CONSUMER PROTECTION THROUGH THE REGULATION OF THE PROMOTION OF CRYPTOASSETS

Authored by: Elizabeth Meade (Senior Associate) and Anna-Rose Davies (Associate) - Cooke, Young & Keidan LLP

In the UK, plans have been in motion to bring cryptoassets within existing financial services frameworks since at least 2020. In the interim however, high public interest - coupled with a lack of regulation on promotions - has left room in the market for scammers, Ponzi and pump-and-dump schemes, and other market manipulators to target potential investors. Even putting aside blatantly fraudulent activity in the market, there are concerns that consumers may suffer substantial losses after being attracted by volatile prices, but without being aware of the associated risks. Within the last year, the industry has also experienced a series of high profile collapses, and those which have been accompanied by serious allegations of fraud and mismanagement of consumer funds have brought a certain urgency to the task of regulating the crypto industry.

Against this background, the UK Government announced its intention to legislate to bring promotions of certain cryptoassets within the FCA's remit,[1] and just over a year later on 1 February 2023, HM Treasury published a policy statement on the intended approach to the financial promotions regulation.[2] On 27 March 2023, HM Treasury published a draft of The Financial Services and Markets Act 2000 ("FSMA") (Financial Promotion) (Amendment) Order 2023, along with a draft explanatory memorandum.

This new regime is aimed at improving consumer understanding of the risks associated with investing in cryptoassets, and ensuring that cryptoasset promotions are subject to the same standards as for broader financial services.[3]

It is the first measure expected to come into force, which will eventually be accompanied by a wider regulatory regime for cryptoassets generally. The focus on consumer promotions is unsurprising, given that the FCA has repeatedly warned that consumers

1 HM Treasury, "Cryptoasset promotions Consultation", January 2022. "See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/902891/Cryptoasset_promotions_consultation.pdf

2 HM Treasury, "Consultation Outcome: Government approach to cryptoasset financial promotions regulation policy statement", updated 27 March 2023. See: https://www.gov.uk/government/consultations/cryptoasset-promotions/government-approach-to-cryptoasset-financial-promotions-regulation-policy-statement

3 https://www.legislation.gov.uk/ukdsi/2023/9780348246490/pdfs/ukdsiem_9780348246490_en.pdf

should be prepared to lose all their money if they invest, with cryptoassets currently being excluded from protection or compensation under the Financial Services Compensation Scheme.[4]

It is an area that has also received significant attention in the US, with the Securities and Exchange Commission having recently imposed hefty fines on celebrities including Lindsay Lohan, Akon and Kim Kardashian for the promotion of cryptoassets without disclosing that they were paid to do so.

The new promotions regime

The new regime will come into being by way of an expansion to the scope of the financial promotions restriction in section 21 of FSMA by amending the FSMA (Financial Promotion) Order 2005. Section 21 provides that a person, in the course of business, must not communicate an invitation or inducement to engage in investment activity. In practice, the scope of what constitutes a promotion can be wide, including traditional advertisements in person, advertisements online, e-mails, and social media marketing.

It will only apply to "qualifying cryptoassets". As some cryptoassets are already regulated by the FCA (e.g. controlled investments such as those classified as security tokens), the purpose of the regime is to bring those which currently sit outside the FCA's regulatory remit into the scope of the financial promotions regime. This includes tokens such as BTC and ETH. Notably, NFTs are excluded, with a cryptoasset needing to be both fungible and transferable in order to pass the first hurdle of being considered as "qualifying".

Who will the new regime apply to?

The new regime will apply to firms making promotions to cryptoassets to UK consumers regardless of whether the firm is based overseas or what technology is used to make the promotion, as it will cover promotions that originate outside the UK, but are "capable of having an effect in the UK".[5]

Subject to UK Parliamentary approval, there will be four routes to promote cryptoassets to UK consumers:

1. The promotion is communicated by an FCA authorised person.
2. The promotion is made by an unauthorised person but approved by an FCA authorised person.
3. The promotion is communicated by a cryptoasset business registered under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 with the FCA (the "MLRs").
4. The promotion otherwise complies with the conditions of an exemption in the Financial Promotion Order.

Making promotions outside of one of these routes carries a risk of serious consequences. Under section 25 FSMA, a person commits a criminal offence if they carry on activities in breach of section 21 and can be subject to a maximum of two years imprisonment, a fine, or both.

The FCA also expects that the new regime will take a consistent approach to that taken for other high-risk investments.[6] This means that crypto businesses will likely be required to use risk warnings and provide 24-hour cooling-off periods, and overall, promotions are required to be clear, fair, and not misleading.

What will it mean in practice?

