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Financial Conduct Authority

By online submission

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Dear Sir/Madam

Re: FCA Discussion Paper on proposed future regime on fiat-backed stablecoins

We welcome the opportunity to provide input to this FCA Discussion Paper on the proposed regulatory regime for stablecoins. The EMA represents a range of FinTech payment service providers and crypto asset firms engaging in the provision of alternative digital payment services, including the issuance of e-money, e-money tokens, and cryptoassets. Our members include leading payments and e-commerce businesses providing online payments, card-based products, electronic marketplaces, and increasingly cryptocurrency exchanges and other cryptocurrency related products and services. The EMA has been operating for over 23 years and has experience in the impact of various regulatory frameworks that are applied to electronic money and payments. A list of current EMA members is provided at the end of this document.

We would be grateful for your consideration of our comments, which are set out below.

Yours faithfully

Dr Thaer Sabri
Chief Executive Officer
Electronic Money Association

EMA Response to Proposals

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.

When considering issuers of regulated stablecoins for wholesale and retail purposes, distinctions are in our view necessary. Wholesale and retail stablecoin operations cater to different market segments and thus present distinct risks and operational characteristics.

For retail purposes, the focus is on protecting consumers by ensuring stablecoin issuers have robust consumer protection frameworks in place. This would involve measures like ensuring the stability of the coin's value, safeguarding against operational risks, providing clear and understandable terms of use and ensuring that the issuer is in a position to redeem coins on presentment.

On the other hand, wholesale issuers deal with more sophisticated entities and larger transaction volumes, which may necessitate a tailored regulatory approach. Wholesale stablecoin transactions often involve interbank settlements, securities settlements, or large-value payments, which are critical to the functioning of the financial markets. Therefore, regulatory requirements for wholesale issuers could be more focused on systemic risk reduction, financial stability, and the integration with existing financial market infrastructures. Ensuring the ability to redeem is however a common element for both use cases.

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?

The assessment of costs associated with the proposed regulatory regime appears broad, taking into account both direct costs like IT development, system maintenance, staff training, and reporting, and indirect costs such as the potential for higher prices to consumers if firms decide to pass on these costs. Additionally, the proposed regime may create barriers to entry or lead to firm exits, which could affect competition in the sector.

However, it's also important to consider other types of costs. For instance, there could be costs related to the adaption of business models to comply with new regulations. Firms may need to rethink their strategies, which could lead to opportunity costs or the need for investment in new technologies or processes. There's also the potential for increased legal and regulatory fees as firms seek to navigate the new regulatory landscape.

Moreover, the proposed requirements could lead to a concentration of market share in the hands of a smaller number of players who can afford to bear these costs, potentially impacting smaller firms or new entrants. In addition, it would be prudent to consider the long-term economic impact, such as the potential for reduced liquidity in the market or changes in consumer behaviour due to increased costs or decreased trust in stablecoins if the regulatory measures are calibrated onerously.
These additional considerations should be factored into the overall assessment to ensure a balanced approach that mitigates risks without unduly burdening the industry or limiting its potential for growth and innovation.

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?

The benefits outlined in the discussion paper about regulating fiat-backed stablecoins as a means of payment are significant. Cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, and increased competition are strong incentives to move forward with regulation.

To elaborate, real-time payment processing and the potential for cross-border transactions without the traditionally high costs could significantly increase financial inclusion and competition. This could lead to lower transaction fees and better services for both consumers and the industry. The interoperability of fiat-backed stablecoins has the potential to streamline transactions and provide a more seamless experience for users globally, which can contribute to economic efficiencies and growth.

Aside from the identified benefits, there could be additional advantages such as fostering innovation in the payments sector. Regulating stablecoins might encourage the development of new financial products and services that leverage the stability and efficiency of these digital assets. Moreover, it could enhance the resilience of the payment system by diversifying the range of payment options available to consumers and businesses, thereby reducing dependency on traditional banking infrastructures that may be vulnerable to outages or other disruptions.

Another possible benefit that might not have been fully explored is the environmental impact. If fiat-backed stablecoins can be operated on energy-efficient platforms, which may in turn be distributed, they could offer a more sustainable alternative to traditional financial systems that rely on energy-intensive processes.

