SEBA BANK

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The UK tackles stablecoins

The Digital Regulator

Redefining Finance for the New Economy

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Executive summary

On 7 January 2021, the UK government released a consultation paper that examined recent developments in Distributed Ledger Technology (DLT) and proposed an authorisation regime for stablecoins. Stablecoins have the potential to bring efficiencies to (cross-border) payments, promote financial inclusion, and facilitate the implementation of retail Central Bank Digital Currency (CBDC). The UK emerged as the third jurisdiction to single out and address stablecoins. Switzerland issued guidelines in September 2019, the EU issued regulatory proposals in September 2020, and the Financial Stability Board (FSB) provided a fundamental endorsement of stablecoins in October 2020. The UK government proposes to include stablecoins that can be reliably used for retail or wholesale transactions and that achieve a stable peg to assets such as single currency, multi currencies, or gold within the scope of the regulation. It further proposes to exclude stablecoins that achieve a stable value through algorithms that control their supply. The regulatory requirements would extend to the organisation, operation, and governance of the stablecoin arrangement. Global stablecoins would be subject to additional requirements as well. Existing cryptoasset regulation would be leveraged and extended to cover stablecoins.

The last few weeks have offered several noteworthy regulatory developments in the digital space. On 1 February 2021, the civil law aspect of Switzerland's DLT legislation came into force, allowing the transfer of rights and claims as a ledger-based security on a distributed ledger system without involving any intermediary. The legislator thus honoured a request from the blockchain industry to advance the implementation from 1 August 2021 to 1 February 2021. We have extensively reported on developments in the Swiss DLT law in Digital Regulator December 2020. This development has allowed cryptobanks, such as SEBA Bank, to issue their Series B Participation Certificates as tokenised equity securities on the blockchain. The FSB and the Bank for International Settlements (BIS) have also anticipated increased focus on stablecoins and CBDC in 2021. Furthermore, the US Office of the Comptroller of the Currency (OCC) has allowed US banks to handle stablecoins for payment activities.

The UK is the third jurisdiction to address stablecoins after Switzerland and the EU.

1. The UK Approach to Stablecoins

The UK Government issued a consultation document titled 'UK regulatory approach to cryptoassets and stablecoins' on 7 January 2021. The initiative followed the government's Cryptoassets Taskforce report, issued in October 2018, that set the regulatory direction for cryptoassets and enabled the Financial Conduct Authority (FCA) to implement guidelines for the usage of cryptoassets. The consultation document examines recent developments, such as the advent of stablecoins, Decentralized Finance (DeFi), and DLT related financial market infrastructure, and favours stakeholders' views on a range of issues and proposals, which take a substantive form in relation to stablecoins.

The approach to cryptoassets

- The UK financial authorities increased their involvement materially with respect to cryptoassets in September 2017, after the FCA warned investors about the risks of investing in cryptoassets in the context of the Initial Coin Offering (ICO) mania.
- The government launched the Cryptoassets Taskforce that brought together representatives from Her Majesty's Treasury, the FCA, and the Bank of England (BoE) in March 2018. The final report released in October 2018 fundamentally supported DLT and its applications in financial services. The report set the following priorities: preventing the use of cryptoassets for illicit activity, guarding against threats to financial stability, and mitigating the risks posed by cryptoassets to consumers and market integrity. The report defined three categories of cryptoassets: exchange tokens, security tokens, and utility tokens. The government endorsed a technology-neutral approach to the regulation of DLT, establishing that cryptoassets would be subject to financial regulations if they match the definition of any specified instrument in the Regulated Activities Order 2001 (RAO). It also concluded that native cryptocurrencies such as bitcoin and ether would be classified as unregulated tokens because they are not centrally issued and do not give rights or entitlements to holders.
- The FCA issued the final cryptoassets regulatory guidance on 31 July 2019, which clarified the handling of different categories of cryptoassets and other related activities in relation to the FCA's regulatory perimeter and the applicable regulations (such as the RAO, the Markets in Financial Instruments Directive, the E-Money Regulations 2011 (EMR) and the Payment Services Regulations 2017 (PSR)). It also introduced a regulatory sandbox in November 2018. Additionally, it clarified in April 2018 that the offering of cryptocurrency derivatives required authorisation. Finally, it banned the sale of crypto-derivatives to retail consumers owing to suitability concerns in October 2020.

The approach to stablecoins

- Stablecoins are a key innovation that emerged after the comprehensive governmental report of 2018. The government characterises stablecoins as an evolution of cryptoassets that seek to minimise the volatility of their value through a peg that may take a variety of forms, including algorithms. It notes that the nature of the holder's claim on the referenced asset may vary, and the governance and organisation surrounding the stablecoin arrangement might be either more or less complex. The government also concludes that the risks raised by the stablecoin arrangement and the applicability of financial regulations may differ depending on their design.
- The government proposes to rely on the existing FCA classification and regulation of cryptoassets. It also proposes to regulate such stablecoins that can be reliably used for retail or wholesale transactions through EMR and PSR laws. The government further proposes to exclude algorithmic stablecoins from the authorisation requirements because such stablecoins would not be suitable for retail and wholesale transactions. Finally, regulatory requirements would also extend to the organisation and governance of the firms involved in operating the stablecoin arrangement. The requirements would also cover activities such as managing the inventory of tokens and reserve assets as well as validating and executing stablecoin transactions.
- Global stablecoins would be subject to the Banking Act 2009 and the Financial Services Act 2013, empowering the BoE with the responsibility for regulating important payment systems and their service providers. The requirement of having a UK based establishment and being authorised in the UK to market stablecoins to UK consumers is left open at this stage. The consultation on these proposals, which also address other important topics such as DeFi and DLT related financial market infrastructure, ends on 21 March 2021.

