

Discussion Paper (DP23/4) Regulating cryptoassets - Phase 1: Stablecoins Innovate Finance response

About Innovate Finance

Innovate Finance is the independent industry body that represents and advances the global FinTech community in the UK. Innovate Finance's mission is to accelerate the UK's leading role in the financial services sector by directly supporting the next generation of technology-led innovators to create a more inclusive, more democratic, and more effective financial services sector that works better for everyone.

The UK FinTech sector encompasses businesses from seed-stage start-ups to global financial institutions, illustrating the change that is occurring across the financial services industry. Since its inception in the era following the Global Financial Crisis of 2008, FinTech has been synonymous with delivering transparency, innovation and inclusivity to financial services. As well as creating new businesses and new jobs, it has fundamentally changed how consumers and businesses access finance.

Summary

Innovate Finance welcomes the opportunity to respond to the FCA's Discussion Paper (DP23/4) 'Regulating cryptoassets - Phase 1: Stablecoins' and supports the overall intention set out in the DP to create a regime for fiat-backed stablecoins, including when used as a means of payment. We have previously advocated for a clear regulatory roadmap for the regulation of crypto assets in the UK and see this regime as an important step in the process. However, it is just one component of the overall regulatory framework required and we urge the FCA to continue developing its wider policy approach for other elements of the crypto asset roadmap to ensure the UK maintains momentum and keeps up with other jurisdictions.

The DP outlines a number of potential benefits of stablecoins based on current or potential future use cases. That said, despite the focus on stablecoins used for retail payments, the DP itself lacks discussion on the way in which stablecoins could become part of a diverse set of retail payment options in the UK, or the benefits this could provide. We note the Bank of England's own recognition on the future role stablecoins could play in the UK retail payment context:

"Payment systems using stablecoins might be able to offer significant benefits to users. For example, the technology means that they could contribute to faster, cheaper and more efficient payments, both domestically and for cross-border use. And they may offer greater functionality and programmability – the ability to automate the transfer of value more extensively and more efficiently via 'smart contracts'. They could provide greater choice by

competing with existing forms of money and payment systems. And they could open the door to future innovations that meet evolving transaction needs.”¹

For stablecoins to become part of a diverse mix of payment methods for retail payments, it's important that the regulatory framework implemented is one that is proportionate and provides the scope for stablecoin payments to develop as a market. Our members have concerns that the current FCA proposals could potentially lead to a regulatory environment where the requirements on firms operating in the stablecoin market are more onerous than other related regulatory frameworks, such as electronic money (e.g. required capital requirements). An unequal regulatory landscape would potentially impede the ability of stablecoins to scale as a means of payment in the UK because they would face punitive regulatory treatment compared to other types of payment. Moreover, we believe that the FCA's final approach should adopt the approach of 'same risk, same activity, same regulation', as recommended by the Financial Stability Board (FSB).

One major issue we see across both the FCA and Bank of England DPs is how some of the main underlying principles in designing the regulatory framework do not seem to be consistent with the actual risks or business models in question. This leads to a second overarching challenge we see in both DPs from the FCA and the Bank of England, that in proposing a comprehensive regime for stablecoins used as a means of payment before any market has developed, risks undermining its development. Setting out such a prescriptive framework based on today's use cases will potentially inhibit new innovation in the future, unless both the FCA and Bank of England actively consider how these regimes will adapt over time to cater to a wider set of use cases. We strongly urge consideration of how to ensure any regime is future proof in this respect.

One idea suggested by members is that in developing these proposals further, it would be helpful to understand how proportionality may be applied to the proposed stablecoin regime across the different actors involved fulfilling different roles and responsibilities. For example, we recognise that ensuring consumer protection may be more critical in certain parts of the stablecoin regime, such as always ensuring 1:1 backing (and therefore require more regulatory obligations on the relevant actors), while a regulatory framework that allows for more flexibility for firms to offer different types of services may be suitable for firms providing other types of services (e.g. the customer redemption process).

