

UNDERSTANDING DIGITAL TOKENS

# Legal Landscapes Governing Digital Tokens in the United Kingdom



*Prepared by the Token Alliance – an industry initiative of the Chamber of Digital Commerce*

## CHAMBER OF DIGITAL COMMERCE

The Chamber of Digital Commerce is the world's largest trade association representing the blockchain industry. Our mission is to promote the acceptance and use of digital assets and blockchain technology. Through education, advocacy, and working closely with policymakers, regulatory agencies, and industry, our goal is to develop a pro-growth legal environment that fosters innovation, jobs, and investment.

## TOKEN ALLIANCE

The Token Alliance is an industry-led initiative of the Chamber of Digital Commerce, developed to be a key resource for the emerging industry surrounding the generation and distribution of tokens using blockchain technology. Comprised of more than 400 industry participants, the Alliance includes blockchain and token and legal experts, technologists, economists, former regulators, and practitioners from around the globe. The Token Alliance develops community-driven guidelines for the responsible development of tokens.

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Promotes real-world application of smart contracts to enhance the way business is conducted.



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### STATE WORKING GROUP

Engaging with state and local governments on the regulation and implementation of blockchain technology.



### CHAMBER OF DIGITAL COMMERCE CANADA

Promoting the acceptance and use of digital assets and blockchain-based technologies in Canada.

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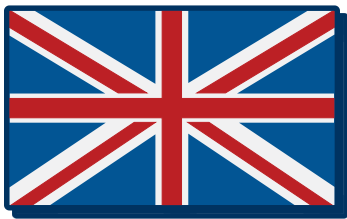
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# II. PART 1: REGULATORY OVERVIEW OF DIGITAL TOKEN MARKETS

## SECTION 3: UNITED KINGDOM



### I. INTRODUCTION

The regulation of digital tokens is a developing area as the current United Kingdom (“U.K.”) financial services law was not developed with the use of digital tokens in mind. Over time new legislation may well be introduced (and interpretations of current legislation may change) to take account of the expected increase in the use of digital tokens, sharp and frequent price volatility of digital tokens and to safeguard the economy against the use of digital tokens (such as virtual currencies) for criminal purposes and intent. It also is important to bear in mind that subtle differences in the legal structure and commercial function of a digital asset can have significant regulatory consequences. It is not a “one size fits all” regime.

### II. POTENTIAL LEGAL CLASSIFICATION AND RELATED REGULATORY CONSIDERATIONS

#### A. OVERVIEW

Broadly, there are several generic approaches to the regulation of digital tokens in the U.K. One is to treat them as a commodity or other form of physical property. Where this is the case, the marketing, purchase and sale of the digital token will largely be unregulated from a U.K. financial services law perspective, save if the contracts for the trading of the digital tokens fall within the scope of the U.K. law definitions of a derivative. Another is to treat them as a financial instrument (principally a security) but also possibly a unit in a fund (including a collective investment scheme, which is broadly defined

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## GENERIC REGULATORY APPROACHES TO TOKENS IN THE U.K.

**1** | A COMMODITY  
OR OTHER FORM  
OF PHYSICAL  
PROPERTY

**2** | A FINANCIAL  
INSTRUMENT

**3** | MONEY OR FORM  
OF CURRENCY

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and capable of capturing arrangements involving digital tokens or an alternative investment fund). The third approach is to treat them as money or a currency (potentially e-money or entailing the provision of a payment service).

In this regard, whether the digital token will be subject to regulation will depend on whether it is designed as a medium of exchange or whether it has more narrow functions such as solely enabling for the payment for services provided within the particular digital token's closed infrastructure.

The regulatory categorization of the digital token is important as it will determine the extent to which (if at all) any U.K. authorization, prospectus, marketing restrictions, systems, controls, procedural, conduct of business, anti-money laundering and anti-terrorist financing requirements apply.

### B. U.K. COLLECTIVE INVESTMENT SCHEME ANALYSIS

The term "Collective Investment Scheme" ("CIS") is deliberately broad and vague and so it is capable of capturing a wide range of arrangements even if the parties to the arrangements do not intend to create or establish a 'fund' or a collective investment.

