



A GUIDE TO THE UK REGULATIONS
FOR CRYPTOASSET BUSINESSES

Key Takeaways from NCA's National Strategic Assessment of Serious and Organized Crime 2020

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Key Takeaways from NCA's National Strategic Assessment of Serious and Organized Crime 2020

The NCA's 2020 [National Strategic Assessment of Serious and Organized Crime](#) identified some 2018 trends which became more prevalent during 2019. These include the increased use of encryption tools, the dark web and virtual assets, which refers to technologies such as blockchain, Bitcoin, cryptoassets and virtual currencies for criminal purposes.

This is seen in reported losses of £338 million in 2018/2019 from victim reported fraud. While many victims may consider themselves financially savvy, many were enticed by the fraudulent offer of high returns from investments into cryptoassets.

And criminals continue to identify new ways of using virtual assets for criminal purposes. For example, they use virtual assets, such as Bitcoin, to buy and sell commodities on illicit online marketplaces and to launder criminal profits. The fear is that the rapidly rising value of virtual assets will lead to an increase in their popularity and use.

It is therefore essential to develop new and robust privacy features for virtual assets. It is reported that six of the top 10 most valuable cryptocurrencies are developing these features.

£338 million reported victim losses from investment fraud in the year ending March 2019, many were enticed by the fraudulent offer of high returns from investments into cryptoassets.

A summary of UK AML/CFT laws for cryptoasset providers

On 10 January 2020, the amendments made to the UK's Money Laundering Regulations ([Money Laundering and Terrorist Financing \(Amendment\) Regulations 2019, the "ML Regs"](#)) came into force.

These amendments incorporate international standards set by the Financial Action Task Force (FATF) and to transpose the EU's 5th Money Laundering Directive.

Virtual Asset Service Providers (VASPs) functioning in the UK are required to register with the FCA and follow its guidance and rules on anti-money laundering, including adhering to the international standards set by FATF and complying with ML Regs.

The UK government remains active. In the first week of January this year, the Treasury released a consultation paper to gather feedback from industry and stakeholders on the government's regulatory approach to cryptocurrencies and stablecoins.

This consultation solicits opinions on how the UK can ensure that its regulatory framework is "equipped to harness the benefits of new technologies, supporting innovation and competition, while crucially maintaining the highest regulatory standards so that people can use new technologies reliably and safely."

In this guide, we will discuss the current regulations for VASPs in the UK, upcoming regulations, and FCA's registration procedure for cryptoasset providers.

"The UK has the potential to be a leading global centre for the issuance, clearing, settlement, trading and exchange of crypto and digital assets."

Kalifa Review of UK Fintech

What does the FCA consider a cryptoasset?

According to the ML Regs, a cryptoasset is a cryptographically secure digital representation of value or contractual rights that uses a form of distributed ledger technology and can be transferred, stored, or traded electronically;

cryptoassets include both those that are centralized, i.e., issued by an administrator, and those that are decentralized.

What are cryptoasset exchange providers?

A cryptoasset exchange provider is a firm or sole practitioner which, by way of business provides one or more of the following services, including where the firm or sole practitioner does so as creator or issuer of any of the cryptoassets involved when providing such services:

1. Exchanging, or arranging or making arrangements with a view to the exchange of, cryptoassets for money or money for cryptoassets.
2. Exchanging, or arranging or making arrangements with a view to the exchange of, one cryptoasset for another, or
3. operating a machine that utilizes automated processes to exchange cryptoassets for money or money for cryptoassets.

What are custodian wallet providers?

A custodian wallet provider is a firm or sole practitioner who, by way of business provides services to safeguard, or to safeguard and administer:

1. Cryptoassets on behalf of its customers, or
2. private cryptographic keys on behalf of its customers in order to hold, store and transfer cryptoassets, when providing such services

Which businesses need to be regulated?

From 10 January 2020, existing businesses (meaning those operating immediately before 10 January 2020) carrying out cryptoasset activity in the UK must be compliant with the ML Regs. This includes the requirement to have been registered with the FCA by 9 January 2021 in order to continue doing business.

Those businesses which began operating after 10 January 2020, are required to obtain full registration with the FCA before conducting business.