Another thematic point that members have raised is in relation to the proposals to extend existing FCA rules to the stablecoin ecosystem, and the impact this will have in practice. We explore this point in a number of our responses below but one illustrative example is the application of the CASS regime. Our members have questions regarding the application of the CASS regime to this new market, in particular how suitable it will be given the novel types of businesses and technology involved. We welcome the recognition of the impact on record

¹ Bank of England, Regulatory regime for systemic payment systems using stablecoins and related service providers, <https://www.bankofengland.co.uk/paper/2023/dp/regulatory-regime-for-systemic-payment-systems-using-stablecoins-and-related-service-providers#:~:text=Payment%20systems%20using%20stablecoins%20might,and%20for%20cross%2Dborder%20use.>

keeping of the pseudonymity of crypto asset wallets, and would like to see further clarity set out by the FCA on the novel ways the CASS regime will need to reflect the novel way crypto assets function.

We would also welcome further clarity on how the proposals meet the FCA's secondary objective to facilitate the international competitiveness and growth of the UK economy in the medium to long term. We note there are only two references to 'competitiveness' in the 110 page DP and feel it would be beneficial for the FCA to set out in more detail the considerations and decisions taken in designing the regime to meet the competitiveness objective. To echo the concerns mentioned above regarding the potential development of an unlevel playing field and the risk of impeding the adoption of stablecoins, we note that it is not clear to our members how the current proposals seek to position the UK at the forefront of payment innovation and international competitiveness.

Questions

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.

The FCA should consider variations to the regulation of stablecoins which are solely for wholesale use based on recognition of the potentially different use cases, opportunities and risks. That being said, the FCA would need to make clear distinctions between these two types of stablecoins and would need to ensure that wholesale stablecoins cannot be used for retail purposes. Retail stablecoins that are being used for wholesale purposes will continue to have the same rules applied to them.

Wholesale adoption of stablecoins will help encourage wider innovation in this space. As such, the FCA may wish to consider what flexibilities can be afforded to the manner in which wholesale stablecoins are backed. Whilst a 100% backing and 1:1 arrangement is necessary for retail use, the FCA may wish to consider whether alternative obligations can be put in place for wholesale stablecoins which are issued by non-bank financial institutions where existing prudential measures can already mitigate against risk. This differing approach would be taking into account the greater sophistication in wholesale market participants and allow for flexibility to ensure that the UK stablecoin market thrives.

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?

We agree that the proposed regime would result in both direct and indirect costs. While we recognise the need to ensure market integrity and consumer protection, our members believe that any final rules must provide sufficient proportionality and flexibility to ensure that high direct costs do not lead to resulting indirect costs which makes it challenging for firms to deliver commercially sustainable business models (e.g. higher prices compared to other payment

methods).

Additionally, the FCA should bear in mind that the regime will result in costs to overseas firms in order to engage an authorised payment arranger in the UK to approve an overseas stablecoin.

As the FCA moves forward in developing its proposals, we believe further consideration should be given to the FCA's secondary objective to support the international competitiveness and growth of the UK economy in the medium to long term, especially in relation to the impact that direct and indirect costs could have on the viability of a prosperous and well functioning competitive market for payment stablecoins in the UK.

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?

We welcome the FCA's future looking perspective in relation to this question, and the potential benefits of fiat-backed stablecoins as a means of payment. We believe that a proportionate regulatory regime could provide the benefits outlined in the question. Our view is that the future of UK payments will be characterised by different payment methods that may serve different use cases most effectively, or be based on consumer preference, and ultimately support financial inclusion by providing increased optionality for consumers. Therefore, it is essential that the regulatory environment creates conditions for different payment methods to flourish, and avoid treating any one type more punitively than another.

Moreover, we note that references in the DP to improving consumer and merchant payments also overlap with findings from the recent Future Review of Payments by Joe Garner. While stablecoins were outside of scope of the review, the final report highlighted how in the UK currently merchants suffer from a lack of options other than card payments. A future payment landscape for consumers and merchants could see genuine choice between digital payment methods, including stablecoins.