There is a widespread agreement that stablecoins have the potential to bring efficiencies to cross-border payments, promote financial inclusion, and even facilitate the implementation of retail CBDC. The UK becomes the third jurisdiction to address stablecoins by issuing regulatory proposals concerning this innovative cryptoasset class. In 2019, Switzerland was the first jurisdiction to act following the incorporation of the Libra Association in Geneva. The EU presented specific proposals for stablecoins and global stablecoins in September 2021. The FSB fundamentally endorsed stablecoins in October 2020 by issuing recommendations promoting effective regulation, supervision, and oversight of global stablecoin arrangements. The UK approach shares similarities with the Swiss approach as it builds on existing regulation governing cryptoassets and takes a technology-neutral stance. The EU issued a relatively detailed proposal which distinguished between global and non-global stablecoins and presented commonalities with certain aspects of the Swiss FinTech license.

Conclusion

The issuance of regulatory proposals concerning stablecoins by the UK government in January 2021 follows the EU regulatory proposals issued in September 2020 and the Swiss guidelines issued in September 2019. Moreover, the FSB has provided supporting principles in October 2020 which indicate recognition by the authorities of the business case for stablecoins. Stablecoins provide efficiency in cross-border payments and enhanced financial inclusion; they also have a potential role in the implementation of retail CBDC. However, the FSB looks to promote this DLT innovation in a risk-controlled and sustainable environment. Furthermore, regulatory action taken by countries such as the UK creates legal certainty for the private sector's initiatives related to stablecoins.

The last few weeks have offered several noteworthy regulatory developments in the digital space, including the entry into force of the civil law aspect of Switzerland's DLT legislation, allowing the transfer of rights and claims as a ledger-based security on a distributed ledger system without any intermediary. The FSB and the BIS have also anticipated increased focus on stablecoins and CBDC in 2021. Furthermore, the OCC has allowed US banks to use stablecoins for payment activities. India also confirmed its negative stance on cryptoassets, while eyeing a CBDC and promoting DLT. Dubai announced plans to improve and expand its regulatory framework for digital assets.

2. Other Noteworthy Developments

The civil law aspect of Switzerland's DLT legislation came into force on 1 February 2021. SEBA Bank immediately took the opportunity to issue tokenized assets on the blockchain.

- On 1 February 2021, the civil law aspect of Switzerland's DLT legislation came into force, allowing the transfer of rights and claims as a ledger-based security on a distributed ledger system without involving any intermediary. The legislator thus honoured a request from the blockchain industry to advance the implementation from 1 August 2021 to 1 February 2021. We have extensively reported on developments in the Swiss DLT law in Digital Regulator December 2020. On 1 February, SEBA Bank issued its Series B Participation Certificates as tokenised securities on the blockchain based on the ERC20 Ethereum protocol.

The FSB and the BIS have anticipated increased focus on stablecoins and CBDC in 2021.

- The FSB announced that enhancing the cross-border payments will be part of the work programme for 2021. The FSB will also issue a report on the regulatory and supervisory approaches with respect to stablecoins.
- The BIS announced that CBDC will be a focus area of its Innovation Hub. The Hub intends to study retail CBDC, investigating two models (a hybrid CBDC and private CBDC-backed stablecoins) for the distribution of a retail CBDC through commercial banks and payment service providers.

The OCC has allowed US banks to use stablecoins for payment activities.

- The OCC issued a letter that removes any legal uncertainty about the authority of banks to 'connect to blockchains as validator nodes and thereby transact stablecoin payments on behalf of customers who are increasingly demanding the speed, efficiency, interoperability, and low cost associated with these products'. The OCC also clarified that banks will need to comply with applicable law and engage in safe, sound, and fair banking practices.

Fresh warnings have been issued by New Zealand and UK authorities about the risks of investing in cryptocurrencies following the sharp increase in the price of bitcoin.

- New Zealand's Financial Markets Authority has issued a warning against investing in cryptocurrencies, reminding the market participants that digital currencies are currently not regulated in the country and that bitcoin is a highly volatile asset.
- The UK FCA warned market participants that investments in cryptoassets are highly volatile and have the potential for a 100% loss. Investors should particularly ensure that they understand the associated volatility risk and product complexity.

India confirms its negative stance on cryptoassets while eyeing a CBDC and promoting DLT.

- The Indian government clarified its stance on cryptocurrencies by introducing the Cryptocurrency and Regulation of Official Digital Currency Bill for consideration and passing. The bill supports the creation of an official CBDC. However, it also seeks to prohibit private cryptocurrencies. On the positive side, it promotes the underlying DLT.

Dubai announces plans to improve and expand its regulatory framework for digital assets.

- The Dubai Financial Services Authority (DFSA) is planning to introduce a regulatory framework for tokenised securities and cryptocurrencies as part of its 2021–2022 business plan. The regulatory approach will facilitate innovation while requiring strict adherence to the DFSA's licensing, prudential, and conduct requirements. The framework will specifically include anti-money laundering measures.

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