

Surfing on the Ocean of Crypto Regulation

BY FTI CONSULTING

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The digital asset industry has expanded across the world, revolutionizing global finance options for millions. While the boundaries have expanded, the regulatory landscape remains fragmented. As well as evaluating economic incentives, companies now look at the regulatory and political sentiments when deciding on new business development opportunities.

THREE REGULATORY POWERS

If we talk regulation, the EU, the UK, and the U.S. are the three powers controlling the space. The EU has been the first mover with its Markets in Crypto Assets Regulation (MiCA). While already marked as the global standard setter, it is far from being one. The UK has taken a different approach with its consultation and call for evidence on the future financial services' regulatory regime for crypto assets, a move that can be considered as setting up for competition with the EU. Among the three jurisdictions, the U.S. is currently a watcher. It is yet to pass any comprehensive piece of legislation on crypto assets, with the Securities and Exchange Commission (SEC) taking the lead by "regulating through enforcement." The ongoing lack of regulatory clarity or roadmaps has made many in the industry and Congress skeptical of the U.S.'s position in the space, with some raising concerns about the industry offshoring.

Comparing the Narratives



EU

Political rhetoric from EU capitals has always moved toward favoring a more risk-averse and protectionist approach regarding regulation of crypto assets. The market downturn just before MiCA was finalized further reinforced this trend, emphasizing a focus on security and sovereignty.



UK

The UK government initially adopted a welcoming stance to crypto assets, but economic pressures, a prolonged bear market, and criticism from the opposition have since dampened this enthusiasm. Consumer protection is a priority across all parties, and regulators are getting more power in this area.



US

Digital asset scrutiny in Washington is at an all-time high, with senior members of Congress and regulators ringing alarm bells over the industry. The recent volatility due to the fall of FTX and the collapse of three "pro-crypto" banks have raised the ante in Washington for greater regulatory clarity to address the impact on consumers and investors.

State of Play

EU



A key regulatory instrument in the EU is MiCA – a framework dedicated to regulating any issuer and any service provider in the crypto industry. MiCA is expected to enter into force in mid-2023. MiCA provisions on stablecoins will start applying in July 2024, and provisions on issuers on other crypto assets and crypto asset service providers (CASPs) will start applying in January 2025. These rules will fundamentally change the risk profile for CASPs and issuers in the EU. Yet the debate around crypto assets is far from over despite the agreement of MiCA. The multi-stakeholder and political environment of the EU exacerbates the clash between innovation and regulation, and reviews, revisions and secondary legislation are expected in the future. Reviews of DeFi, crypto lending and NFTs are already anticipated by policymakers.

January 2025

MiCA applies to crypto service providers and crypto asset issuers

UK



The Financial Services and Markets Bill in Parliament gives regulators the power to oversee crypto firms and specifies the insolvency procedures in case of their collapse. These regulations treat crypto assets as a form of payment. Notably, the definition of “digital settlement assets” differs from the EU’s MiCA definition and currently does not include NFTs, but the Treasury has the authority to revise this definition as technology evolves. With a crucial Treasury consultation open for feedback and two select committees investigating digital assets, the avenues for engagement have never been wider, or the stakes higher.

Summer 2023

Financial Services and Markets Bill passed into law, and regulators set out plans for implementation.

US



The Biden Administration in the U.S. has been skeptical of the broad adoption of crypto without clear regulatory frameworks and guidelines for the industry and banks. In March 2022, the administration released its Executive Order on Digital Assets that outlines a series of studies and considerations for digital asset regulation and oversight. The 118th Congress is also shaping to focus more on crypto, with House Financial Services Committee Chairman Patrick McHenry (R-NC) calling for crypto regulation to be prioritized and the creation of the digital asset subcommittee. While crypto has had some bipartisan appeal, as indicated by legislation from Senators Cynthia Lummis (R-WY) and Kristen Gillibrand (D-NY) comprehensive crypto bill, generally, the parties coalesce around particular issues with Democrats focused on consumer and investor protections and Republicans, looking to innovation and global competitiveness. No legislation has gained traction. However, there are calls to prioritize stablecoin legislation and House Financial Services leadership recently introduced a bipartisan bill on the issue.