In addition, the FCA alludes to the "global nature and interconnectedness" of stablecoins, which we interpret as their potential to improve cross-border payments. The United Nations 2030 Agenda for Sustainable Development commits, by 2030, to reduce to less than 3% the transaction costs of migrant remittances and eliminate remittance corridors with costs higher than 5%. According to one of our members, current trends indicate the UK will fail to meet that target, meaning hundreds of millions will be paid in extra fees by UK remittance senders. Between 2010 and 2020, those living in the UK sending money abroad to support family and friends paid £6.7 billion in remittance fees alone. On average, each transfer made in 2020 cost 6.8% of the total transferred amount. The development of fiat-backed stablecoins as a means of payment presents an opportunity to find ways to continue to reduce remittance fees while providing good outcomes for consumers.

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.

We recognise the need to limit backing assets to ensure firms can manage market risks and ultimately protect consumers. However, Innovate Finance encourages the FCA to build in greater flexibility into the framework to allow issuers to propose alternative compositions of backing assets which may be considered. This will allow room for this framework to evolve with the industry as the stablecoin market matures and there is greater confidence in how it operates. This flexibility again will put the UK in a strong position in signalling that it is open for innovation.

In particular, we encourage the FCA to include Reverse Repurchase Agreements within the category of acceptable backing assets. Reverse repos can serve as a high quality and liquid asset because they are typically of short-term duration and are overcollateralized by other acceptable backing assets, thereby addressing risks while maintaining liquidity for consumers.

That being said, the FCA should be mindful that should it restrict backing assets that existing stablecoin projects have tended to use a wider range of backing assets which means there could be a transitional period for businesses as they consider the viability of designing a business model under the FCA's proposed approach.

We would also welcome clarity on the maturity range suggested in the DP, in particular if there would be any lower threshold under the 'one year or less' approach.

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?

We agree that there may be a risk (in terms of foreign currency translation risk) where reserve assets are denominated in a fiat currency different from the currency of the peg (this is echoed in the S&P Global's recent publication on assessing the stability of stablecoins²).

That being said, we believe there may be benefits in allowing partial backing in another currency. Exploring the market at present, it is clear to see that there are a number of use cases using other currencies. A regime which allows this will not only attract these issuers to the UK but also enable a flexible regime that will develop with the stablecoin market. Innovate Finance are cognisant of the concerns around this and propose that backing by one or more different currencies requires adequate disclosures and the FCA may also want to restrict which currencies are allowed to be used i.e. those with deep secondary markets.

² S&P Global, Stablecoin Stability Assessment, <https://www.spglobal.com/ratings/en/products-benefits/products/stablecoin-stability-assessment>

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?

Yes. It is important that in designing a proportionate regulatory framework there is a balance between market integrity, consumer protection, and promoting effective competition in the interest of consumers. If issuers were unable to derive revenue from interests and returns it would severely limit the types of commercial activity available to them. This would also mean that regulated stablecoin issuers have more diversified revenue opportunities available to them.

Our members are concerned, however, about the interaction between the FCA's proposed approach to regulating stablecoins and the Bank of England's DP on regulating systemic payment systems using stablecoins and related service providers, which outlines a proposed framework where stablecoin issuers would not be able to earn interest on assets held. While we appreciate there would be a transitional process in the event any stablecoin issuer is deemed to be systemic, our members have raised concerns on the commercial practicality of having to pivot a business model when moving between regimes. We believe more guidance is needed on the regulatory roadmap for stablecoin issuers to assist firms for business planning purposes.

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?

We fully support the FCA's overarching aim for safeguarding regulated stablecoin backing assets 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.

