3-2019

Proposed regulatory framework of crypto-assets in the UK: A critical analysis

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18 March 2019

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On 23 January 2019, the Financial Conduct Authority (FCA) issued a guidance on cryptoassets (FCA-GC) with the purpose of improving and clarifying the regulatory framework of cryptoassets in the United Kingdom. The FCA welcomes comments from the general public. In a response to this guidance, I seek to address two fundamental flaws that I have found in the FGC-GC: (i) the misleading classification of tokens proposed in the guidance; and (ii) the lack of protection of the purchaser of tokens and other stakeholders.

The FCA-GC categorises crypto-assets into three types of tokens: (i) *exchange tokens*, for those tokens that can be used as a means of exchange; (ii) *security tokens*, for tokens meeting the definition of a security or specified investment; and (iii) *utility tokens*, for those cryptoassets granting rights to a current or prospective product or service provided by the issuer. In my opinion, this classification is misleading. As mentioned in my recent paper on Initial Coin Offerings ("ICOs"), co-authored with Nydia Remolina, many regulators – including the FCA in this guidance– mix up the *function* of a token with its *legal nature.*From a legal (securities regulation) perspective, tokens can only be classified as a *security*(financial instrument) or not.

Therefore, the FCA should abandon the classification of cryptoassets adopted in its guidance. Instead, following what my-author and I have proposed in our paper, I would suggest classifying tokens based on their criteria: (i) legal nature; (ii) functionality; (iii) accounting and finance nature.

From a *legal perspective,*tokens can only be classified as security tokens or non-security tokens. This classification would depend on whether the token, based on its features and distribution, meets the definition of security existing in a particular jurisdiction. From a *functional perspective,*tokens could be classified as utility tokens, payment tokens and asset tokens, as proposed by FINMA. From a *finance perspective,*tokens can only be classified as equity tokens or debt tokens, depending on the rights conferred to the purchasers of tokens ("tokenholders"). If a tokenholder is entitled to a fixed return or to a given set of products or services, we propose to classify these tokenholders as debtholders. By contrast, if the tokenholder is entitled to variable returns depending on the issuer´s future performance, the tokenholder should be classified as an equityholder, even if these equityholders should be distinguished from shareholders in the context of corporations.

The regulatory framework proposed by the FCA also fails to protect tokenholders and other stakeholders. First, under the regulatory approach proposed by the FCA, the regulator cannot easily investigate ICOs. They can only investigate those issuances of security tokens reported to the regulator. Therefore, there will be a high risk of scams, as well as situation in which promoters will not comply with securities laws when they should. To solve this problem, my co-author and I propose that *any*issuance of tokens, no matter whether they are security or non-security tokens, should be disclosed to the securities regulator (or any other public agency) through a simple, harmonized *electronic form*. This electronic form should contain some basic information of the issuer and the ICO, including the promoter´s location, description of the token, blockchain governance, qualifications of the technical team, and risk

factors, as proposed by some authors. Likewise, we believe that it should also include other information potentially relevant for investors and consumers, such as the identity of the promoters and their legal advisors, the accounting and finance aspects of the ICO, and any legal or contractual provisions available to protect tokenholders.

Second, the FCA-GC does not recommend banning the purchase of tokens to some institutions whose particular features should make them ineligible to engage in (at least) pre-sale of tokens, that is, tokens referred to products, technology or projects that have not been developed yet. In my opinion, due to the riskiness of these tokens, commercial banks and pension funds should not be allowed to participate in a *pre-sale* of tokens. On the one hand, these institutions invest savings and retiring pay of many non-adjusting creditors (that is, debtholders unable to adjust the terms of their contracts). On the other hand, the potential losses associated with these institutions may create several externalities for society, including lack of confidence and, ultimately, systemic risk. Finally, it should be taken into account that more than 80% of ICOs are scams. Therefore, while there could be some individual and social gains (e.g., profitability and promotion of innovation) associated with allowing commercial banks and pension funds to engage in this type of trading, there are seem to be more risks and costs associated with this policy. As a result, even if the purchase of pre-sale of tokens is accompanied by an increase in the level of capital of these institutions, I do not find convincing reasons to allow pension funds and commercial banks to engage in these investments. If so, they would only be allowed to purchase tokens associated with products and technologies already developed.

Finally, the FCA-GC does not seem to provide an adequate protection to non-security tokenholders -- that is, the purchasers of non-security tokens. While security tokenholders are protected by securities laws, non-security tokenholders have been left basically without any legal protection – only the white paper, whose enforceability is not even clear. Therefore, in addition to the protecting non-security tokenholders through the electronic form, I think other legal devices should be implemented, including the imposition of cooling off periods, regulation of products, conduct obligations or litigation rules. By implementing these mechanisms, not only non-security tokenholders will enjoy a higher level of protection ex post, but it will also incentivize better behavior ex ante by promoters seeking to take advantage of consumers' biases, asymmetries of information and minimum legal protections.

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