Finally, the use of stablecoins could also have positive implications for monetary policy and financial oversight, as it may provide regulators with new tools and data to better understand and manage economic activity.

These additional benefits could be considered when evaluating the full impact of the proposed regulation on fiat-backed stablecoins.

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?
The approach to regulating stablecoin backing assets, as proposed, does seek to ensure that stablecoins can be redeemed on demand and are therefore capable of maintaining their value. Limiting acceptable backing assets to government treasury debt instruments with maturities of one year or less, along with short-term cash deposits, is consistent with redemption requirements, but is likely to reflect day to day operational expectations, rather than market behaviour.

We have significant experience in the electronic money sector, the regulatory framework for which is structured in an analogous manner. Experience demonstrates that redemption requests and therefore calls on safeguarded funds vary with the velocity of the payment instrument, and the extent to which such instruments recirculate. In almost all cases, there will be a core segment of funds that remains static and which is unlikely to be utilised for redemption purposes on a day to day basis. It would seem reasonable, once such a segment is identified, to reduce liquidity obligations in relation to this part of the fund, enabling longer term, but no more risky investments to be utilised. Income from safeguarded funds will mitigate other costs that are borne by the issuer and ultimately enable more competitive products to be offered. Restricting such investments on the other hand introduces inefficiencies and transfers revenue outside of the system.

We are therefore in agreement with the approach taken by the FCA in general, but suggest differentiating between different segments of safeguarded assets, enabling better investment, and ultimately a more efficient sector.

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?

There are benefits for regulated issuer's backing assets to be held in the same currency as the denomination of the underlying regulated stablecoin, mitigating foreign exchange risks and demonstrating stability of the stablecoin's value relative to its reference currency.

Allowing partial backing in another currency, however, could introduce benefits such as diversification of assets and potentially higher yields from investments in different currency markets. This could be accompanied with a requirement for hedging such risks, setting FX exposure limits and requiring own funds to be set aside to mitigate such risk. This was for example the approach applied to electronic money institutions under the first electronic money Directive, and can be reviewed in the FCA Handbook ELM Sourcebook of the time.

If firms are given the choice, they may choose to hold funds in the same currency for ease of risk management, whilst more sophisticated businesses may choose to mitigate FX exposure using a number of different methods at their disposal.

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?

The current convention is that stablecoin issuers primarily generate revenue from the interest and returns on the backing assets. The proposal suggests that regulated stablecoin issuers should be able to retain this revenue, aligning with current market practices and distinguishing stablecoins from deposits. This approach ensures that issuers can cover the costs of maintaining the stablecoin and incentivizes the operation and growth of their platforms.

However, this proposal also acknowledges the potential for consumer perceptions of unfairness, if interest rates remain high or increase further. For clarity we wish to emphasise that any interest that could be paid to users would be interest on the stable coin and not on the safeguarded funds, even if that is ultimately the source of such funds. Safeguarded funds are the price paid by users for stable coins, and they cannot have any proprietary rights to those funds whilst they also have unfettered legal rights to the stable coins themselves.

Issuers may over time wish to incentivise the use of a stable coin, and if the business case permits this, there could be some allowance made for interest or other similar incentive to be paid to users holding balances of stable coins.

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?

i. Legal obstacles: While it may be possible to legally impose a statutory trust over backing assets as envisaged by CASS, this would not reflect the underlying property relations and would therefore result in an arrangement at odds with established principles of property and contract. The backing assets held by the stable coin issuer are their own funds, as they reflect the price paid by the user of the coins. The user holds the coins absolutely and no longer has any proprietary right over the price paid, which they have offered as consideration for the coins. The issuer now holds the funds absolutely, but is under an obligation to safeguard such funds and to meet limitations on investment, in order to ensure that it can meet redemption obligations when they arise. The user has a contractual right to request redemption. The backing assets are therefore not the property of users of the coins and should not be made so artificially. While the user has a personal right for redemption against the issuer, the backing assets themselves do not form part of the financial service provided to the user, as is the case in investment services, for which the CASS regime has been created.

