



BLOCKCHAIN INVESTMENT & ADVISORY

# FCA Consultation Paper on Cryptoassets

## Goals of this Piece:

- A common sense explanation of the proposed UK regulation
- Where we think the proposal is positive or negative for the market

Earlier this year the FCA released a Consultation Paper on the regulation of cryptoassets.<sup>1</sup> A Consultation Paper is an outline of what the FCA is thinking and an invitation for market participants to comment before they publish their final rules later this year. We are talking to the FCA and our thoughts and concerns are outlined here..

## Key Takeaways

We had a hard look and overall like where the FCA is heading. It is a sensible approach following standard securities regulations without going overboard. We feel that the FCA approach of looking at the intrinsic properties of the token in question is clearer and more sensible than the rule based standards used by the SEC.

If you don't read further remember this:

- If it looks like a security, it probably is a security
- Be careful how you market/sell your tokens - financial promotion entails a big set of rules and prohibitions
- Bitcoin, Litecoin, Ethereum, and the like (FCA calls them exchange tokens) are not regulated
- Payment services regulations (PSRs) and E-Money regulations (EMRs) mostly do not apply except perhaps to stablecoins

## Section 1: What does this mean?

The gist of it is quite simple: Business activity relating to security tokens (Specified Investments, Transferable Securities) or tokens that constitute E-Money or are involved in payment services

---

<sup>1</sup> CP 19/3: Guidance on Cryptoassets. Link: <https://www.fca.org.uk/publications/consultation-papers/cp19-3-guidance-cryptoassets>

is subject to regulation. Utility tokens and exchange tokens are not regulated so any activity in them is not regulated either.

**This regulation is the same for cryptoassets as for traditional instruments.** In FCA parlance: “The FCA is technology neutral” (§3.66).

### Token Issuance

An issuer of security tokens is not itself regulated, but the act of issuance is.

#### Security Tokens

Security tokens issuance is subject to securities issuance regulations. This mainly concerns financial promotion rules - study them, get an advisor, and please do not promise specific returns.

#### Transferable Securities

Same as for security tokens but there is an additional need for a prospectus (the same one as for traditional securities). The prospectus needs to be reviewed by the FCA. A first time issuer will also need to complete an eligibility review with the FCA. This can happen concurrently with the prospectus review, but get started early, this may take a while, especially in a new market like crypto (§3.75 - §3.81).

There are exceptions to the prospectus rule possible in the UK (as in most other jurisdictions). They mostly enable smaller issues or issues that target a smaller set of investors.

#### Utility Tokens, Exchange Tokens

These are unregulated and hence no specific rules on issuance. Same as selling shoes on ebay. Regardless, our philosophy at NKB has always been to follow the spirit of financial markets regulations and so do study up on financial promotion rules in the UK and the USA.

### Trading Exchanges and Platforms

#### Security Tokens, Transferable Securities

Exchanges offering trading in regulated instruments have quite a bit of regulation to follow. The FCA highlights a few, but is clear that there are more. Most important: operating a multi-lateral or organised trading facility, dealing in investments as principal, and dealing in investments as agent (§3.72). Bottom line: don't even think about operating a regulated instrument exchange without legal advice.

#### Utility Tokens, Exchange Tokens

These are not regulated so trading them is not regulated either. Again, it's like trading shoes on ebay. We still recommend a legal advisor though.

### Advisors, Intermediaries, Brokers

Similar to exchanges, if what you are advising on, intermediating, or broking, is a security, then a whole set of regulations apply. If you are limiting yourself to utility or exchange tokens, they do not apply, but do not operate without legal advice anyway.

### Wallet Providers and Custodians

There are specific rules relating to managing investments and safeguarding investments that apply to anyone offering these services for securities tokens.

### Payment Providers

This is where the Consultation Paper is most vague. But in general, the normal rules on money remittance and cash placement apply. Additionally for stablecoins, E-Money regulations may apply.