Section 235 of the Financial Services and Markets Act 2000 (as amended from time to time) ("FSMA") defines a CIS as "any arrangements with respect to property of any description... the purposes or effect of which is to enable persons taking part in the arrangements... to participate in or receive profits or income arising from the acquisition, holding, management, or disposal of the property or sums paid out of such profits or income."<sup>1</sup>

Further elements of the definition are that the participants do not have day-to-day control over the management of the property.<sup>2</sup>

In addition, the arrangements must have either of the following characteristics:<sup>3</sup>

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1 Section 235 of FSMA.  
2 *Id.*  
3 *Id.*

- » pooling of contributions and profits or income of the participants in the scheme (which would include the holders of the digital tokens); and
- » the property is managed as a whole on behalf of the operator of the scheme.

Typically, a CIS takes in money from investors and invests it in some other type of property. It is that other property, plus any uninvested contributions and undisbursed profits and income, which would normally be regarded as the underlying property of the CIS.

In the context of digital tokens, arrangements are capable of being treated as a CIS in circumstances where participants pay cash to an 'issuer' in exchange for a certificate or token which gives the participants/investors an entitlement to underlying property (e.g., gold, silver, wine, art, etc.), if the underlying property is managed by a third party (the term managed could entail administrative functions such as arranging for the property to be stored and/or insured) or if the contributions or profits of the participants/investors are pooled. Therefore arrangements relating to digital tokens need to be carefully scrutinized to determine whether they are within the U.K. CIS regime even if the intention is not to create a fund or collective investment.

Even if the arrangements fall within the basic definition of a CIS, they will not be caught if an exemption in the Schedule to the FSMA Collective Investment Scheme Order 2001 (the Order) applies. There are exemptions for arrangements relating to debt instruments, joint venture arrangements and those structured as bodies corporates.

The regulatory consequences of an arrangement relating to a digital token being a CIS are twofold:

- » A CIS arrangement triggers authorization requirements and compliance with certain rules for certain parties.

For example, establishing, operating or winding up a CIS is a regulated activity under Section 19 of FSMA and no exemption applies. This may be relevant to the person who is charged with establishing the arrangements, or arranging for the issuance of the certificates or tokens relating to digital tokens or arranging for the tokens to be stored and/or insured. Therefore, if this is done in the U.K., the operator will require authorization from the U.K. Financial Conduct Authority (FCA). Other activities that may require authorization, in relation to arrangements that amount to a CIS include managing investments, advising, dealing as principal or agent and arranging. It is an offence to carry on a regulated activity without authorization under Section 23 FSMA. Any contracts made by an unauthorized person (with participants/investors) in carrying on a regulated activity are unenforceable unless the court is satisfied that it is just and equitable to allow them to be enforced pursuant to Section 28 of FSMA.



» A CIS arrangement will have an impact on the ability to market the CIS to investors in the U.K.

For example, it may only be possible to market the CIS to certain professional investors, high net worth individuals or certified sophisticated investors as units in a CIS are “controlled investments” under FSMA, and so Section 21 and Section 238 of FSMA will apply to their marketing.<sup>4,5</sup>

### C. U.K. ALTERNATIVE INVESTMENT FUND ANALYSIS

An Alternative Investment Fund (“AIF”) is defined in Article 4(1)(a) of the Alternative Investment Fund Managers Directive (“AIFMD”) as any “collective undertaking including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy and which is not required to be authorized under Article 5 of Directive 2009/65/EU” (the EU Directive dealing with authorization of open ended retail funds). All elements of the AIF definition must be present in order for the digital token arrangements to be treated as an AIF.

An AIF is a particular type of fund or collective investment vehicle, which overlaps in certain respects with the definition of a CIS, but they are not exactly the same. For example, an arrangement structured as a closed ended body corporate is capable of being categorized as an AIF whereas such an entity would not be a CIS.