Practical obstacles: There may also be adverse practical consequences arising from the imposition of a statutory trust over the backing assets. Giving users of coins proprietary rights in these funds could mean that, in the event that the coins themselves are lost, stolen or otherwise misappropriated from a user's wallet (i.e., through fraud), users could simply abandon their rights in them and enforce their property rights in the backing assets as beneficiaries under a trust. This would lead to a situation whereby misappropriated coins would continue to circulate in the economy independently of any backing by funds, with obvious monetary and payment system implications. While it may be practically possible to restrict redemption claims to those holders able to present coins of an equivalent value, it is uncertain how this could be achieved in law. The outcome that should be avoided is that, in a dispute over misappropriated coins, the claim to be the legitimate owner of the coins and the claim to be the legitimate owner of the backing assets are made by two different people, as the resulting legal uncertainty could lead to an increase in litigation. Any uncertainty about the possible redemption of coins at the end of the payment chain could also affect the acceptance of the coins by merchants in payment.

Additionally, If the backing assets were beneficially owned by users and held by issuers merely in their capacity as trustees, this could remove these funds from the asset side of issuers' balance sheets, where they are required to match the corresponding redemption liabilities. It is uncertain whether funds held on trust would satisfy the definition of an 'asset' for the purposes of the IFRS, which requires an economic benefit to flow from the asset to the accounting entity. A solution would need to be found so as to avoid issuers having to find additional liquidity equivalent to segregated assets in order to avoid balance sheet insolvency.

In summary, there are a number of adverse legal and practical consequences that may flow from a trust arrangement. These will undermine the UK's competitive position as a jurisdiction in which stablecoins are issued, as a trust arrangement is unlikely to be required in other jurisdictions. This may have a secondary impact on FinTech and financial innovation in the UK generally. While we agree with the need to protect backing assets from the claims of third parties, a trust arising at the point of issuance is not the right solution. What could be considered is to make the arising of a trust over segregated assets

contingent on a specified insolvency event, which would meet the objective of giving coin holders beneficial interests in the backing assets that would allow for equitable tracing of assets wrongly transferred to a third party on insolvency and may increase the likelihood of a full and timely payout. However, it is not clear whether this could be achieved under the law of England and Wales.

The record-keeping and reconciliation measures are essential to ensure the accuracy of backing assets and to enable quick resolution of any discrepancies.

Technological obstacles:
The unique nature of digital assets and the use of distributed ledger technology may require the development of new tools and processes for monitoring and reconciling stablecoin issuance and backing assets under CASS-style rules. The need for daily reconciliation and real-time record-keeping could introduce operational complexities, especially for issuers with a large volume of transactions. It should also be kept in mind that the global nature of stablecoins may involve multiple legal jurisdictions, creating complexity in the enforcement of rules and the repatriation of backing assets, should these be held in other jurisdictions.

ii. Additional controls that could be considered include:

- Stress Testing: Regular stress testing of stablecoin backing assets to ensure they can withstand market volatility and redemption pressures.
- Third-Party Audits: Independent audits to verify the accuracy of the backing asset records and the operational effectiveness of the safeguarding measures.

iii. Backing of all issuer-held coins:
The approach to require stablecoin issuers to back all coins in circulation is accepted, including those minted by issuers themselves. However, these coins must be distinguished from coins that are minted but are not 'issued'. In other words, coins that do not enter circulation and therefore do not acquire any economic value should not be required to be backed up. Issuers should, however, be required to clearly distinguish which of the coins they hold have a redemption right associated with them (and therefore have value) and which do not. This approach would reflect the issuer's dual role as both the asset provider and a consumer within the regulatory framework.

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?

i. The appointment of an independent custodian to safeguard backing assets may prove to be costly and it may be more appropriate to do so where the the size of safeguarded assets exceed a given value, perhaps where these are systematically significant. Taking experience from the e-money sector into consideration, there has not been a need to appoint an independent custodian to date.

ii. As for alternatives to the two models mentioned, one could consider a decentralized model where the backing assets are safeguarded by a smart contract mechanism on a blockchain, which can automatically handle the administration and enforcement of backing asset requirements. This could potentially offer increased transparency and reduce the reliance on a single point of failure, but it would also introduce technological risks and would require rigorous testing and auditing to ensure it offers equivalent or improved 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 whether this might this 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?

i. In the normal course of events, redemption requests would be dealt with in the secondary market; indeed we are not aware of many stable coin issuers who do deal directly with retail holders.
ii. The objective of ensuring next business day redemption in the event of unusual market conditions is not unreasonable in most cases, but must be provisioned on their not being an unusual issue that requires resolution, such as a technical malfunction of some kind.
iii. We note also for example that issuers are unlikely to have a direct relationship with users and that the business relationship is likely to be with exchanges and custodians. This may then give rise to CDD/KYC obligations at redemption that may require fulfilment before payment can be made.

iv. Additionally, users may reside outside of the UK and may not be reachable through payment systems by the next business day; again this will need to be taken into consideration.