### Anti Money Laundering (AML) Regulations

FCA touches on this. The important point is: AML rules always apply. Given some of the participants in our market, be careful, always!

### Financial Promotion

Financial promotion rules always apply, even for unregulated tokens. “For instance, when marketing unregulated cryptoasset products, the firm must not be unclear, unfair or misleading in its marketing and make sure customers are aware the cryptoasset activity is unregulated” (§4.15).

## Section 2: What is what and what is regulated

The Consultation Paper is an alphabet soup of regulations and directives; hard to understand without the relevant background. Here we attempt to introduce some clarity into the subject.

### European vs UK Regulation

Financial markets regulation in the UK is a combination of EU and UK regulation. In general, the EU passes a directive which is then incorporated into UK law. The catch is that the incorporation is not one for one. The UK may modify some aspects. This results in a mostly overlapping **but not an identical** set of rules.

### Regulatory Perimeter

A term that the FCA uses to distinguish what falls under the definition of regulated instrument (within the perimeter) and what does not (outside the perimeter).

## Exchange Tokens

Bitcoin, Litecoin, Ethereum, and similar. Specifically: “these are not issued or backed by any central authority and are intended and designed to be used as a means of exchange” (§2.5).

The FCA has determined that these are outside of the perimeter and hence not regulated. This has broad consequences. For example an exchange offering trading only in exchange tokens would not be carrying out regulated activity and hence would itself not be regulated.

Our FCA response:  
We agree and give FCA a thumbs up.

## Security Tokens

The FCA uses the term “security token” to refer to tokens that fulfill the definition of a Specified Investment (see below).

## Utility Tokens

Essentially a catch-all term for all tokens that are neither security nor exchange tokens. Not regulated.

Note that the utility token can still be considered E-Money (see below).

## Specified Investment under RAO

*A UK term defined under the Regulated Activities Order (RAO), which is the broad financial markets regulation in the UK. Consultation paper paragraphs 3.43 - 3.47.<sup>2</sup>*

Specified Investments are all tokens that look or feel like “traditional instruments like shares, debentures or units in a collective investment scheme” (§3.43) or “those tokens that give rights to other tokens that are themselves Specified Investments” (§3.44) aka derivatives.

The most relevant types of Specified Investment (security tokens) according to the FCA:

- **Shares:** Tokens that give holders similar rights to shares, like capital distribution, voting, ownership, or control.
  - Note that the token does not need to include all those rights, any of them will do. For example a token giving right to proportional capital distribution but not control qualifies and vice versa.
  - There is some nuance as to what rights are considered control: “some tokens give voting rights on direction without it being considered control” (§3.47) - so the details of these rights are relevant. It seems to us that the FCA is using a fairly strict definition of “control”, meaning that the token must include rights which give

---

<sup>2</sup> FCA Handbook definition: <https://www.handbook.fca.org.uk/handbook/glossary/G1117.html> and definition with detailed guidance: <https://www.handbook.fca.org.uk/handbook/PERG/2/6.html>.

a near complete control of the token issuer for the token to be considered a security.

- An important point is that for the token to be considered a share-like Specified Investment, the issuer must have “share capital.” This is relevant to tokens governing Decentralized Autonomous Organisations (DAOs), which are (in theory) decentralized and hence without a central issuing party.
- **Debt:** All forms of debts and loans; “A token that creates or acknowledges indebtedness by representing money owed to the token holder” (§3.47). No maturity restrictions so ultra short or long maturity instruments count as well.
- **Warrants, Certificates, Derivatives, Rights:** Tokens subscribing, giving rights to, referencing, etc. other tokens that are themselves Specified Investments.
- **Units in collective investment schemes:** “A token that acts as a vehicle through which profits or income are shared or pooled ...” (§3.47).