Arrangements that relate to body corporates, partnerships, unincorporated associations and a fund set up as a trust, which pool together capital raised from participants/investors for the purposes of investment (e.g., the pooled capital is used to purchase gold or silver) with a view to generating a pooled return for those investors from investments (e.g., the arrangements are capable of generating a return for the participants) may amount to an AIF.

An arrangement relating to digital tokens that meets the basic definition of an AIF under the AIFMD will not constitute an AIF if it falls within an exemption under Article 2 of the AIFMD. There are exemptions for holding companies, certain joint ventures and securitization special purpose vehicles.

The regulatory consequences of an arrangement being an AIF may trigger a requirement for the manager to be authorized (known as the AIFM), the appointment of a depositary, and compliance with various procedures, controls, capital and conduct requirements. There are restrictions in relation to the marketing of AIFs, including the type of investors who can be marketed to, prior notifications to EU regulators and reliance on private placement rules.

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4 Section 238(1) of FSMA restricts the marketing by authorized persons of an unregulated CIS unless it falls within one of the exemptions to this restriction (under FSMA (Promotion of Collective Investment Schemes) (Exemptions) Order 2001) (as amended) (the “CIS Promotion Exemptions Order”) or under Chapter 4 of the Conduct of Business Sourcebook of the FCA Handbook.

5 Authorized persons may market unregulated CISs to certain categories of persons in the U.K. under the CIS Promotions Order, including, investment professionals (Article 14), certified high net worth individuals (Article 21), high net worth companies (Article 22), sophisticated investors (Article 23), self-certified sophisticated investors (Article 23a), associations of high net worth or sophisticated investors (Article 24).

## D. U.K. E-MONEY ANALYSIS

E-money is defined in the Directive 2009/110/EC as electronically (including magnetically) stored monetary value represented by a claim on the electronic money issuer which: (i) is issued on receipt of funds for the purposes of making payment transactions; (ii) is accepted by a person other than the electronic money issuer; and (iii) is not otherwise excluded. The E-money directive is implemented in the U.K. through the Electronic Money Regulations 2011.

There is an explicit exclusion for monetary value stored in instruments that can be used to acquire goods or services only in the issuer's premises or under a commercial agreement with the electronic money issuer, either within a limited network of service providers or for a limited range of goods and services (the limited network exclusion) which may be relevant for arrangements involving digital tokens. The Payment Services Regulations 2017 introduced a notification obligation on firms relying on this exclusion where the total value of the payment transactions executed by the firm under the limited network exclusion exceeds € 1 million over a 12-month period.

In many instances, the digital token will not be treated as e-money because:<sup>6</sup>

- » there is no claim against the issuer of the digital token for the value of the digital token acquired (indeed, in many instances, there will not even be an issuer);
- » it does not have 'monetary value' (as it is not a currency); and
- » the digital token is not issued on receipt of funds (*e.g.*, assuming that the term "funds" means fiat currency, which is a term used to differentiate between "real currency" - meaning traditional currency such as USD, GBP, Euro, and Yen - from virtual currency).

However, the success of the digital token over time could alter how it is categorized from a regulatory perspective (*e.g.*, it is accepted as a medium of exchange - *i.e.*, currency - and therefore has monetary value).

If the digital token is e-money, this may require the issuer of e-money to be registered with the FCA, though there is a lighter touch regime for small e-money issuers. E-money issuers are subject to certain capital requirements, systems and controls, reporting and operational requirements.

## E. U.K. PAYMENT SERVICES ANALYSIS

The Payment Services Directive ("PSD") regulates a broad range of services including those that enable: (i) cash to be placed on a payment account, (ii) cash withdrawals to be made from a payment account, (iii) the transfer of E-money; (iv) the execution of payment transactions where the funds are covered by a line of credit (*e.g.*, direct debits, credit transfers), (v) customers to purchase goods and

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<sup>6</sup> Article 2(1) of the Electronic Money Regulations 2011, Article 2(1) of the Payment Services Regulations 2017 and Glossary of the UK FCA Handbook.

services through their online banking facilities or by e-money, and (vi) money remittance that does not involve the creation of payment accounts .