Though the FCA's crypto registration is not called a licensing regime under the law, it is regarded as similar to a license, as cryptoasset providers (such as cryptocurrency exchanges and custodian wallet providers) are not able to function in the UK without it.

cryptoasset exchange and custodian wallet providers based in the UK come under the ML Regs and they must [register with the FCA](#) and comply with ML/CTF regulations in order to continue their business in the UK.

“Almost a third of Brits (31%) are curious about investing in cryptocurrency.”

Ziglu and OnePoll Survey

What about Brexit?

On 16 December 2020, the Financial Conduct Authority (FCA) [announced the establishment of its Temporary Registration Regime](#).

This allows existing cryptoasset firms which have applied to be registered with the FCA to continue trading. The FCA is advising customers of cryptoasset firms that should have applied to the FCA, but have not done so, to withdraw their cryptoassets or money before 10 January 2021.

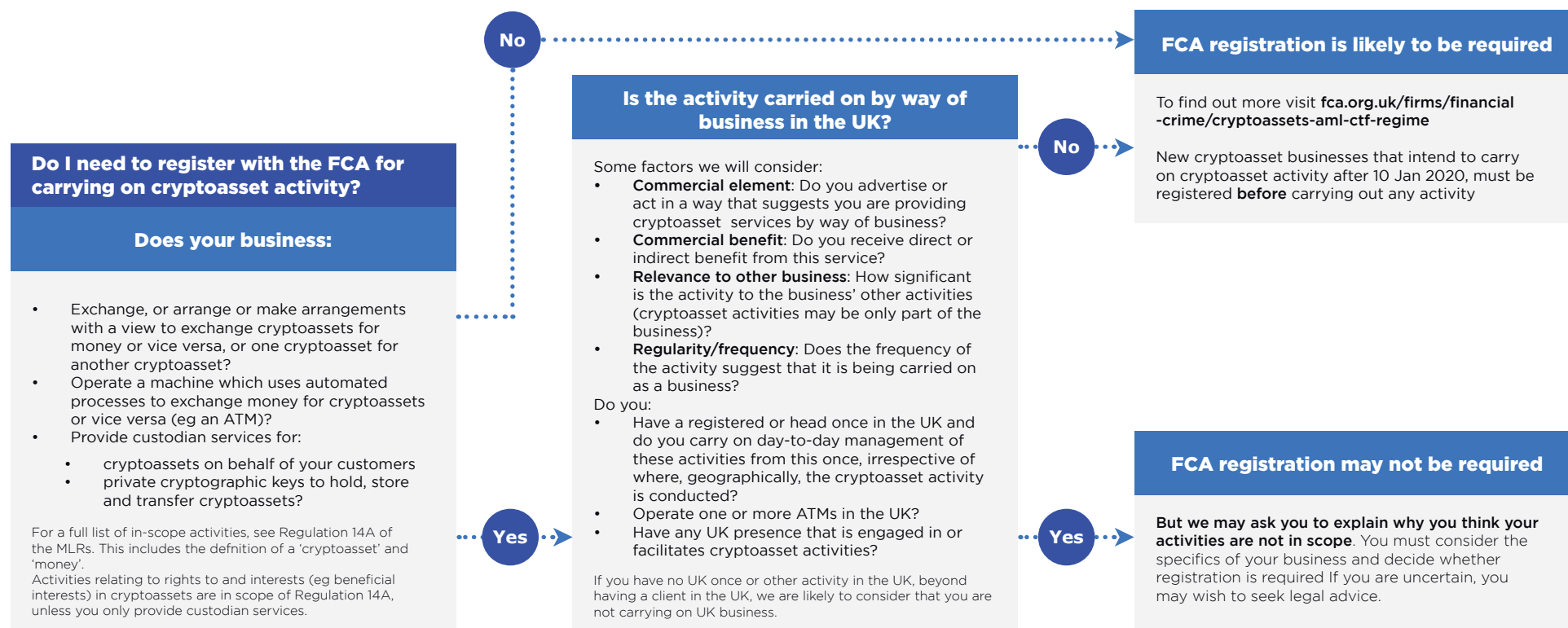
The Temporary Registration Regime is for existing cryptoasset businesses that have applied for registration before 16 December 2020, and whose applications are still being assessed. This is to enable those existing businesses to continue to trade after 9 January 2021 until 9 July 2021, pending the FCA's determination of their application. New businesses (who began operating after 10 January 2020), are required to obtain full registration with the FCA before conducting business.