2023

No legislation has gained traction in the U.S. However, there are bipartisan calls to prioritize stablecoin legislation

A vertical image on the left side of the page shows a person surfing on a blue ocean. The image is overlaid with a digital grid pattern that curves across the scene, suggesting a connection between nature and technology. The overall color palette is various shades of blue.

Comparative Analysis

All three jurisdictions are at varying stages of crypto asset regulation, however, they share core themes that are worth analyzing for different crypto business models. The comparative analysis below shows key divergences and what to look for when entering new market.

While divergent now, it is also worth mentioning the ongoing cooperation among them. As EU policymakers view MiCA rules as a regulatory blueprint for other countries, European Commissioner for Financial Stability, Financial Services and Capital Markets Union Mairead McGuinness calls for a global approach to crypto regulation. Recently a delegation of U.S. officials visited Europe to discuss MiCA with policymakers and the industry. With the Windsor Framework - a major UK/EU post-Brexit agreement - now signed, UK officials are revisiting the UK – EU Financial Services Memorandum of Understanding. This will provide a framework for voluntary regulatory cooperation in financial services between the UK and the EU, and facilitate dialogue on financial services issues, including crypto.

We also see the potential of cooperation on international level. The U.S., UK and EU are board members of the Financial Stability Board (FSB). In the 2022 international recommendations on the regulatory treatment of crypto assets and global stablecoins, it calls for international cooperation among authorities and ensuring comprehensive governance and risk frameworks are put in place. Thus, we expect a certain level of regulatory convergence at the broadest level on both global stablecoins and crypto assets.

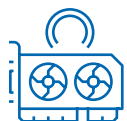
EU



UK



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ISSUANCE OF CRYPTO ASSETS

MiCA will oversee the issuance and offering of crypto assets to the public in the EU, as well as the submission of requests for the admission of such crypto assets to trade on a crypto asset trading platform. These activities will be subject to a specific set of requirements, including the obligation to release a white paper containing a comprehensive description of the proposed crypto asset offering or trading admission. It also has liability rules for the provision of incorrect, deceptive, or incomplete information in the white paper and marketing communications.

The Financial Services and Markets Bill expected to pass by the summer, seeks to bring the issuance and custody of fiat-backed stablecoins into the UK's regulatory perimeter. These will fall under the remit of the Financial Conduct Authority, the primary regulating body for financial services in the UK. At a minimum, stablecoins issued in the UK, whether in GBP or other currencies, are expected to be in scope.

Alongside this Bill, HM Treasury has recently released a consultation paper titled 'The Future financial services regulatory regime for crypto assets.' The consultation sets out the Government's proposed regulatory regime for crypto assets in the UK, including a proposal to establish an issuance and disclosures regime for admitting a crypto asset to a trading venue. This includes controls such as adequate investor protection and a minimum standard of information regarding a crypto asset being made available to investors.

The first and only comprehensive crypto asset legislation introduced last Congress- expected to be reintroduced soon- is the Responsible Financial Innovation Act. The bill addresses several aspects of the crypto asset industry. The framework also codifies legal standards for classifying crypto assets as securities or commodities. The bill establishes a regulatory regime for payment of stablecoins, requiring stablecoin issuers to maintain high-quality liquid assets valued at 100% of the face value of all outstanding payment stablecoins. The bill requires stablecoin issuers to provide public disclosures on the assets backing the stablecoin and their value. Additionally, the bill would commission various studies to provide further guidance and research on the digital asset ecosystem.

EU



UK



US



CRYPTO ASSET SERVICE PROVIDERS

MiCA lays down a series of EU registration requirements for CASPs along with specific provisions on offered services, such as custody of crypto assets, running a crypto exchange, hosting crypto wallets, or facilitating crypto transactions.

Currently, companies in the UK must register with the Financial Conduct Authority if they wish to provide crypto asset services within the scope of the money laundering regulations.

Furthermore, the 'Future financial services regulatory regime for crypto assets' consultation proposes to establish a regulatory framework for crypto trading venues. Accordingly, persons carrying out certain designated crypto activities would be subject to prudential rules and various other requirements covering consumer protection, operational resilience, and data reporting.