A next business day obligations will therefore usually be achievable, particularly where redemption happens in the course of normal business through the secondary market. Where an issuer is placed in a position to meet redemption obligations directly however, and with holders of coins with whom they have not had a business relationship, some greater allowance is likely to be required.

v. A regulated issuer should be able to outsource or involve a third party in delivering aspects of redemption if it ensures greater efficiency and reliability. This could either be under a distribution type of contract where the third party acts in its own capacity, such as an exchange, or could be in the role of outsourced service provider, when acting as a redemption mechanism of last resort.

vi. Beyond cost-reflective fees, other restrictions to consider could be temporary suspension of redemptions in extraordinary market conditions to prevent a financial panic or the collapse of the stablecoin. This would be akin to traditional financial institutions halting trading to prevent a run on the bank.

vii. The proposed redemption policy could incur costs related to maintaining liquidity to meet redemptions, administrative costs for processing redemptions, and potential outsourcing fees if third parties are involved. There would also be costs associated with the necessary compliance checks, like AML and CFT requirements.

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

Before executing a redemption request, a regulated stablecoin issuer should gather sufficient proof of identity and ownership to comply with AML requirements. Further checks will be dependent on the legal attributes of the coin. Is it for example a coin that is subject to the "innocent acquisition rule", or can fraudulent funds be traced. If the holder is regarded as the rightful owner, then AM/CTF/Sanctions checks would be sufficient. If that is not the case, then some additional investigation may be necessary to ensure that the party seeking redemption is the rightful owner of the coins.

Checks could include:

Verifying the identity of the customer, which could involve collecting government-issued identification documents, such as a passport or driver's license as well as sanctions checks.

Performing additional AML checks,where there are reasons to consider the transaction as higher risk.

Confirming the ownership of the stablecoin holdings, which might require evidence of the original purchase transaction or the individual's control over the wallet containing the stablecoins.

Redemption would occur in the same currency in which the stablecoin is denominated to prevent any issues with currency exchange and to ensure a straightforward transaction. Any redemption fees charged would be expected to be cost-reflective and not punitive, but need not be restricted to the actual costs of processing the redemption. This is because of the varying business models and the relatively narrow sources of revenue that are available to issuers.

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

The approach to applying the Consumer Duty to regulated stablecoin issuers and custodians is comparable to other payment products in the marketplace. The Consumer Duty emphasises the need for FCA-regulated firms to act in ways that deliver good outcomes for retail customers, which is essential in the context of stablecoins. Given the novel nature of stablecoins and their potential to be accessed by retail consumers, it's crucial for issuers and custodians to consider their obligations throughout the stablecoin life cycle.

This approach aligns with the broader regulatory focus on consumer protection and market integrity, ensuring that stablecoin issuers and custodians prioritise the interests and welfare of their users, especially in a market that can be complex and challenging for retail consumers to navigate.

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.

The classification of regulated stablecoins should be carefully considered. Keeping them within the category of 'restricted mass marketed investments' aligns with crypto assets that have a very different set of attributes and therefore risk profile. The risks and characteristics of stablecoins, depart from the broader category of restricted investments, having a stable value and being fully redeemable at pa. They do not pose the kind of risks that would justify restrictions relating to financial promotions.

This would bring stable coins into line with e-money and other payment products.

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

Mandating individual client wallet structures for certain situations or activities, as opposed to omnibus wallet structures, does have merits in relation to security and clarity of ownership. Individual wallets do provide clear delineation of each client's assets. However, omnibus wallet structures offer operational efficiencies and cost reductions, particularly for high-frequency transactions.