Our members still have some questions and concerns regarding the application of the CASS regime to this new market, in particular how suitable it will be given the novel types of businesses and technology involved. We welcome the recognition of the impact on record keeping of the pseudonymity of crypto asset wallets, and would like to see further clarity set out by the FCA on the novel ways the CASS regime will need to reflect the novel way crypto assets function. It is important that expectations for firms are clear to ensure that a lack of clarity does not lead to challenges in meeting regulatory requirements concerning the safeguarding of assets. Our members also urge the FCA to not be prescriptive with any technological requirements, so as to ensure the rules in place are both future proof and do not stifle innovation.

We would also emphasise that when extending CASS to stablecoin backing assets, the FCA will need to be careful to ensure that there are no unintended consequences. The proposal suggests that rules surrounding holding cash as backing assets will be similar to Client Money Rules; however, it is not clear whether the FCA intends to apply the same rules to non-cash backing

assets. If this is the case, members urge the FCA to consider the impact of this carefully and welcome the opportunity to discuss this further. The FCA may also want to consider workshops with industry on this topic and what the practical implications would be from a technology and business perspective.

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?

No response.

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? 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?

We welcome and recognise the importance of ensuring a stablecoin holder's right against the issuer to cash out at par value. Ensuring this is vital to ensure appropriate level of consumer protection, and provide the trust required to establish the potential of fiat-backed stablecoins as a means of payment in the UK.

If stablecoin issuers are required to provide redemption by the end of the next UK business day, this could be a challenge in scenarios where it is the first time interacting with a customer and are required to carry out AML checks, and similarly for redemption requests from unhosted wallets. Our members believe a greater balance is required in such circumstances between ensuring consumers can redeem their stablecoin in a timely manner while also ensuring the appropriate financial crime checks are completed. This would also be in line with the FCA's commitment to reduce and prevent financial crime.

Our members believe that a regulated issuer should be able to outsource all or elements of the redemption activity, while retaining the ultimate legal liability. Some issuers may not be consumer-facing businesses and not operationally set up to deal with redemption requests, preferring to outsource this activity to third parties who have consumer-facing capabilities. It would also provide more proportionality in the regime and give stablecoin issuers more choice in how they design their business model, while not impacting the underlying legal rights of

stablecoin holders. Such an approach would also mirror emerging international approaches in this area, notably the EU's Market in Crypto Assets (MiCA) regulation.

The FCA should also be mindful of how existing requirements relating to operational resilience and outsourcing may apply in the context of stablecoins (e.g. FCA's PS21/3, PRA's SS1/21 and SS2/21), as well as the Bank of England's (CP26/23) developing regime covering 'critical' cloud-based TPPs.

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

No response.

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

Our members support the intention of the Consumer Duty in ensuring clear expectations and good outcomes for consumers. It would be helpful for the FCA to provide more detail on the precise expectations across the stablecoin value chain for the Consumer Duty applying to a newly regulated activity to help drive better outcomes for firms and consumers.

Members also note that Consumer Duty rules should not extend to wholesale use of fiat-backed stablecoins, as this would likely duplicate pre-existing regulatory requirements of Payment Providers.

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.

As a payment system and one backed by assets, stablecoins should not be treated as 'restricted mass marketed investment'. they are entirely different to, and of a far lower risk than, the current definition of 'restricted mass marketed investment' which in the FCA handbook is defined as "any of the following:

- (a) a non-readily realisable security;
- (b) a P2P agreement;
- (c) a P2P portfolio."

For the same reason they should not be captured in a tailored category specifically for the purpose of crypto asset financial promotions. Any financial promotion rules should be based on those for e-money .

Moreover, if stablecoins maintained their status as 'restricted mass-marketed investments', it could actually create a confusing situation for consumers on their intended role as a means of payment.

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

Innovate Finance does not consider it necessary to put in place individual client wallet structures. Whilst it may be a choice for some to do so, this should neither be prevented nor mandated. Instead, the standard put in place should be to segregate own funds and cryptoassets from clients' funds and cryptoassets and have them on separate records or in separate wallets. Members consider that it is sufficient for client funds to be held in an omnibus account. Furthermore, it should also be possible for sub-custody arrangements, in line with traditional securities rules.

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.

