Regulation of Cryptoassets: Imposing Law on the "Wild West"

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2018 was a year of international scrutiny for digital currencies. As regulators around the globe wake up to the potential dangers posed by the new technology (now falling under the umbrella term of "cryptoassets"), pressure has been mounting on the UK government and the Financial Conduct Authority ("**FCA**") to impose some form of regulation on the industry. Last year, we took a look at some of the areas likely to cause most concern and discussed how these risks might best be mitigated.[1] Now, almost one year later, we consider what, if any, progress was made in 2018, and what the future may hold for the regulation of this rapidly developing market.

The need for regulation

After the final few months of 2018, there can be no doubt of the urgent need for regulation of cryptoassets. Several damning reports, such as one published in September 2018 by the UK Parliament's Treasury Select Committee, have highlighted the lack of oversight of the markets, with the Committee dubbing industry the "Wild West".[2] A similar report from the New York Attorney-General's office criticised "pervasive" conflicts of interest and the lack of sufficient measures to prevent market abuse.[3]

Hot on the heels of these pronouncements, the UK's Cryptoasset Taskforce – which comprises representatives of the FCA, HM Treasury and the Bank of England – identified three major harms which are associated with cryptoassets.[4] Firstly, harm to consumers, who, in purchasing highly volatile and potentially unsuitable digital assets, open themselves up to large losses without traditional safeguards such as compensation. Secondly, the potential harm to market integrity, caused by opacity in market practices and widespread misconduct; and finally, the risk of financial crime, stemming from concerns that anonymously-held cryptoassets are used to launder money, fund illicit activities such as terrorism and human trafficking, and defraud consumers. The Taskforce concluded that decisive action must be taken. But what would such action look like?

How should regulation be approached?

The Treasury Select Committee's report suggested that rather than creating a new framework specifically to regulate digital assets, it would be quicker for them to be brought into the scope of existing regulation. While this is arguably true, quicker is not necessarily better. Trying to shoehorn cryptoassets, with their unique challenges and fast development, into rules designed for more traditional financial instruments could be a recipe for disaster: indeed, the FCA has acknowledged in its most recent consultation that "new business models don't always map neatly into our regulatory framework" and that the complexity of some cryptoassets makes it difficult to determine whether they do in fact fall within its remit.[5] It may become abundantly clear, very quickly, that the existing regulatory framework is simply not fit for this purpose. Such a situation may be even more dangerous than no regulation at all; paying lip service to the call for regulation in a half-hearted way has the potential to leave open loopholes prime for exploitation. Attempts to fill these gaps would result in a messy mishmash of old and new rules, while leaving them unplugged is equally as worrying.

However, if the FCA is to develop a new regulatory framework for this evolving asset class, it must not do so in isolation. One theme to be drawn out of the myriad of commentary from 2018 is the need for international consistency. The very nature of cryptoassets and associated blockchain technology means that these assets are decentralised and can be difficult to pin to a particular jurisdiction or regulator. A globally co-ordinated approach would ensure that there are no weak links in the chain – under-regulation in a given jurisdiction could, and likely would, be easily exploited. In responding to the Treasury Committee's report, the Government and the FCA have acknowledged this need for international co-ordination and will hopefully take this forward into 2019.

Steps have already been taken to map out new international standards, with the Financial Action Task Force ("**FATF**") agreeing amendments to its Standards and Recommendations to help prevent the misuse of what it terms "virtual assets" in money laundering and terrorist financing.[6] The FATF plans to update its guidance to help countries implement these changes and, given the speed of innovation in the sector, will revisit the issue later this year to ensure that the Standards remain relevant. Similarly, the European Banking Authority has called for the feasibility of pan-European rules on the regulation of cryptoassets to be considered by the European Commission.[7]

What might 2019 have in store?

A number of consultations are in the works for the FCA. 2019 has already seen the launch of a consultation on guidance in an attempt provide clarity to firms about which cryptoassets fall within its existing regulatory perimeter.[8] The consultation sets out the FCA's assessment of how the current regulations apply to different types of cryptoassets, inviting views from stakeholders by early April. Final guidance is due in summer 2019. A further consultation by the FCA later this year will look at a possible ban on cryptocurrency derivatives, while HM Treasury intends to explore the possibility of expanding the FCA's remit to cover further types of cryptoassets. The Government has previously indicated that it is willing and able to give the FCA more power to oversee cryptoassets[9]; 2019 may be the year these powers actually materialise.

In the meantime, the FCA is keeping itself busy. A Freedom of Information Act request at the end of 2018 teased out some interesting figures on the FCA's investigative approach[10]: as of 12 November 2018, the FCA had opened investigations into 67 companies involved in cryptocurrency business.

49 of these investigations have since been discontinued, with 39 resulting in consumer alerts – which warn the public that a company could be operating without proper authorisation and may be a scam – being issued. The fact that so many investigations have been closed in such a short period of time is striking. On one hand, this may be representative of the FCA's decisive approach in closing cases which do not merit further scrutiny. However, it is possible that it is a symptom of a wider problem: that the FCA simply lacks the clarity and the tools needed to police this new landscape. Enforcement action cannot be taken in the absence of a clear regulatory framework. The FCA's hands are tied until a coherent and comprehensive approach to this market is agreed.

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1 WilmerHale W.I.R.E. Article, "Digital Currencies: Taming an Unpredictable Market" (6 April 2018) https://www.wilmerhale.com/en/insights/blogs/WilmerHale-W-I-R-E-UK/digital-currencies-taming-an-unpredictable-market

2 House of Commons Treasury Committee Report on Crypto-assets (12 September 2018), accessible at https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/910/910.pdf

3 Office of the New York State Attorney General, Report on Virtual markets Integrity Initiative (18 September 2018), accessible at https://ag.ny.gov/sites/default/files/vmii_report.pdf

4 Cryptoassets Taskforce: final report (October 2018), accessible at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/crypto

5 Guidance on Cryptoassets, FCA Consultation Paper CP19/3, January 2019 https://www.fca.org.uk/publication/consultation/cp19-03.pdf

6 FATF statement, "Regulation of virtual assets" (19 October 2018) http://www.fatf-gafi.org/publications/fatfrecommendations/documents/regulation-virtual-assets.html

7 Financial Times, "European Banking Authority calls for pan-EU rules on crypto assets" (9 January 2019) https://www.ft.com/content/cb03dd96-1378-11e9-a581-4ff78404524e

8 Guidance on Cryptoassets, FCA Consultation Paper CP19/3, January 2019 https://www.fca.org.uk/publication/consultation/cp19-03.pdf

9 Financial Times, "UK government 'ready' to allow regulator oversight of crypto assets" (20 December 2018) https://www.ft.com/content/21e9c220-043c-11e9-99df-6183d3002ee1

10 Financial Times, "FCA probes 18 businesses involved in cryptocurrency transactions" (30 December 2018) https://www.ft.com/content/04e22444-0c32-11e9-acdc-4d9976f1533b