Registration for crypto asset service providers has yet to be implemented on a federal level; however, some states have begun their versions of registration. The New York's Department of Financial Services "BitLicense" is a special business license for cryptocurrency companies in New York. The license involves complying with know-your-customer, anti-money laundering, and capital standards. It is a limited-purpose trust charter.

Most states regulate virtual currency under existing money transmitter rules.

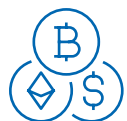
EU



UK



US



TYPES OF CRYPTO ASSETS

Crypto assets that qualify as financial instruments will fall under the Markets in Financial Instruments Directive II and be treated equally.

The MiCA Level II framework will further specify criteria for financial instruments to avoid any regulatory arbitrage.

Crypto assets not qualified as financial instruments are covered by MiCA. These are e-money tokens (EMTs), asset reference tokens (ARTs) and utility tokens.

EMTs are stablecoins designed to maintain a stable value by referencing the value of an official currency.

Asset reference tokens ARTs are another type of stablecoin designed to maintain a stable value through referencing any other value or right, such as a basket of official currencies or commodities.

Utility tokens are intended to provide access to a good or a service. They are not stablecoins and are not intended to have value beyond their intended use.

The UK Government has divided crypto assets into two distinct groups, with different timeframes for regulation. The first is fiat-backed stablecoins, which have been prioritized in 'Phase 1' of the UK's plans to legislate crypto assets.

Beyond this distinction, while HM Treasury has acknowledged the presence of different types of crypto assets such as governance tokens and Non-Fungible tokens, the Government's recent consultation seeks not to regulate types of crypto assets, but rather the activities of the crypto assets in 'Phase 2' of crypto regulation. Here, the principle of "same risk, same regulatory outcome" is applied.

The consultation marks a divergence from the sectoral approach of the EU's Markets in Crypto-assets Regulation in favoring a more flexible and tailored approach to crypto while remaining bound by the "same risk, same regulatory outcome" principle.

No legislation has gained traction so far on the classification of crypto assets. However, there are bipartisan calls to prioritize stablecoin legislation and House Financial Services leadership recently introduce a bipartisan bill on the issue.

The President's Working Group led by the U.S. Treasury Department suggests that stablecoins could pose risks to the financial services sector if left unmanaged while acknowledging the potential benefits of the technology. The agencies recommend that Congress act promptly to enact legislation to ensure that stablecoins and stablecoin payment arrangements are consistently subject to a federal framework that places stablecoins under bank-like supervision.

Stablecoin legislation is the primary focus of several Congressional bills, with House Financial Services Committee Chairman McHenry (R-NC) and Ranking Member Maxine Waters (D-CA) recently releasing a bipartisan stablecoin bill.

EU



UK



US



NFTs

European co-legislators opted to exempt NFTs from the scope of MiCA unless they act like financial instruments. However, NFTs will not remain out of scope for perpetuity as the EU has plans to regulate them.

The European Commission is mandated to submit a report 18 months after the entry into force of MiCA to evaluate the possibility and viable means of regulating these products.

There is interest from EU Member States, such as France, to promote NFTs. The French Digital Affairs Minister announced that the government would support the NFT ecosystem with public funds.

The UK Government is seeking to regulate the financial activities of crypto assets, rather than crypto asset types. If NFT's are used without falling under the list of the UK's regulated financial activities, such as authentication of a product or user's identity then they will not fall under the scope of future regulation.

Within Parliament, the Digital, Culture, Media and Sport Committee is holding an inquiry into the operation, risks, and benefits of Non-Fungible Tokens and the wider blockchain. Legislators are considering whether NFT investors are put at risk by the market. The inquiry is also investigating the wider benefits that NFTs and the blockchain could provide the UK economy, demonstrating official's interests in NFT's and the services they provide. The deadline to submit evidence to the Committee was 6 January 2023. The Committee will now consider both written and oral responses and produce a report of their findings in the next few months.