In many cases, the issuance as well as the purchase and sale of the digital token will not amount to the provision of a payment service subject to regulation under PSD, on the basis that the arrangements do not:

- » enable cash to be placed on a payment account or cash withdrawals to be made;
- » enable direct debits or credit transfers (e.g., standing orders) to be made;
- » facilitate payment transactions where the funds are covered by a credit line since the digital token holders have to pay for the digital token upfront (i.e., they are pre-paid); and
- » there are no money remittance services as funds are not received from a payer for the sole purpose of transferring a corresponding amount to a payee or to another payment service provider acting on behalf of the payee, and the funds are not received on behalf of, and made available to, the payee.

There is an exclusion for services based on specific payment instruments that can be used only in a limited way, which may be relevant in the context of digital tokens provided that they meet one of the following conditions:<sup>7</sup>

- » they allow the holder to acquire goods or services only in the issuer's premises;
- » they are issued by a professional issuer and allow the holder to acquire goods or services only within a limited network of service providers which have direct commercial agreements with the issuer;
- » they may be used only to acquire a very limited range of goods or services; or
- » they are valid only in a single EEA State, are provided at the request of an undertaking or a public sector entity, and are regulated by a national or regional public authority for specific social or tax purposes to acquire specific goods or services from suppliers, which have a commercial agreement with the issuer.

Those who provide payment services may be required to be authorized by the FCA and must comply with certain systems, controls and conduct requirements.

## **F. OTHER U.K. REGULATED ACTIVITIES ANALYSIS**

Arrangements relating to digital tokens may entail the carrying on of a regulated activity. Section 19 of FSMA states that a person must not carry on a regulated activity in the U.K., or purport to do so, unless he is an authorized person or exempt person or an exclusion applies. This is referred to as the

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<sup>7</sup> Schedule 1, Part 2, 2(k) of the Payment Services Regulations 2017.

“general prohibition.” Carrying on a regulated activity in breach of the general prohibition is a criminal offence and may result in certain agreements being unenforceable.

A regulated activity is described in FSMA as a specified activity that relates to a specified investment or property of any kind and is carried on by way of business (Section 22, FSMA). Specified activities include dealing as principal or agent in a specified investment, making arrangements “with a view” to persons buying and selling certain specified investment, bringing about transactions in specified investments as well as safeguarding and administering tokens. Specified investments include shares, debt instruments, collective investment schemes, e-money and derivatives as defined in the FSMA (“Regulated Activities”) Order 2001 (“RAO”). Whilst digital tokens are not specifically identified as a specified investment, the characteristics of the digital token would have to be assessed against the criteria of each specified investment to determine whether it is within scope.

In addition, any platform on which the digital tokens are traded or exchanged may be considered to be a regulated market, a multilateral trading facility or an organized trading facility if the digital token is categorized as a specified investment.

Even if a regulated activity is being performed, authorization under FSMA may not be required if an exclusion is available. There are various exclusions in the RAO that may be relevant in the context of digital tokens including for overseas persons or whether the activity is carried out in connection with the sale of goods or the supply of services or there is an absence of holding out.

In the event of a regulated activity being performed and there is no available exclusion, there are three consequences to the digital token being categorized as a specified investment under the FSMA and the RAO as follows:

- » the marketing of the digital token may be restricted under Section 21 and/or Section 238 of FSMA or subject to compliance with certain conduct rules;
- » accessing the platform or exchange and its use by participants may be restricted; and
- » the operator of the platform, the custodian of the digital tokens, the issuer of the digital token and those who make arrangements for others to acquire the digital tokens may be required to be authorized. This in turn would trigger the requirement to comply with certain capital, systems, controls and conduct requirements.

Even if the digital token is not categorized as a specified investment under FSMA and the RAO, the platform or exchange on which the digital token is bought or sold may be considered to be a commodity trading platform. It should be noted that there is no EU-wide regime for commodity trading platforms and so the analysis of whether a commodity trading platform needs to be regulated in a particular EU Member State will have to be considered on a country by country basis. A pure commodity platform would not currently be required to be regulated in the U.K. under FSMA.