Yes – generally speaking (in line with the IOSCO recommendations³) client disclosures should explicitly address the extent to which client assets are aggregated or pooled within omnibus client accounts.

Two additional points that the FCA should consider is that whilst the current proposal mentions safeguarding and managing private keys, it remains silent on the requirements for seed phrases which is important for the FCA to address. The second is that there needs to be greater clarity on where the assets are held in particular in the context where the issuer or custodian is not in the UK. Where a firm has an international footprint, assets may be held outside of the UK and there needs to be greater analysis as to how this will be treated and the impact this can have on retail clients.

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?

Any (re)use of client assets held under custody should only be permitted where clients have expressly given their consent. The custodian should provide clear, concise and non-technical disclosure of these arrangements, so that the client understands that the assets are not held in custody and may not be returned to the client. This is in line with the IOSCO recommendations and may be the approach taken by other jurisdictions in the future.

³ IOSCO, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD747.pdf>

It may be that the lending of assets under custody is not permitted until the regulatory framework under Phase 2 of the Treasury's plan is clarified (e.g. which will address lending of cryptoassets). A similar wait-and-see approach may also be needed in relation to staking of such assets.

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.

Innovate Finance welcomes these proposals, however notes concern that the liability that will be imposed on custodians will be outlined in legislation by HMT as opposed to FCA rules. This does not give the flexibility in how this liability will be applied and members consider that it would be better to come through FCA rules instead. This approach would give greater flexibility to ensure that this regime is fit for purpose. Another concern that members outlined is the need for custodians to identify specific cryptoassets which are held for individual clients. Whilst this may be possible and necessary in some circumstances, we do not consider that this should be the status quo. It is unnecessarily burdensome on custodians and is not consistent with requirements in traditional finance.

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?

The Discussion Paper refers to having in place daily reconciliations. Whilst Members are supportive with reconciliation proposals more broadly, there is a risk that daily reconciliations will not deliver the most effective data points. By requiring constant recalibration, daily reconciliations may capture some irrelevant market noise that is filtered out in due course. Instead, we urge for a less restrictive reconciliation requirement which can be developed through public-private discussions.

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.

Yes, we support the idea that firms providing crypto custody should be permitted to use third parties. As the DP notes, traditional finance firms can use third parties to provide custody services. We believe it is important to create a regulatory regime for stablecoins that allows providers to compete on similar terms to traditional providers, providing the risks are adequately managed. Moreover, as the DP notes, this "could also foster innovation and competition in the crypto asset custody market, potentially providing clients with more choice and better prices for custody services". Ensuring the final framework provides firms with the ability to compete with different service offerings and competitive prices will help drive better regulatory and consumer outcomes.

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?

Members consider that the proposal to include Proof of Reserves as part of client disclosures is not consistent with existing requirements for custody of securities and is overly burdensome on custodians.

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

In the interest of consistency with traditional securities, Members do not consider that there needs to be a separate legal entity set up to carry out custody functions. Furthermore, merely establishing a separate legal entity may not resolve the core issues and to prevent conflicts of interest from arising.

Further, mandating separate legal entities may undermine benefits derived from having a single entity providing multiple services, which include reduced cost, reduced reliance on intermediaries/counterparty risk, and enhanced transaction speed.

However, it would make sense for there to be a requirement to separate key functions, and an entity should be required to obtain authorisations for each different type of service it provides. This would also provide greater transparency around the regulated activities a firm is authorised to carry out. Its client disclosures should also make clear to clients which services are being provided specifically to such clients.

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?*

No response.

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

Members consider that the custodian's relationship should be with the issuer and not be extended to be the issuer's clients i.e. the tokenholder. Extending this, would distort the market as it would require custodians to now interact with each individual client as opposed to the Issuer. This would require custodians to put in place new processes and policies to be able to do this which will come at great cost. In particular, where custodians are just wholesale focussed and do not have a retail business, this would require large scale changes, As such, we urge the FCA not to extend this.

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?

Members are broadly supportive of applying the existing systems and control requirements under SYSC.