**Essentially quite simple. If it feels like a security, it probably is a security.**

### Other Considerations

One of the consequences of this approach is that we feel that many of the ICO tokens issued during the hype of 2017-18 will actually not be securities. A fairly standard token model with 2-3 types of parties using it to transfer value among themselves for various services will not fulfil the FCA definition.<sup>3</sup> There are some examples at §3.53.

On secondary trading, the FCA is clear. The fact that the token is traded or used for “speculative investment purposes” does not mean that it is a security.<sup>4</sup>

Derivatives that reference exchange tokens such as CFDs, options, futures, ETNs, and similar are likely Specified Investments even though the underlying is not (§3.49 - §3.50).

We would also welcome clarity on some of the interesting features of the MakerDAO stablecoin DAI. We consider these important as these types of structures represent some of the financial innovations coming out of the crypto world.<sup>5</sup>

<sup>3</sup> It is akin to an airline miles model, where miles are given to fliers and used for various services or products from the airline directly or from other partners.

<sup>4</sup> “Much like exchange tokens, utility tokens can usually be traded on the secondary markets and be used for speculative investment purposes. This does not mean these tokens constitute Specified Investments” (§3.52).

<sup>5</sup> Hart Lambur, “Announcing US Stock Index Token, Powered by UMA and Dai,” 27 March 2019. <https://medium.com/uma-project/announcing-us-stock-index-token-powered-by-uma-and-dai-c394586c575a>

Our FCA response:

Overall we agree. The FCA is sensibly applying the existing regulatory framework to crypto. It is a view that NKB has subscribed to since it was founded. We seek clarity from the FCA on a few points:

### **1) Derivatives on non-regulated tokens**

We want to understand whether derivatives on exchange and utility tokens (unregulated tokens) are in fact Specified Investments. The FCA hints to this fact in sections 3.49 and 3.50 but the language is vague. In other words, do derivative instruments (e.g. CFDs, options, futures, and exchange traded notes) fall within the perimeter as Specified Investments even if they reference tokens that are themselves not Specified Investments such as exchange or utility tokens?

### **2) Share-like tokens giving holders right to a distribution of profit**

We have seen three distinct categories of share-like security tokens giving their holders rights to a distribution of profits.

Category 1: Token holders receive a proportion of the company's gross or net income. For example, tZero holders receive 10% of the company's gross profit. Open Finance Network (OFN) utilizes a similar structure. Token holders generally do not have any voting rights. It seems that such structures are within the perimeter, but does the relatively small proportion of the company's income being distributed matter?

Category 2: Token holders receive a proportion of a specific business income. For example a fixed percentage of a certain fee. Token holders generally do not have any voting rights. For example lottery.com gives token holders 7% of net raffle revenue. Another example is Siafund whose holders receive a proportion of network fees. Does the profit distribution applying only to a specific type of income matter?

Category 3: Token holders receive no direct distribution, but the issuer repurchases tokens on the open market. For example, Science Blockchain (a tokenized venture fund) uses proceeds from fund liquidity events to buyback tokens. Economically, it is similar to a profit distribution; the cash flows from the company to the token holders, but there is no direct distribution (or it is small). Does that satisfy the criteria of a share-like right to a profit distribution and hence qualify as a Specified Investment? We note that it is not rare for a company to use share repurchases as a method of profit distribution in lieu of dividends.

### **3) Decentralised Autonomous Organisations (DAOs)**

How does the guidance apply to tokens governing DAOs or similar structures? Such tokens give the holders control over said DAO. Token holders also often have the right to a proportional share of profits generated by the DAO, whether directly (more tokens) or indirectly (reduction of the token supply).

However, DAOs are theoretically decentralised with no incorporated body or share capital.

For the SEC, the degree of decentralisation seems to be relevant, meaning that if some group effectively controls a large proportion of the token, it is not truly decentralised.<sup>6</sup> The FCA is a bit murky on this: “The nature of the network does not determine whether a token is a security or not. A security token is determined by its intrinsic characteristics and the rights it confers on holders ... However, the more decentralised the network the less likely it is that the token will confer enforceable rights against any particular entity, meaning it may not confer the same or equivalent rights as Specified Investments” (§4.13). Example: MakerDAO and the MKR token.