## **G. REGISTRY, SETTLEMENT AND CLEARING**

Many digital token systems will operate on a distributed ledger technology basis to register transfers of digital tokens between parties. As such, it is not considered likely that such a system will fall within the current boundaries of regulation in the U.K. However, systems which involve the transfer of digital tokens against value are being reviewed by a number of regulators including in the U.K. because of their resemblance to payment systems.

Digital token arrangements may also require a settlement system in order to transfer the digital token from one account or e-wallet to another and record the transaction pursuant to which the digital token is transferred and the movement of the corresponding “consideration.” Indeed, if over time, the digital token becomes accepted as a medium of exchange for goods and services, then it may be necessary either to expand its registry system into a payment system or settlement system or to develop interoperability between the digital token settlement system and other virtual currency and/or fiat currency payment systems, which may result in it developing into a clearing system.

An entity which interposes itself between “counterparties” to certain types of contracts, thereby becoming the buyer to every seller and the seller to every buyer may be required to be authorized or registered as a central clearing party (“CCP”). This may be applicable to certain infrastructure arrangements involving digital tokens, depending on how they are categorized under the financial system. In the U.K., CCPs are supervised by the Bank of England and are subject to various capital, systems and controls, margin, and procedural requirements.

## **H. FUTURE U.K. REGULATORY DEVELOPMENTS**

European regulators, including the FCA, have recently issued warnings regarding the risks associated with investing in digital tokens such as bitcoin and ether. This has principally been driven by the recent volatility in the price of these virtual currencies. The FCA has warned investors that:

(a) virtual currencies are not issued or guaranteed by a central bank or public authority; (b) virtual currencies do not have any legal status as a “fiat currency”; and (c) the purchase and sale of virtual currencies are not subject to safeguards and protections as they are unregulated in the U.K.<sup>8</sup>

The U.K. Government has signaled its intention to extend certain anti-money laundering and counter terrorist financing rules to virtual currency exchange platforms and certain custodial e-wallet providers through proposed changes to the EU Fourth Anti-Money Laundering Directive and the Fifth EU Anti-Money Laundering Directive.

If adopted, the Fifth EU Anti-Money Laundering Directive, which is expected to be agreed at the EU level this year, will require virtual currency exchange platforms and custodial e-wallet providers to

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<sup>8</sup> FCAWebsite: Consumer Warning about the risks in investing in cryptocurrency CFDs (dated 14/11/2017). FCA Website: Consumer warning about the risks of Initial Coin Offerings (dated 12/09/2017).

conduct KYC due diligence checks on traders and users to determine their source of wealth and their source of income. Additional checks would be required if the trader or user is located in a “high risk” jurisdiction. In essence this will require virtual currency traders/users to disclose their identities and exchange platforms and e-wallet providers will be required to report any suspicious activity to the national crime agency.

Whether this will ultimately lead to virtual currencies and other digital tokens being subject to bespoke general regulatory rules which introduce authorization requirements, prospectus-like disclosures, marketing restrictions, systems, controls, procedural, and conduct of business requirements remains to be seen. In a recent statement the FCA announced that it will be issuing joint guidelines (expected in late 2018) with the Bank of England on the possible future regulatory treatment of virtual currencies.

The FCA also recently stated that:

- » “cryptocurrency derivatives are...capable of being treated as financial instruments under [MiFID II], although [the FCA] does not consider cryptocurrencies to be currencies or commodities for regulatory purposes...Firms conducting regulated activities in cryptocurrency derivatives must, therefore, comply with all applicable rules...and regulations;”<sup>9</sup> and
- » it is “likely” that firms engaging in certain activities (e.g., dealing, arranging and advising) “in relation to derivatives that reference either cryptocurrencies or tokens issued through an initial coin offering (ICO), will require authorization by the FCA.”<sup>10</sup>

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9 <https://www.fca.org.uk/news/statements/cryptocurrency-derivatives> The FCA does not provide a definition for “so-called cryptocurrencies.”

10 Ibid.



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