initiating the placing, transferring, or withdrawing funds. Examples include payments with credit cards, transferring funds from a bank account to pay bills or using a mobile application to send funds.
Payment system	A payment system allows settlement of payment transactions through the transfer of value. There are eight designated payment systems in the UK: BACS, CHAPS, Credit and Cheque, Faster Payment Scheme, Link, Mastercard, Visa Sterling, Finality Payment system which used DLT to transfer funds.
Peg	A stablecoin's targeted reference value (eg 1:1 with the US dollar)
Private Key	An alphanumeric string that is univocally associated to a blockchain address and enables the possessor of the key to sign (i.e., authorise, send, validate) transactions.
Proof of Reserves	Proof of Reserves (or PoR) is an independent audit process which cryptoasset firms can use to verify that the client assets they are holding in custody correspond 1:1 with the assets they hold in reserve.
Public Key	An alphanumeric string that is univocally associated to a blockchain address and which has two main functions: to enable the generation of (read-only) addresses for the reception of messages and/or transactions, and to enable the decoding and verification of a signed message and therefore allows recipients of the message to verify and accept it.
Redeeming	The process whereby the stablecoin issuer returns, at the request of the stablecoin holder, the monetary value held by the issuer when it issued the stablecoin.
Security tokens	Cryptoassets which use a technology such as DLT to support the recording or storage of data and already meet the definition of a specified investment under the RAO and are therefore already subject to regulation.

Term	Definition
Settlement account	An account containing money and/or assets that is held with a central bank, central securities depository, central counterparty or any other institution acting as a settlement agent, which is used to settle transactions between participants or members of a commercial settlement system.
Smart contracts	Programmes stored on a blockchain that offer blockchains functionality to run self-executing code to automatically enforce pre-specified terms when certain conditions are met.
Trading pair	Two assets that can be traded for each other on an exchange. This can either be crypto to crypto, or crypto to fiat.
Wallet	A device or service that stores users public and private keys allowing them to interact with various blockchains and allows them to send and receive cryptoassets.

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