“Cryptocurrency is most popular in London, where three in ten people (30%) have already bought some.”

Ziglu and OnePoll Survey

Do I need to apply to the FCA for registration?

A crypto-asset provider or custodian service provider that maintains a physical presence in the UK (such as an office or ATMs) or is engaged in or facilitates crypto-asset activities needs to be registered with the FCA. Those who don't have an office or other activity in the UK, beyond having a client in the UK, are unlikely to be considered by FCA as they are not conducting their business in the UK. Refer to the following chart from the FCA for a detailed overview of who should be registered:



FCA's Cryptoasset Registration Flowchart

How to register?

The FCA's registration process is relatively simple. The applicants must fill in the application form on the online portal '[Connect](#)' and pay the registration fee. When filling out the application form, the applicant must indicate which of the crypto activities require registration under the AML/CTF regime it carries out or plans to carry out. One or more of the following activities can be chosen:

1. fiat-to-crypto exchange;
2. crypto-to-fiat exchange;
3. crypto-to-crypto exchange;
4. operation of a crypto ATM;
5. provision of custodian wallet service;
6. facilitation of peer-to-peer exchange of crypto;
7. participation in Initial Coin Offerings (ICO).

Once the application is submitted, the FCA may take up to 3 months to assess the application. It is important that an applicant fully discloses all the relevant information requested by the FCA in the application form.

The FCA assesses applications based on the information provided including information about the applicant and all key individuals who hold a relevant function to assess whether or not the applicant is fit and proper (as set out in Regulation 58A).

Apart from business and operational matters and the profile of key individuals, the FCA also requires a detailed proposal plan on how the applicant plans to mitigate AML/CFT risk. The FCA mandates that the applicant [outline customer on-boarding and due diligence processes along with transaction monitoring and record-keeping procedures](#).

You can find out more about the FCA's application process [here](#).

UK regulatory approach to cryptoassets and stablecoins: consultation and call for evidence

In the last two years, the UK has revamped its approach to regulating cryptoasset providers and businesses. It has made amendments to the money laundering and terrorist financing regulations and introduced an FCA registration regime and a consultation paper on the regulatory approach to crypto-assets and stablecoins.

The UK looks set to lead the global financial sector once again, this time with carefully crafted policy to encourage virtual currency adoption and innovation while keeping consumer protection at the center of its legislative agenda.

A week after officially exiting from the EU, in the first week of January, the Exchequer [released a consultation paper](#) to gather feedback from stakeholders concerning the government's regulatory approach to cryptocurrencies and stablecoins.

This paper marks the second Treasury-led crypto consultation. The first, announced last summer and concluded in October, set out plans to increase oversight in [cryptocurrency](#) promotions in order to protect investors, the results of which will be published "in due course", as per Her Majesty's Treasury's latest update. Furthermore, the FCA, which is fully-funded by the firms it regulates, has also [proposed to increase fees and levies from 2021/22](#) for all financial institutions that require a FCA's license/registration to operate, including cryptoasset businesses.

The latest consultation solicits opinion on how the UK can ensure that its cryptocurrency and stablecoin regulations are equipped to harness the ongoing advancements in technology, supporting innovation and competition while reducing risks to consumers.

Following are the key objectives of the Treasury's January 2021 consultation paper:

1. Protecting financial stability and market integrity. This includes maintaining the appropriate regulatory standards, ensuring infrastructure is operationally resilient and that safeguards are in place to mitigate any risks to financial stability.
2. Delivering robust consumer protections. This means ensuring consumers benefit from the same level of protection they would when other regulated instruments are being used for the same purpose (e.g. payments).
3. Promoting competition, innovation and supporting UK competitiveness. This means continuing to encourage and support UK fintech firms, and ensuring consumers and businesses have access to a variety of high-quality services and products.

The UK government is planning to achieve the above objectives by following a set of principles which include “maintaining the current division of UK regulator responsibilities as far as possible and applying the principle of ‘same risk, same regulatory outcome’. The approach supports the government’s desire to ensure a level playing field and reduce opportunities for arbitrage. In practice, it means drawing on existing regulations and requirements insofar as they are applicable, with adjustments or additional requirements where needed to address specific characteristics or risks.”

