The crypto-asset industry
Evidence submitted to the Treasury Select Committee by the Investment Association

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.4 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 44% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Introduction

The majority of cryptoassets are viewed as alternative asset classes and at the moment are not typically made available to UK consumers by most IA members. However, our members are increasingly experiencing demand from institutional investors for the investment expertise provided by portfolio managers and risk management professionals in this area. The market for investment products with cryptoasset exposure in other locations is growing, and many IA members offer collective investment products with at least some exposure to cryptoassets in other jurisdictions (not for UK consumers).

We are also aware of the appetite of UK consumers to access cryptoassets, particularly cryptocurrencies, which has been well documented by the FCA and others. This raises questions around the effectiveness of the messaging provided by UK policymakers on the risks of such exposure and shows the current difficulty in encouraging consumers to invest for their future in a well-diversified and risk-managed way via a variety of asset classes and utilising the expertise of a financial adviser and/or an investment professional.

It is also the case that the rise of the cryptoasset industry provides challenges and opportunities for the mainstream investment industry. The use of distributed ledger technology (DLT), a technology that lends itself well to transaction-based shared record keeping, is increasingly being implemented within the sector, and both the tokenisation of mainstream traditional assets and the emerging digital-native asset classes provide opportunities for a widening of investment exposures to suit the needs of long-term investors.

In this context, our response concentrates on the latter two areas of focus for the inquiry: the impact of DLT on our part of the mainstream financial services industry, and the regulatory response to cryptoassets so far.

Comments on selected questions/issues raised

- **Are the Government and regulators suitably equipped to grasp the opportunities presented by crypto-assets, whilst at the same time mitigating against the risks?**
  The regulatory authorities are naturally focused on risk mitigation and consumer protection. HMG's recent remarks on making the UK a crypto-hub are welcome, not least in balancing the positive opportunities of innovation against the more cautious messaging from regulators.

  We should recognise that we are potentially on the brink of wholesale changes to the financial services infrastructure. At its core, decentralised finance (DeFi) intends to fundamentally disrupt the existing framework of financial services delivery. If harnessed appropriately, that disruption has the potential significantly to benefit customers, both retail and institutional. Alongside industry, regulators and policymakers are seeking to understand the risks and opportunities posed by this and how products and services will be provided in future, and how to ensure this is conducted in a responsible way with consumer protection at its heart. The process of regulation itself may need to evolve as innovation accelerates.

Our recent report[1] recommends that the level of knowledge and experience within both firms and policy-making bodies keeps pace with developments in the emerging technology / DeFi / DLT arena. There is a need to adequately resource and develop technical expertise to address these transformative changes and to demonstrate the UK's ability to lead and shape global regulatory standards. We should also approach DeFi reforms in an open-minded way, recognising that that existing industry functional divides may not be relevant if tech provides more efficient ways of achieving the same outcomes. In other words, while remaining technology-neutral, we should not try to fit new ways of doing things into existing frameworks where these are too rigid or have pre-existing views on the number of entities required to fulfil a function, or indeed prescribe their function.

A key recommendation is that HM Treasury establish a DeFi taskforce in partnership with industry to assess the overall policy implications for the investment management sector from the opportunities already identified - and those yet to materialise.

- **How can distributed ledger technology be applied in the financial services sector?**
The investment funds industry sits at the heart of the investment management sector, enabling millions of individual savers to access capital markets through collective investment schemes. A key element of the change expected in our part of financial services in the coming years will involve the greater use of DeFi in driving operational efficiencies, ultimately to the benefit of customers. There are a wide range of different potential uses of DLT, something that is particularly well-suited to transaction-based record-keeping, which provides a central foundation for the investment funds industry. The industry currently relies on multiple centralised entities for this function. DeFi provides alternatives to established operating structures, which offers the potential for innovation and the creation of new services for improving efficiency in financial markets.

These operational benefits of DLT are set to be seen first through tokenised funds. These digital funds shift the trading and ongoing administration of the fund from a centralised entity to the shared ledger, and offer benefits such as more efficient trading, the ability for market participants to have access to a real time view of the shareholder register at any time, reduced settlement timeframes and the ability to service customers more effectively.

These benefits are being utilised in other fund domiciles globally but are currently unavailable in the UK. We detailed the route to market in our recent report[2], where we called upon the regulator to work at pace to establish the framework for tokenised funds to operate in the UK.

Outside of funds, the sector has multiple other uses for DLT, mainly in the area of capital markets access. Current clearing and settlement processes involve verification by a centralised body, which can be time consuming and costly. Digital issuance offers the possibility of disintermediating many of the parties in the chain, such as central securities depositories (CSDs), custodians and paying agents. It should be possible to settle large volumes of transactions using DLT faster and more cheaply.