The prudent approach may be a combination of both – utilising individual deposit wallets and then subsequently sweeping and maintaining funds into an omnibus cold wallet for security purposes. A clear user allocation system will need to be implemented to ensure that funds for each individual can be allocated on a consistent basis.

Regarding a firm's own funds, these are better maintained separately and not mixed with consumer funds in an omnibus structure.

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.

For firms using omnibus wallet structures, as well as individual wallets, detailed client disclosures should be implemented. These disclosures should clearly explain the nature of the custody structure, the risks involved, and how clients' ownership rights are preserved.

In addition, despite the funds being mixed, it is critical to maintain the ability to determine each individual's proportion of the funds on a live basis, and implement timely reconciliations and rebalancing following deposits and withdrawals.

Regarding cost efficiency, omnibus structures are generally more cost-effective in business-as-usual scenarios due to shared infrastructure and operational efficiencies. However, in firm failure scenarios, individual client wallets may offer more straightforward asset distribution and lower risk of ownership disputes, potentially reducing the costs associated with resolving such disputes.

In contrast to the application of CASS to safeguarded funds, we are not opposed to its application to the custody of the stable coins. This is because the stable coins are in fact the property of the users, whereas the safeguarded funds are not.

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?

We regard such uses of stable coins as separate services to the core service of stable coins as a means of payment. We are not against such use cases, indeed this is part of the innovative nature of DLT services. They should however be regarded as value add or ancillary services and be addressed as such.

Such services, depending on their nature, will need to be appropriately regulated and ensure transparency and informed consent from clients. For example, using clients' assets for lending or staking could be allowed if clients are fully informed and have explicitly consented to such uses.

The terms should be clear prior to any usage of these assets, and the risks should be fully disclosed to clients in a format which is clear. Appropriate risk warnings should also be presented, and it may be prudent to consider whether this service should be offered to 'qualified' retail and institutional clients.

There should be distinctions based on the type of client, the nature of the activity, and the individual risk profiles. This practice introduces significant risks, including potential conflicts of interest and increased exposure to market volatility, which must be carefully managed.

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.

Systems and controls: The proposals for minimising the risk of loss or diminution of clients' cryptoassets seem well-founded and align with the need for robust organisational arrangements in cryptoasset service providers. The requirements for cryptoasset custodians to have adequate organisational structures to minimise risks due to misuse, fraud, poor administration, inadequate record-keeping, or illicit activities are welcome.

Disclosure and liability: The requirement for custodians to disclose their safeguarding controls and liability in client agreements is an appropriate approach, enabling a degree of flexibility in contractual agreements and service levels. Ensuring transparency and disclosure obligations to clients on the extent of liability and means of recourse is welcome.

Records: Obligations in relation to accuracy of records, and ensuring assets are clearly attributable to individual clients or to the firm are also welcome. Similarly, the flexibility in how these can be maintained is also welcome and appropriate. Firms are in a good position to decide whether choose to rely on 'on-chain' records or to maintain their own 'off-chain' records in addition to those on-chain.

Additional controls that could be considered include an obligation for periodic audits of custodians' systems and controls, and the implementation of advanced security measures to protect against cyber threats.

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 proposals on reconciliation require 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. This appears reasonable, and we look forward to the detailed provisions.

The proposal that custodians shortfalls that arise if discrepancies are not resolved following reconciliations is likely to require qualification. We would welcome further information on this proposal and the opportunity to engage on this issue.

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.

Allowing firms providing crypto custody to use third party service providers as part of their custody service is welcome. It may be that specialist service providers will emerge who could offer technical and other services that enable more enhanced or secure custodial services to be offered.

The proposed tests that custodians would apply when choosing an outsourced service provider, such as having appropriate skill and expertise as well as establishing written agreements that set out service levels, are appropriate and may over time evolve to address other qualification attributes.

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?

The proposals for ensuring adequate governance and control appear to be prudent, including the implementation of client disclosures and statements, the potential appointment of a CASS oversight officer, the consideration of client asset audits, and monthly regulatory reporting.

There are, however, significant costs associated with the implementation of each of the above measures. Consideration should be paid on how the costs can be managed, providing for example for the CASS oversight officer to also be able to serve other functions in the firm, and if the client asset audits and regulatory reporting can vary in their period depending on size.. An impact assessment that considers the ability of different sizes of firms to put in place such arrangements would be helpful. The regime could perhaps be calibrated to recognise alternative means by which custodians can achieve the same outcome.