The new regime will significantly curtail the ability of crypto businesses to promote "qualifying" cryptoassets to UK consumers, unless they are prepared.

The FCA has published a letter it sent to a number of international businesses on 5 April 2023, calling on them to consider which of the four routes they intend to use to communicate financial promotions to UK customers once the new regime comes into force. They

4 We note that HM Treasury's February 2023 Consultation Response Document stated that the availability of FSCS pretension for claims against failed cryptoasset custodians was under consideration and was to be determined by the FCA, but also noted that it was not the Government's intention for FSCS protection to apply to investor losses arising from cryptoasset exposures more generally.

5 Financial Services and Markets Act 2000, s 21(3).

6 https://www.fca.org.uk/news/statements/cryptoasset-firms-marketing-uk-consumers-must-get-ready-financial-promotions-regime

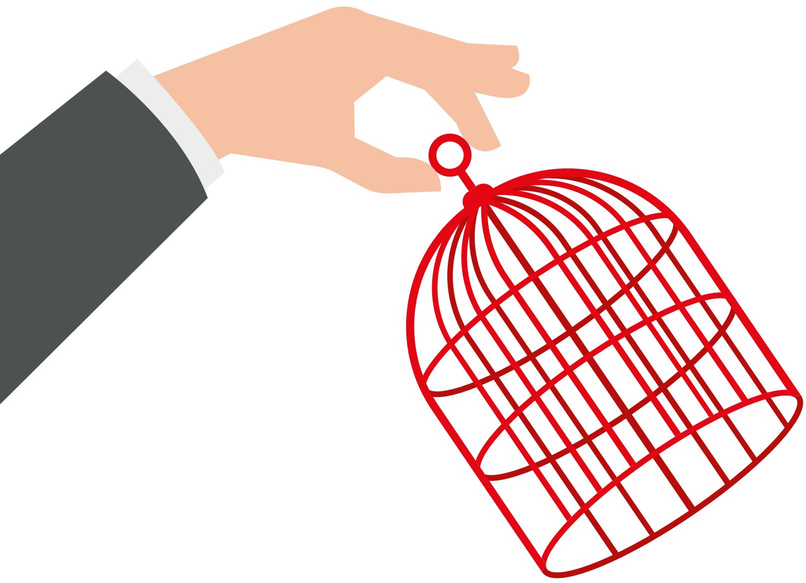
have pointed firms specifically to the process for seeking regulation under the MLRs.

This particular route was introduced following industry feedback which will allow those businesses already registered under the MLRs, but are not otherwise authorised persons, to communicate their own financial promotions. This was required as the original proposals meant firms needed to be FCA authorised to communicate or approve qualifying cryptoasset promotions. Given that most crypto businesses in the UK are not FCA authorised (as they do not deal in controlled investments), it would have amounted to an effective ban on promotions. The temporary exemption will ostensibly incentivise cryptoasset businesses both to be based in the UK and to be compliant with the MLRs.

However, it remains to be seen whether this exemption will open up the scope much further.

Since January 2020, the FCA notes that it has received 300 applications from cryptoasset businesses and has determined 260 applications as of January 2023.[7] Of those, the FCA approved and registered 41 cryptoasset businesses (15%). 195 applications (74%) were either refused or withdrew the application, and the FCA rejected 29 (11%) submissions.

This would suggest that in practice, the exemption will not apply to many firms. It is, in any event, only intended to be temporary and will be reviewed by the Government "alongside the future regulatory approach to cryptoassets".[8]



It was also originally planned for there to be a six-month implementation period. However, this period has now been decreased to four months – highlighting the fact that these measures are seen by the Government as being urgently required in order to protect consumers from harm.

Whether the new regime will in fact dampen enthusiasm from investors will remain to be seen.

Despite recent turmoil in the crypto market, recent surveys show that 5-10% of UK adults now own cryptoassets, an increase of more than 100% over the past 1-2 years.[9]

Research by JP Morgan in the US has also shown that most crypto users make their first transactions during spikes in prices.[10]

While overall timing for the regime remains unclear, what is certain is that firms who wish to continue marketing to UK consumers, wherever they may be based, should be considering which of the four routes is best suited to them to ensure they are prepared.

7 https://www.fca.org.uk/firms/cryptoassets-aml-ctf-regime/cryptoasset-aml-ctf-regime-feedback-good-and-poor-quality-applications.

8 https://www.legislation.gov.uk/ukdsi/2023/9780348246490/pdfs/ukdsiem_9780348246490_en.pdf

9 https://www.gov.uk/government/publications/individuals-holding-cryptoassets-uptake-and-understanding

10 https://www.jpmorganchase.com/institute/research/financial-markets/dynamics-demographics-us-household-crypto-asset-cryptocurrency-use#finding-1