Separately, the tokenisation of illiquid asset classes, such as property and infrastructure, can potentially open up alternative investments to a wider range of investors, as well as increase their underlying liquidity by splitting the immovables into smaller lots that are easier to trade on a secondary market. The new Long-Term Asset Fund (LTAF) structure aims to expand the range of investment options available to DC pension and, subject to current FCA consultation, certain retail investors. The illiquid nature of these asset classes has traditionally precluded their use in portfolios built around the operational model of daily pricing and open-ended investment vehicles. In beginning to open up these currently harder-to-access markets, it is hoped that the LTAF will be the first step in a wholesale democratisation of private markets, offering consumers a more diverse range of asset classes, helping to align returns to longer life expectancy and

[1] The Investment Association: *Investing for the Future* July 2022
[2] Ibid

providing vital investment into long-term UK infrastructure projects. DLT may increasingly be able to help in this effort.

- **Is the Government striking the right balance between regulating crypto-assets to provide adequate protection for consumers and businesses and not stifling innovation?**
  Cryptocurrencies are currently outside of the regulatory framework in the UK. Defined by policymakers within the 'unregulated tokens' section of the UK's cryptoassets taxonomy, this means that consumers who hold cryptocurrency aren't protected by the Financial Ombudsman Service or Financial Services Compensation Scheme (FSCS).

  The IA strongly supports HM Treasury's commitment to promote competition, innovation, and support UK competitiveness across the financial services sector. Cryptoassets, such as stable tokens, could deliver significant and substantial benefits across the financial services sector. However, consumer protection is paramount and those wishing to gain exposure to cryptoassets should be able to do so in a safe manner, with a full understanding the risks involved. Despite the volatility associated with unregulated assets such as exchange tokens, many UK consumers have direct exposure to cryptoassets, without first having built up sufficient deposit savings or investments via mainstream assets. Other investors have taken advantage of more indirect ways of obtaining exposure to the wider ecosystem, such as via investments in companies with a participatory role in the cryptoasset industry.

  All things equal, the increasing demand amongst institutional and retail investors for cryptoasset exposure (with a market capitalisation of $1 trillion[3] , despite the recent downturn in crypto markets) has meant that the associated risks have become demonstrably greater. Without further changes to the existing regulatory sphere, many investors seeking out exposure to cryptoassets will continue to be driven towards unregulated avenues. These can encourage more high-risk investment or speculation, and can be characterised by the presence of asymmetric information, a prevalence of scams and lack of consumer protections in the event of firm failures. At present, some unregulated cryptoasset firms engage in practices that are not aligned with the statutory objectives of regulatory bodies, in turn producing negative outcomes for consumers.

  By carefully widening the regulatory perimeter, regulatory bodies will be better placed to deliver on their objectives of protecting financial stability, market integrity and consumer protection. Expanding the regulatory framework to cover an appropriate range of cryptoassets – notably stablecoins - should produce better governance and higher standards across cryptoasset firms via robust and effective authorisation and supervision throughout the regulatory lifecycle. In time, it may also be appropriate for regulated investment funds to offer a small allocation to the crypto market as part of a well-diversified portfolio.

  In developing a robust regulatory architecture for cryptoassets, it is essential to consider the impact on the FSCS to ensure that it remains a compensation scheme of last resort. Firms with similar business models, regulatory environments and likelihood of failure resulting on a call on the FSCS should be 'pooled' in a way that reflects the actual level of risk. Well-run firms should not be paying for the cost of failure of ill-equipped or poorly managed ones.

  In keeping with this narrative, the IA encourages the government to continue to develop a regulatory framework that better enshrines UK competitiveness; market stability; and consumer protection. In particular, as part of the current FSCS levy reform within the evolving environment, the principle of 'polluter pays' needs be restored to avoid a drag on UK competitiveness.

- **Could regulation benefit crypto-asset start-ups by improving consumer trust and resilience?**
- **How are Governments and regulators in other countries approaching crypto-assets, and what lessons can the UK learn from overseas?**

[3] *CoinMarketCap* Accessed 9 September 2022

The timeline to develop the UK's future crypto regulatory framework is lagging behind its competitors. Whilst the Financial Services and Markets Bill explicitly references the regulators' intention to expand the legislative perimeter to certain cryptoassets, further consultations will need to be undertaken before a holistic taxonomy of regulatory requirements are revealed.

In contrast, competitors such as Singapore successfully legislated for cryptoassets under the Payment Services Act of 2020. Similarly, the EU is already seeking approval from the European Council and European Parliament to finalise its markets in cryptoassets (MiCA) proposal by the end of this year.

As recognised by the UK Crypto and Digital Assets APPG, the relative immaturity of the UK's regulatory framework for cryptoassets may be explained by the underlying tension between the priorities the government and regulators.

Judging from the experience of other countries, a possible solution to this deadlock could be for policymakers and regulators to continue to collaborate so to develop a framework that reflects the complementary nature of their priorities. The statutory objective of regulators, to protect consumers and maintain market stability, does not conflict with the ambition of policymakers. Rather, it is a necessary building block to support the government's ambitions to make the UK a 'crypto hub', not a conflicting objective.

Accordingly, the IA supports the formation of a clear regulatory approach that balances the prioritisation of direct foreign investment into the UK economy by fostering an innovative marketplace, with greater investor protection.

12 September 2022
Ends