#### **4) MakerDAO MKR token role to stabilise the DAI ecosystem**

The MKR token entails the automatic creation of new MKRs which are sold to recollateralize the system in the event of a large fall in the value of the collateral in the DAI CDP contracts. Is the theoretical existence of such ongoing ICO relevant?

#### **5) Collateralized Debt Positions (CDPs)**

CDPs were made famous by the MakerDAO stablecoin DAI, but similar constructs are now used in a variety of projects. In essence it is a loan of the DAI that is collateralized by some other cryptocurrency (often ETH). For the privilege of taking out the loan, you pay a stability fee in % which economically works like an interest.

It is clear that CDPs have features of a debt instrument. However, there is no legal issuer. The issuer is the smart contract running on a decentralized network.

Finally, the most publicized use of the CDP (DAI) is to gain leverage over the underlying ETH, in essence to buy ETH on the margin. As such, the CDP can be understood as a form of a derivative on ETH and hence within the perimeter as a Specified Investment as outlined in sections 3.49 - 3.50.

#### **6) ICOs issued during the boom of 2017/2018**

It's our understanding that most of these would fall outside of the perimeter: we seek clarity on whether this is correct. Example: Filecoin, Basic Attention Token (Brave), Civic.

#### **7) Proof of Stake**

Proof of Stake systems exhibit features of a debt position where token holders deposit their tokens into the staking mechanism and are rewarded an economic rent for their troubles. There is no issuing entity as the earned tokens (the rent) are usually created automatically on the chain. We feel that given the lack of a central issuing entity means

<sup>6</sup> William H. Hinman, “Digital Asset Transactions: When Howey Met Gary (Plastic),” 14 June 2018. <https://www.sec.gov/news/speech/speech-hinman-061418>

that the token would not be classified as a Specified Investment, however the issue is important enough to seek clarification anyhow.

### Financial Instrument under MiFID II

*EU Term defined under the EU Markets in Financial Instruments Directive II (MiFID II) and incorporated into UK law.<sup>7</sup>*

For purposes of the Paper, this is the MiFID II equivalent of a RAO Specified Investments. The actual definition is a bit narrower than Specified Investment, but the FCA concerns itself with Specified Investments and uses this term mainly as the MiFID equivalent.

### Transferable Securities under MiFID II

*Defined under the EU Markets in Financial Instruments Directive II (MiFID II) and incorporated into UK law. A subset of MiFID Financial Instruments.<sup>8</sup>*

Transferable Securities are Specified Investments (security tokens) that are also traded. The FCA definition:

- A token which is “negotiable on the capital markets (for example because it can be transferred from one person to another)” (§3.47) is a transferable security.
- The token does not have to be listed in order to be considered a transferable security.
- If the token has transfer restrictions it may not be a transferable security under MiFID.

### E-Money Regulations (EMRs) & Payment Services Regulations (PSRs)

The FCA excludes exchange tokens from the E-Money definition “because, amongst other things, they are not usually centrally issued on the receipt of funds, nor do they represent a claim against an issuer” (§3.60).

Stablecoins are specifically mentioned as potentially being E-Money. It seems the FCA is not itself decided on this and is asking for feedback. Note that in the FCA’s definition, stablecoins are not only tokens that are 1:1 backed to fiat, but also tokens stabilised through other means like baskets or algorithmic supply maintenance.

A good example of where some further clarity would be helpful is the MakerDAO DAI stablecoin. It is algorithmically stabilized through supply management. However, it is not issued by a central authority.

PSRs are relevant for E-Money tokens: “Payment services regulation under the PSRs only covers activities involving funds, which can include bank notes, cash and e-money” (§3.59).