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.***

Broadly, yes. However, it would be helpful for the FCA to set out additional practical guidance on how existing operational resilience requirements are expected to apply in this context, whilst showcasing their connection to the proposed mitigation of risks within the legal framework between exchanges and issuers.

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.

No response.

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?***

We support the principle of introducing regulatory measures to ensure proper governance arrangements. We would welcome further guidance on how the SMCR regime could be applied, specifically to overseas issuers, and scale-up firms with international staffing models. This provision is particularly important regarding the Regulator's international competitiveness secondary objective, and to what extent a healthy market will be established in consequence.

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)?

We agree that the FCA's Principles of Business and other high level standards should apply to regulated stablecoin issuers and custodians. It is important that fiat-backed stablecoins used as a means of payment have similar expectations compared to other regulated products and services that enable payments. For the market to develop and achieve good consumer outcomes it is appropriate firms operate using similar principles as other regulated firms.

The FCA should also ensure the rules are in line with the IOSCO recommendations – for example, disclosures regarding material sources of operational and technological risks.

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?

No response.

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.

Members are broadly supportive.

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.

Overall, members are supportive of not extending the FSCS to fiat-backed stablecoins. Whilst the argument was made that doing so would make a real statement that the UK is the place for developing digital payments solutions and would further entrench the notion of singleness of money, ultimately, the costs of running this which would be levied from custodians and then ultimately from customers perhaps does more harm than good. Members also noted that there is no FSCS protection for e-money and therefore not extending the scheme would also be consistent with the treatment of e-money.

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***

Our members are concerned that the capital requirements lack sufficient consideration of the fact that reserve assets will be maintained to cover 100% of outstanding liabilities. This is different than in other banking or capital markets which enable credit creation and commercial bank money, thus obviating the need for additional buffers designed to address traditional higher risk banking activities.

Q32: Do you agree with applying the existing CASS rules on postfailure 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.

No response.

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.

No response.

Q34: Do you agree with the proposed overall approach for postfailure 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?

No response.

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.

No response.

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?

No response.

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?

Yes, where the activity is still the same (i.e. custody of client assets) the same requirement should apply.

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?

No response.

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?

We would like to recognise the innovative thinking that has gone into the idea of allowing overseas stablecoins to be used for payments in the UK. However, it's important that any framework has clear objectives, benefits and protections to make it a potential success. Our members raised several concerns around the introduction of the payments arranger framework. It was noted that the responsibility placed on these firms could cause a number of issues including being unable to effectively verify the compliance of an overseas firm. Members request the FCA to provide further information on how this framework would apply in practice, how it will ensure consistency in application from payments arrangers as well as how it will prevent there being a concentration risk amongst a few payments arrangers.

Moreover, having payments arrangers verify overseas stablecoins for the use as payment in the UK will also lead to greater costs for overseas stablecoins operating in the UK and may result in them restricting use in the UK which would impact the goals of being a global leader in this area.

Further, it is not clear to us how a payment arranger would (if it all) transition into the new regime proposed by the Bank of England for systemic payment systems using stablecoins.

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?

In principle we welcome the novel approach the UK is considering in relation to overseas stablecoins, in contrast to other regimes like MiCA. However, our members are concerned that the idea may struggle to get off the ground due to the level of uncertainty and lack of clarity around how it would work in practice.

It could be challenging for a UK based firm to adequately assess an overseas stablecoin “against standards which are equivalent to those required for regulated stablecoins” as set out in the DP. First, there could be a high degree of uncertainty as to whether the FCA would regard the overseas stablecoin to meet equivalent standards in the absence of any formal equivalence mechanism between jurisdictions. Second, approaches to regulating fiat-backed stablecoins differ around the world, where a framework even exists, which again could lead to a situation where firms find it challenging to make a determination if an overseas stablecoin would meet FCA standards. The burden on the payment arranger could be so high that firms just conclude it either isn’t feasible to meet the required standards, or isn’t worth the effort from a commercial perspective.

[ENDS]