Additional controls which may be considered include:

- The establishment of a dedicated compliance function within custodian firms, which would oversee the accuracy and timeliness of these reports. This individual could also serve as the CASS oversight officer.
- Implementation of automated systems to ensure consistent reporting standards.

Challenges to introducing these controls could include the technical integration of reporting systems, potential privacy concerns, and the need for industry-wide standards to prevent discrepancies in reporting methods. Mitigants might involve phased implementation with clear guidelines, industry consultations to address privacy and standardisation issues, and possibly a sandbox environment to trial the reporting mechanisms before full-scale implementation.

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

The services offered by CASPs are likely to combine custody with other services. It is important that the controls relating to custody are implemented fully, but this does not in our view require the separation of that activity into a separate legal entity. This will of course be informed by the nature of the liability regime that is developed; which may lead to firms voluntarily arranging their businesses in this way. We believe that this should be optional, and providers should not be compelled to do so.

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?

i. There will be a range of issues that will be shared between institutional and retail clients, but there will also be specific requirements that will characterise the different services. We do not believe that sector specific requirements will however impact the extent of safeguarding controls that would be applied.

ii. The operational impact could include the need for additional infrastructure and staff, while the cost impact could be significant in terms of setting up new entities and systems. Individual firms will be able to provide specific information to the FCA and may do so separately.

iii. The benefits of prefunding trades include faster execution and reduced credit risk. We are unaware of how prefunding for the purchase of the assets would impact the arrangements in place for custody. Prepayment is likely to be undertaken in relation to the exchange rather than custody service.

iv. The impact on the management of client accounts is likely to vary by firm; individual firms may wish to address this separately.

v. Addressing any conflict of interests is welcome.

vi. Alternatives to ensure consumer protection could include stringent regulatory oversight of combined entities, enhanced transparency requirements, and robust internal firewalls between different service functions.

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

Safeguarding: We have addressed the question of applying the CASS framework to funds representing safeguarded funds -(please refer to our response to Question 7 above) , and have clarified that we believe the CASS framework is an inappropriate regime, as such funds belong to the issuer and not to the customers holding stable coins.

We would distinguish prepayments held by an exchange in contemplation of purchases that are yet to be made, such funds could be subject to trust arrangements and the CASS framework, provided this is an operationally manageable regime, and significantly, provided such funds are not already held under another regulatory framework, such as hat pof payments or e-money.

Redemption: we can contemplate custodians providing redemption services but are keen to better understand how this would differ from the activity of an exchange in this respect. Redemption would be a repurchase of the stablecoins by the custodian using its own funds, with a view to selling such coins back to the issuer, or holding them for its own purposes. Is this what is contemplated by this question?

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?

The application of the existing high-level systems and controls requirements to the stablecoin sector would be appropriate if applied in a proportionate and selective manner. It is important to undertake a sector-specific assessment and consider the extent to which SYSC provisions meet the needs of the sector and the extent to which they may be excessive.

We believe the electronic money regime may provide a more calibrated benchmark, having similar risks and relating to similar use cases.

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.

We are supportive of applying operational resilience provisions to the sector.
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.

The existing financial crime framework is extensive, requiring all firms to have systems and controls to counter the risk that regulated stablecoins are misused for the purposes of financial crime.

This includes the application of the financial crime rules set out in SYSC 6 of the Handbook to regulated stablecoin issuers and custodians, as well as the existing requirements under the FSMA and the MLRs. As a result, firms would be required to assess how their operations might be misused by criminals such as those seeking to launder money or the proceeds of corruption, commit fraud and breach sanctions.

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 further be expected to establish and maintain effective systems and controls to counter the risks of

financial crime. As part of SYSC 6, regulated stablecoin issuers and custodians will also be required to appoint a laundering reporting officer responsible for the oversight of the activities of the firm and to ensure the firm is compliant with all 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, as well ensuring that there is individual accountability if something goes wrong.

The utilisation of this existing financial crime framework for regulated stablecoin issuers and custodians is a sound approach, but there is concern to ensure that the regime is applied to the sector in a risk sensitive manner, and that the novel nature of many aspects of the sector are addressed in a proportionate manner.