<sup>7</sup> FCA Handbook: <https://www.handbook.fca.org.uk/handbook/glossary/G1519.html>

<sup>8</sup> FCA Handbook: <https://www.handbook.fca.org.uk/handbook/glossary/G1186.html>

Our FCA response:

We are happy with the FCA's approach. The FCA could have chosen to go a much more onerous route here.

Clarity on stablecoins needed especially around decentralised structures such as the MakerDAO DAI.

### Crypto Derivatives

The FCA seems to be going out of its way to highlight the risks associated with crypto derivatives. We feel that crypto derivative products are a promising area of financial innovation that can come out of the crypto world.

Our FCA response:

We feel that FCA's tone in regards to crypto derivatives is unjustified. We do not dispute that derivatives are inherently risky or volatile nor that they should be regulated specifically. However, we dispute that crypto derivatives are inherently more risky or volatile than other types of derivatives. We can point to a number of existing non-crypto derivatives that exhibit the risks that the FCA is describing with respect to crypto derivatives. We feel that as with the overall tone of the Paper, crypto derivatives should be handled the same way as traditional derivatives. Example: Leveraged index return products (2x SPX, 3x SPX, -2x SPX) - a seemingly simple but devilishly misleading and volatile instrument.

Do you agree?

### Section 3: Next Steps for FCA

Coming up in UK regulation:

- Consultation on potential prohibition of crypto derivatives to retail investors (2019)
- Publish findings of consumer survey on the use of cryptoassets (early 2019)
- The EU Fifth Anti-Money Laundering Directive (AMLD5) will be incorporated into UK law (late 2019) with specific details on virtual currency wallet providers and exchanges.

## **DISCLAIMER:**

The information contained herein is strictly private and confidential and being furnished to a limited number of prospective investors who have the necessary professional experience of participating in private equity, unregulated schemes and other such sophisticated investments, to high net worth individuals, companies and associations and to other persons to whom it may lawfully be communicated, (all such persons being referred to together as 'relevant persons'). Any investment, or investment activity to which this document relates is only available to relevant persons and all persons who are not relevant persons should not rely or act on this document. This is not an advertisement and is not intended for public use or distribution. This document may not be reproduced, redistributed, or copied in whole or in part for any purpose without NKB GROUP AG's prior express consent.

This document has been prepared in good faith, however the information contained herein is subject to change without notice and is provided as of the dates indicated. No representation or warranty, express or implied, is given by or on behalf of NKB GROUP AG, or any of its affiliates, directors, officers, employees, advisers or any other persons as to the accuracy, fairness or completeness of the information or opinions herein and save in the case of fraud, no liability whatsoever is accepted by any such person for any loss, howsoever arising, directly or indirectly, from any use of such information or opinions or otherwise arising in connection herewith.

This document is intended for discussion purposes only and does not purport to contain all information that may be required to form the basis of an investment decision. Nothing in this document constitutes any type of recommendation or investment, account, legal, regulatory, tax or other advice. Recipients should consult their own professional advisers regarding the potential consequences of participating in any investment opportunity referred to in this document, including but not limited to the potential legal, regulatory, credit, tax and accounting impact of such an investment based upon their individual circumstances.

No action has been taken to permit the distribution of this document in any jurisdiction where any such action is required. Such distribution may be restricted in certain jurisdictions and, accordingly, this document does not constitute, and may not be used for the purposes of, an offer or solicitation to any person in any jurisdiction were such offer

In considering any performance data contained in this document, note that past or targeted performance is not necessarily indicative of future results and the value of investments and the income derived from those investments can go down as well as up. Future returns are not guaranteed and a total loss of principal may occur.

NKB Group AG. Registered No 486551t. NKB Advisory Limited is registered in England and Wales with registered number 11313961 whose registered office is at 1 Connaught Place, London, W2 2ET.

**NKB Group**  
**Offices: London, Vienna/Bratislava, Tel Aviv**  
[www.nkbgroup.io](http://www.nkbgroup.io)