The U.S. has limited regulatory work on NFTs outside of a few subpoenas from the Securities and Exchange (SEC) to NFT creators and crypto exchanges to determine whether NFTs are being used to raise money like traditional securities.

EU



UK



US



PRUDENTIAL TREATMENT

The European Union is currently negotiating the implementation of the Basel III rules under the Capital Requirements Regulation and Directive reviews. Under the European Parliament's suggested text banks could be required to hold a "risk-weighted exposure amount" of up to 1,250% of capital based on exposure to crypto.

HM Treasury's crypto asset Consultation has proposed to establish a regulatory framework for crypto trading venues. Accordingly, persons carrying out certain designated crypto activities would be subject to prudential rules in the UK. Under current proposals, these rules will include prudential regulation, the thresholds of which will be set by the UK's financial services regulator, the Financial Conduct Authority. These may include minimum capital and liquidity level requirements.

The U.S. prudential regulators - the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) - issued a joint statement in February 2023 warning banks about risks for business with crypto. In the statement, banks that host crypto firm deposits were encouraged to monitor liquidity and ensure proper protections were in place to prevent a run. In addition, the regulators described management practices for crypto, noting that existing risk management principles could be applied. The statement reiterated that banks are "neither prohibited nor discouraged" from providing banking services to crypto entities.

EU



UK



US



**UNHOSTED
WALLETS**

The treatment of unhosted wallets (aka self-hosted wallets) is dealt with primarily under AML and Transfer of Funds (TOFR) rules. These wallets are seen as an AML risk due to direct and sole ownership by individuals as opposed to being supported by a hosting CASP. This makes identification of unhosted wallets more difficult.

The UK Government does not currently have any plans to regulate unhosted wallets, as the Treasury seeks to investigate how to best regulate the space without stifling innovation. The crypto assets consultation contains a ‘Call for Evidence’ on DeFi, encouraging industry to write to Government with their views on the regulation of decentralized networks. However, we will be unlikely to see any concrete regulation on unhosted wallets for the next five years.

In 2022, the Government backtracked on initial proposals which would have required cryptocurrency firms to collect personal data from individuals using unhosted or non-custodial wallets for the transfer of digital assets after large industry pushback. The proposed steps were to be included in amendments to the UK Money Laundering Regulations.

Regulating unhosted wallets has been a contentious issue in the U.S., with the Department of Treasury’s Financial Crimes Enforcement Network (FinCEN) working on proposed rules for years. The rule, first proposed at the end of 2020 by the Financial Crimes Enforcement Network (FinCEN), would require crypto exchanges to collect names and home addresses, among other personal details, from anyone hoping to transfer cryptocurrencies to their private wallets. While privacy concerns stalled the rule, U.S. Deputy Treasury Secretary Wally Adeyemo stated in May 2022 that the agency was working on the rule.

FTI CONSULTING: EXPERTS WITH IMPACT

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1982

Year Founded

88

Cities

31

Countries

7,600+

Employees

700+

SMDs

\$6.1B

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of world's best
law firms

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Clients are
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of Fortune
Global
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¹ Number of total shares outstanding as of February 16, 2023, by the closing price per share on February 23, 2023

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AUTHORS

Thea Utoft

Managing Director, Strategic Communications, Brussels
Lead EMEA Financial Services Public Affairs
thea.utoft@fticonsulting.com

Cheyenne Hopkins

Managing Director, Strategic Communications, Washington D.C.
cheyenne.hopkins@fticonsulting.com

Matthew Conway

Managing Director, Strategic Communications, London
matthew.conway@fticonsulting.com

Oleksandra Maksymenko

Senior Consultant, Strategic Communications, Brussels
oleksandra.maksymenko@fticonsulting.com

Ben DeBerg

Senior Consultant, Strategic Communications, Brussels
ben.deberg@fticonsulting.com

Caroline Sayers

Senior Consultant, Strategic Communications, New York
caroline.sayers@fticonsulting.com

Elena Pope

Consultant, Strategic Communications, London
elena.pope@fticonsulting.com

Nathaniel Ogunniyi

Consultant, Strategic Communications, London
nathaniel.ogunniyi@fticonsulting.com

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