



CUMMINGS PEPPERDINE ON CRYPTOASSETS

What is a cryptoasset?

Currently, there is no single global definition of cryptoasset. However the UK government has established a Cryptoassets Taskforce, the members of which are the Financial Conduct Authority (FCA), the Bank of England and HM Treasury, to assess the policy and regulatory implications of cryptoassets, and the underlying technology in financial services.

The Cryptoassets Taskforce has established a framework for categorising cryptoassets. This, with the definition, have been used by the FCA as its starting point for publishing guidance on which different types of cryptoasset fall within the regulatory perimeter set by the Financial Services Markets Act 2000 (FSMA) and the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO).

The Cryptoassets Taskforce has defined cryptoassets as “cryptographically secured digital representations of value or contractual rights that use [that is, are built on] some type of DLT (including blockchain) and can be transferred, stored or traded electronically.”

These have been categorised into three types of token. In addition to these three types of token, the FCA has separated out e-money tokens as a fourth type. E-money tokens are not considered in this note. To provide very brief information, they are regulated under the Electronic Money Regulations 2011 and, depending on the status of the issuer, may be within the regulated arena while a market participant which carries on cryptoasset activities that involve payment services relating to any type of token may be subject to registration requirements under the Payment Services Regulations 2017.

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WHAT ARE THESE THREE TYPES OF TOKEN?

Security tokens

Security tokens have characteristics that mean they are the same as, or akin to, traditional instruments like shares, debentures or units in a collective investment scheme in that they grant some rights of ownership or rights to payment of a specific sum of money, or entitlement to future profits, rights which are associated with traditional regulated securities such as shares and/or debt.

The FCA considers a security to refer broadly to an instrument (that is, a record, written or not) that indicates an ownership position in an entity, a creditor relationship with an entity or other rights to ownership or profit. A token will be a security based on its structure (even if nothing is received for it). It is important to note that the FCA takes the view that if it is clear from the outset that a utility token (see below) may become a security token during its lifecycle, then it is likely to be a security token from the outset.

Security tokens may also be categorised as transferable securities under MiFID II and/or may be used as a capital-raising tool.

Security tokens are within the regulatory perimeter and thus the scope of FCA regulation;

Exchange tokens

Examples of exchange tokens are cryptocurrencies such as, Bitcoin, Litecoin, Ethereum. Exchange tokens do not include money tokens are usually a decentralised tool. They are intended, and designed to be used as a means of exchange (ie payment) for buying and selling goods yet are not widely accepted or recognised as means of payment. They are used as an alternative to fiat currencies and as they are not issued by a government they do not meet that core economic criterion of fiat money.

Additionally, exchange tokens do not grant the token holder any of the rights which are associated with those assets which the RAO defines as specified Investments (which are FCA regulated). They express their own value in other currencies and can be traded on a regulated market.

The FCA likens exchange tokens to other assets which are outside the regulatory perimeter, such as fine wine or art, which can be bought speculatively with a view to realising profits if they rise in value. This means that activities involving the transfer, purchase and sale of exchange tokens, including the commercial operation of cryptoasset exchanges for exchange tokens, are not regulated by the FCA. For example, an exchange that simply facilitates cryptocurrency transactions, such as Bitcoin, will not be carrying on regulated activities.

Exchange tokens are not generally within the regulatory perimeter and thus the scope of FCA regulation;

Utility tokens

Utility tokens grant their holders access to a current or prospective product or service within a discrete network or ecosystem and cannot be used as a means of payment in any other network or ecosystem. Critically, they share with exchange tokens the characteristic of not granting holders rights that are the same as those granted by assets which the RAO defines as specified Investments.

Utility tokens can however be used as a capital-raising tool and traded on a regulated market. The FCA likens utility tokens to rewards-based crowdfunding, where participants contribute funds to a project in exchange, usually, for some reward (for example, access to products or services at a discount) and give examples of utility tokens, highlighting various characteristics that mean they lack the features to be classified as a security token or be used as a means of exchange other than with the issuer.

Care needs to be taken to ensure that they do not meet definition of e-money and that they cannot be a security token. Provided that they do not, utility tokens do not fall within the FCA's regulatory perimeter.

ARE THERE ANY ASSET TYPES TO CONSIDER?

It is also necessary to look at stablecoins. The FCA does not give any single definition of stablecoins (their variation in terms of structure and arrangement means that they cannot be classified as a single type of token) but instead stays looks at the common characteristic of all stablecoins. This is their purpose of attempting to stabilise their value using a variety of mechanisms. A large number of stablecoins are backed with fiat currencies (for example by pegging their value to a fiat currency) while others are backed other assets, which can in fact include other cryptoassets or assets such as Specified Investments or commodities such as oil or gold. All though are backed to provide stabilisation.

Stablecoins may fall within the definition of an e-money token or a security token (either as a derivative, a unit in a collective investment scheme, a debt security, e-money, or another type of specified investment) if they meet all the conditions of security tokens and e-money tokens. This will depend on the nature of the underlying assets, the rights granted by such tokens and other relevant arrangements and needs to be considered on a case-by-case basis.

It is important to note that HM Treasury is consulting on bringing stablecoins that fall within the definition of a new category of token (stable tokens) within the regulatory perimeter.

WHAT OTHER LEGISLATION IS RELEVANT?

Firms carrying on cryptoasset business (please see "Cummings Pepperdine on the regulation of cryptoassets") may also have to comply with other legislation, such as the following:

- The financial promotion regime: unauthorised firms that market products and services relating to regulated tokens comply with the financial promotion restriction under FSMA and understand how the FCA's financial promotion rules may apply to their marketing material, whether written or verbal, even though they themselves are not authorised;
- The Prospectus Regulation (2017/1129): where a token is a transferable security and is offered to the public in the UK or admitted to trading on a regulated market, an issuer must publish a prospectus unless an exemption applies;
- Market Abuse Regulation: some cryptoassets are subject to this regulation and it can present some challenges;
- Money laundering and counter terrorist financing regulations: the Money Laundering Regulations 2017 set out the regime for certain cryptoasset businesses (please see "Cummings Pepperdine on the regulation of cryptoassets");
- the rules of any relevant trading exchange or platform; and
- local laws in all jurisdictions where an offer is available, where the offer is made available internationally.

Other UK and overseas requirements may also apply, depending on the precise nature of the cryptoasset activities carried on.

WHAT OTHER ORGANISATIONS ARE RELEVANT?

In addition to the FCA, it is useful to look at the work of the UK Jurisdiction Taskforce (the "UJKT"). This is a team of industry experts, members of the government and the judiciary that has been formed to help the UK legal sector grow and fulfil its potential. The UJKT has co-ordinated the preparation and publication of an authoritative legal statement on the status of cryptoassets and smart contracts under English private law with the purpose bringing some legal certainty in this area, to improve market confidence.

The UJKT has not sought to define the term cryptoasset, saying that it would not be a useful exercise to do so given the rapid development of technology. Instead, it has focused on identifying the key features of a cryptoasset and answering key questions concerning with ownership, transfer and whether, under English law, cryptoassets constitute "property".

In summary in this point, the UJKT concluded that cryptoassets have all the legal characteristics of property and are, as a matter of English legal principle, to be treated as property (although whether a particular cryptoasset will be property will depend on the facts) and recent case law has supported this view.



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