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?

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)?

Applying the Principles for Businesses and other high-level standards to regulated stablecoin issuers and custodians is consistent with the regulatory framework for financial institutions regulated under the FSMA.

The proposals more generally address investment related risks, as well as those in relation to custody. The DP acknowledges that stable coins are intended primarily for affecting payments, and the conduct of business regulatory regime for payments could benefit from further discussions - this has only been referred to briefly at section 10.27.

Detailed rules regarding information disclosure, beyond those for backing assets, should potentially include: the relative roles of different parties in the value chain, the appropriate party to contact for different issues, reliance on other parties and risks associated with shared infrastructure, such as the blockchain itself.

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?

Specific conduct of business rules for regulated stablecoins issuers and custodians could be beneficial to address the unique risks and operations of stablecoins. Given the 1:1 nature of fiat backing for regulated stable coins, we do not foresee a significant opportunity for inducement and conflict of interests risks.The latter arise where there is price volatility and there is some advantage in having information, disclosing it or manipulating timing of events. The purpose and the main utility of regulated stable coins will be payments and it is unlikely that price volatility will arise.

Please see our response to question 27 regarding addressing payments related COB regulation.

Q29: Do you agree that the dispute resolution mechanisms provided in traditional financial services 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.

Dispute resolution mechanisms from traditional financial services could be extended to the business of regulated stablecoin issuers and custodians to provide a familiar framework for addressing complaints and disputes. It's important to consider any unique aspects of stablecoin transactions that could create complexity for the existing framework, such as the fragmentation of the value chain, the digital nature of asset custody or issues arising from blockchain technology.

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.

The approach of 'wait and see' set out in the discussion paper is in our view appropriate; but merits review periodically to ensure consumer confidence in both issuing and custody services, as well as comparable treatment to e-money and other payment services. We would seek to distinguish risks associated with (i) the loss of custody assets from (ii) the risk of loss of backing funds held by the issuer, and there may emerge a distinction in the appropriate treatment for each.

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

Agreeing with the proposed prudential requirements would depend on the specifics of those requirements, which are not detailed. Furthermore the nature of a stablecoin business can vary considerably from a permissioned system with a limited number of participants, perhaps under a contractual agreement with the issuer, to a permissionless system participant CASPS have not contractual arrangements with the issuer. We can contemplate simple structures with a limited number of participants within a scheme like arrangement, and would anticipate far more limited risks. The applicable regime should be able to distinguish between the two extremes.

Based on general principles for similar regulatory frameworks, the following considerations can be made.

i. Capital Requirements and Quality of Capital: The level and quality of capital that regulated stablecoin issuers and custodians are required to hold is fundamental to their ability to absorb losses and continue operations during times of stress. Such stress however is likely to arise in relation to a payment commercial proposition and not market or credit risk. The main risk is likely to be operational and not specific to stablecoin operations.

ii. Liquidity Requirements and Eligible Liquid Assets: Liquidity requirements should ensure that stablecoin issuers can meet their short-term obligations without disrupting their operations or impacting market stability. Custodians will always have recourse to issuers for redemption and need not hold excessive capital or liquidity. Issuers in turn should be able to distinguish core parts of backing assets that are unlikely to be required in the short term from day to day or weekly or monthly demands for liquidity.

iii. Group Risk: If stablecoin issuers and custodians are part of a larger group of companies, group risk is a valid consideration. The proposals could address inter-company exposures and the risk of contagion within the group, ensuring that problems in one part of the group do not unduly affect the stablecoin operations.

iv. Concentration Risk: Concentration risk proposals should aim to prevent excessive exposure to a single counterparty or a group of connected counterparties. It is appropriate to mitigate the risk of a significant counterparty failing or a correlated group of counterparties experiencing simultaneous distress.

v. Internal Risk Management: Internal risk management is key to identifying, measuring, managing, and reporting risks. A comprehensive risk management framework tailored to the specific risks of each stablecoin operation should be possible. This could include stress testing, scenario analysis, and the implementation of robust controls and governance structures. Distinguishing risks that attach to the custody of cryptographic assets from those to the issuing and operation of a scheme is important in this respect.

We also note that the proposals should be agile enough to adapt to the evolving nature of stable coin issuance, custody and their use as a means of payment.

