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Promotion of Cryptoassets to UK Consumers Will Be Regulated by UK Financial Conduct Authority

*By Jeremy C. Jennings-Mares, Gareth Rees QC, Chloe Kearns and Struan Clark**

This article outlines the key points to note about the UK government's proposal to regulate the promotion of cryptoassets and the likely practical implications for relevant cryptoasset firms.

The UK government has announced, in a recent consultation response¹ (“the Response”), that the promotion of cryptoassets to UK consumers is to be regulated. This represents a significant step towards greater regulation of the cryptoasset industry in the UK.

The promotion of cryptoassets is to generally fall within the Financial Conduct Authority’s (“FCA”) existing financial promotions regime contained in Section 21 of the Financial Services and Markets Act 2000. The government will need to propose legislation in order to effect that change. The FCA is currently consulting on how the financial promotions regime will apply to cryptoassets, once the relevant legislation is implemented, as part of a consultation (“CP22/2 Consultation”) on strengthening its financial promotions rules for high-risk investments more generally.²

This article outlines the key points to note about the proposals and the likely practical implications for relevant cryptoasset firms. The regime is likely to require fairly significant changes to the way some retail-facing cryptoasset firms (wherever they are based) are currently marketing to UK consumers and to the systems and controls of those firms.

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¹ HM Treasury “Cryptoasset promotions: Consultation response,” https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1047232/Cryptoasset_Financial_Promotions_Response.pdf.

² FCA CP22/2 (“Strengthening our financial promotion rules for high risk investments, including cryptoassets”), <https://www.fca.org.uk/publication/consultation/cp22-2.pdf>.

Whilst we do not anticipate that any rule changes will take effect for some time, UK-focused cryptoasset firms should now begin assessing what changes will need to be made, and how they will implement and embed such changes, in order to ensure that they are compliant from day one of the regime.

THE KEY PROPOSALS

What Cryptoassets Will Be in Scope?

The government currently proposes that the financial promotions regime will apply to “any cryptographically secured digital representation of value or contractual rights which is fungible and transferable.”

This definition is expected to capture a significant range of cryptoassets that currently fall outside of the UK regulatory perimeter. However, it will be drafted so as to exclude non-fungible tokens; schemes such as travel passes and supermarket loyalty programs; electronic money; and central bank money.

Who Will the Rules Apply To?

The proposed rules are intended to apply to financial promotions (i.e., communications of invitations or inducements to engage in investment activity) in respect of in-scope cryptoassets to UK customers. They will capture overseas firms marketing into the UK, as well as firms that are based in the UK (including those that are not authorized by the FCA).

Any UK firms that intend to obtain a license or an anti-money laundering registration with an overseas regulatory authority, instead of the FCA, should be aware that they will still need to comply with these rules, to the extent that they promote in-scope cryptoassets to UK customers.

Firms should be mindful that the rules will have broad application, including to marketing via social media and other online means.

Will the Exemptions to the Section 21 Restriction Be Available for In-Scope Cryptoassets?

The government is generally not proposing to make changes to the exemptions contained in the FSMA (Financial Promotion) Order 2005 for financial promotions of cryptoasset transactions. However, firms that focus their marketing activities on UK consumers will find that the most commonly-used exemptions for promotions to retail clients—the high net worth individual exemption and the self-certified sophisticated investor exemption—will not be available for their cryptoasset activities because they apply only to promotions of certain assets, including shares and debentures. They will therefore need to consider getting approval for the retail financial promotions from a UK authorized person.

What Are the Proposed Rules?

Under the FCA's proposals in the CP22/2 Consultation, in-scope cryptoassets are to be included in a new regulatory category of "Restricted Mass Market Investments," and will be subject to strict requirements. At a high level, it is proposed that financial promotions of such cryptoassets to UK retail customers will need to:

- Be fair, clear, and not misleading;
- Include the following, prescribed risk warning in a prominent place:
 - “Don't invest unless you're prepared to lose all your money invested. This is a high risk investment. You could lose all the money you invest and are unlikely to be protected if something goes wrong”;
- Not include any form of incentive to invest; and
- Be approved by a relevant FCA-authorized firm with competence and expertise in the cryptoasset market (and with the relevant permissions under the new "Section 21 Gateway" proposed by the government in its June 2021 response to the consultation on amending the financial promotions "approval regime") (unless an exemption applies).³

In addition, the FCA-authorized firm approving the promotion will have extensive obligations, including to satisfy itself that the promotion complies with the relevant requirements and to monitor the continued compliance of the promotion.

Further, firms will only be permitted to make "direct offer financial promotions" (i.e., promotions that contain an offer or invitation to enter into an agreement and specify the means by which the recipient should respond) to more sophisticated categories of investors.⁴ Such promotions will be permitted only where the firm:

1. Has embedded "positive frictions" into the customer journey (for first-time investors only), in the form of a personalized risk warning pop-up and a 24-hour cooling off period before the customer can invest;

³ Registration with the FCA under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 will be insufficient. The approving firm must be authorized under FSMA 2000.

⁴ Those investors who are "restricted," "high net worth," or "certified sophisticated." Firms should note that the government is consulting on raising the monetary thresholds used to identify "high net worth investors."

2. Categorizes its customers appropriately to ensure that they are “restricted” (i.e. customers that have declared that they have not in the previous year, and will not in the upcoming year, invest more than 10 percent of their assets in Restricted Mass Market Investments), “high net worth” or “certified sophisticated”; and
3. Assesses the appropriateness of the investment for the customer before allowing them to invest. The FCA proposes to introduce guidance on strengthening the requirements for that assessment.

TIMING

The proposed rules are unlikely to take effect for some time. The government will need to propose legislation in order to bring cryptoassets within scope of the financial promotions regime, and firms are to be given an implementation period (approximately six months) starting on the date that the legislation amending the financial promotions regime takes effect, and the FCA has published its complementary rules (including those proposed in the CP22/2 Consultation).

In the meantime, any responses to the CP22/2 Consultation had to be submitted before March 23, 2022. The FCA expects to publish the final rules in the summer of 2022 (though such rules will not take effect in relation to cryptoasset firms until the expiry of the implementation period mentioned above).

PRACTICAL IMPLICATIONS

The proposed rules will likely require certain cryptoasset firms to make significant changes to, and investment in, their systems and controls. This will particularly be the case where the firm is not already authorized by the FCA.

In practice, firms will need to, among other things:

1. Identify what promotions will be in scope of the rules;
2. Revisit and revise their policies and procedures relating to marketing;
3. Establish how they will categorize clients and assess appropriateness;
4. Ensure that there is sufficient internal governance in relation to marketing activities;
5. Embed necessary cultural changes to ensure that staff understand the need to protect the interests of retail customers and ensure that communications are fair, clear, and not misleading;
6. Consider adding staff with appropriate expertise to their compliance

function; and

7. Identify (where the firm is not authorized itself) an appropriate FCA-authorized firm that is competent to approve financial promotions of cryptoassets.

Firms should not underestimate the time it will take to identify, implement, and embed the required changes. They should begin planning and taking appropriate advice now, in order to ensure that they are compliant when the new rules take effect.

We expect the FCA to take assertive action to address failures to comply with the rules and to pursue enforcement action against firms that are consistently, or egregiously, in breach. Breaches of the rules could also expose firms to civil claims from retail customers. Further, unauthorized firms should note that failure to ensure that promotions are approved by an authorized firm could, in certain circumstances, constitute a criminal offence and render relevant agreements with their customers unenforceable.