The UK government is further attempting to ensure an agile approach that reflects international discussions and also has room for accommodating future financial services and payment regulation changes.

Proposed overarching approach and related initiatives

The Treasury’s January 2021 consultation paper outlines a series of proposed regulatory changes with an objective to intensify the scrutiny of illegal cryptocurrency uses and developing a regulatory environment that not only allows the regime to keep pace and adapt as new models or innovations emerge but also ensures that the government has the flexibility to update regulation to take account of the outcomes of ongoing international efforts to develop appropriate global regulatory standards.

The government is considering an approach to cryptoasset regulation under which firm requirements are designed and implemented by the independent regulators. This would involve the independent regulators using agile powers to issue rules or codes of practice, within a framework of objectives and broader considerations set by Her Majesty’s Treasury (HMT) and Parliament.

In practice, this means that HMT will not seek to specify detailed firm requirements through legislation. Instead, the government will aim to define the scope of the regulatory perimeter and the objectives and principles applicable under that new regime. Reflecting this, the government is seeking views on those areas only in this consultation. The UK’s financial services regulators will consult on detailed firm requirements should the government adopt this approach.

Conclusion

The UK's cryptoassets market is rapidly growing. With the increased adoption of cryptoassets among consumers, according to [the FCA's own consumer research](#) in 2019, approximately 2.6 million people in the UK hold digital assets, and with the introduction of various stablecoins, the government now recognizes the need for a robust mechanism to regulate cryptocurrency uses and its service providers across all four countries of the United Kingdom.

The UK government wants to ensure that the approach it adopts encourages adoption and innovation to occur while putting safeguards in place to prevent the illicit use of crypto, such as money laundering and terrorist financing.

How Merkle Science Can Help

[Merkle Science](#) provides blockchain transaction monitoring and intelligence solutions for cryptoasset service providers and financial institutions to address their risk exposure to virtual currency-related crime in accordance with FCA AML/CTF compliance requirements.

Our Blockchain Monitor enables compliance teams to go beyond using a database of bad addresses and configure custom risk rules to identify and detect high-risk transactions or addresses. The following are a few ways through which compliance teams can customize risk parameters:

- Detect direct or indirect interactions with high-risk entities (such as coin-mixers, darknet marketplaces), ransomware addresses, scam addresses, theft and hack addresses, the US OFAC list, and other sanctioned or criminal addresses
- Set specific parameters related to frequency, size of transactions, and custom patterns to flag otherwise concealed criminal activity on the blockchain. (See [FATF's Virtual Asset Red Flag Indicators of Money Laundering and Terrorist Financing](#) for more information).
- Test and optimize risk rules within a “sandbox” environment before implementation to avoid false positives and too many/few relevant risk alerts

For more information about how Merkle Science could help your firm comply with FCA virtual currency requirements reach us at contact@merkle-science.com.



About the authors:



Claire Cummings

Claire Cummings is a solicitor who has over 20 years' experience in financial services for alternative investments, with particular expertise in cryptoassets and the digital asset arena and is currently the Managing Partner at Cummings Pepperdine.

As a solicitor, Claire has acted as alternative funds and fund managers, brokers and distributors and has spent time as in-house counsel, director, and compliance officer of a CTA advising on a wide range of transactions. Claire's work includes advising on the FCA's rules on marketing crypto-assets, MiCA, AIFMD, MiFID II, and EMIR issues, and also guiding organizations on cryptocurrencies, token issues/ICOs, setting up funds, and drafting fund documentation.

Claire draws on her experience as a solicitor, managing partner, and director of a fund management company to work with her clients as they establish and build their businesses.



Mriganka Pattnaik

Mriganka Pattnaik is the Co-Founder and CEO of Merkle Science. Merkle Science is a Singapore-based regtech company that provides blockchain transaction monitoring and intelligence solutions for digital asset service providers, financial institutions, law enforcement agencies, and government agencies to detect, investigate and prevent money laundering, terrorist financing, and other criminal activities.

Mriganka has prior experience across investment banking and technology. He has worked in investment banking at Bank of America and then subsequently at Luno, a Naspers backed cryptocurrency exchange. At Luno, he helped the company scale across three continents. He led business expansion and operations in SEA where he navigated diverse regulatory requirements and built their relationships with banks. Mriganka has also previously built his own medical technology startup in the past.





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