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.

We have addressed the application of the CASS regime to backing assets in our response to question 7; we do not believe that backing assets can be considered client money when the holder has full legal title to the crypto asset itself. During the lifetime of the business and in normal business conditions, the backing assets are the property of the issuer and it should have full title to such assets. However, we are not against restrictions on the availability of such funds to creditors in the event of insolvency, nor indeed against a trust coming into effect at insolvency, and the CASS rules on post-failure treatment of custody assets could be adapted to stablecoins.

Applying the CASS rules to custody activity on the other hand is appropriate, as such assets are the property of users and they should be regarded as client assets.

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.

We are in agreement over the costs of return of assets being borne by the firm and not to be taken from safeguarded assets. This can apply to both the safeguarding regime applied to backing assets held by the issuer or stable coins held by a custodian.

We further acknowledge the challenges that an issuer of crypto assets will have in establishing the identity and in communicating with asset holders. We believe the process described at paragraph 9.11 is a reasonable approach to ensuring that the maximum number of asset holders have a good opportunity to be recompensed and to have stablecoins redeemed.

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?

The proposed approach for post-failure trading should aim to sustain market stability and consumer protection. However, the unique liquidity profile of digital assets might require different approaches to manage trading post-failure effectively.

For instance, considering 'circuit breakers' to pause trading in case of wild price fluctuations or ensuring that there's a mechanism for orderly market function without necessarily liquidating positions could be considered. Additionally, creating a fund or insurance mechanism to cover the shortfall in the event of insolvency might avoid the need for immediate distribution of backing assets.

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.

The primary challenge when returning stablecoins to consumers is verifying their entitlements, especially since stablecoins can be held in private wallets. Additional protections that could facilitate a prompt return might include:

- Establishing a clear and efficient claims process that respects the privacy of wallet owners while allowing for verification of their holdings.

- Developing wind-down arrangements that include pre-planned, orderly processes for the return or transfer of assets to consumers.

- Considering a bespoke resolution regime that could address the speed and cross-border nature of stablecoin transactions to ensure consumer protection is not compromised in the event of a firm's failure.

These additional measures are better developed in consultation with industry stakeholders to ensure they are practical and effective in the context of the digital asset ecosystem.

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?

We concur with the need to safeguard both stable coins and fiat currency that is in the possession of payment providers, and for the fiat requirements to be those under the PSRs while those for stable coins to be those contemplated under new rules.

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?

The custody requirements outlined in Chapter 5 in relation to crypto assets can indeed apply to custody services 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?

Care needs to be taken in applying COB obligations to payment arrangers (and custodians) enabling payment services using stable coins or within a hybrid model. Obligations in relation to liability for execution of transactions, or flowing failures of infrastructure will need to distinguish those aspects that are within the control of the arranger from those that are inherent to the stable coin system. Failures due to infrastructure issues, or that involve dependencies on third parties need to be taken into consideration.

Opportunities could include faster settlement times, reduced costs, and increased accessibility to financial services. Regulation of payment arrangers should aim to mitigate these risks while harnessing the benefits, possibly by requiring robust risk management practices and consumer protection mechanisms.

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?

The Treasury's proposal to allow overseas stablecoins to be used for payments in the UK could introduce a range of benefits for consumers, primarily the increased competition in the market, a wider range of products and services, and innovation in the payment sector.

However, the risks of such an approach include the potential for regulatory arbitrage between jurisdictions, issues with enforceability of UK regulations over overseas entities, and the challenges in ensuring equivalent levels of consumer protection.

The costs for payment arrangers could vary greatly depending on the regulatory compliance requirements and the need to establish interoperability with overseas stablecoin systems. The viability of the business model would depend on the ability to manage these costs while providing competitive services.

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?

Assessing overseas stablecoins to equivalent standards as regulated stablecoins poses a range of challenges, including differing legal frameworks, distinct regulatory standards, and challenges to enforcement mechanisms across jurisdictions.

Payment arrangers should only be liable for overseas stablecoins that fail to meet FCA standards if due diligence was insufficient or if there was some failure in the manner in which they relied on information provided by the issuer or a third party. To manage these risks, thorough assessment procedures, ongoing monitoring, and clear accountability mechanisms could be established.

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