Written evidence submitted by Kraken

Introduction

We are pleased to provide written evidence to the Treasury Committee's inquiry into the cryptoasset industry. This important inquiry comes at a key juncture, as the UK Government weighs new rules in line with its commitment to securing the UK's position as a global cryptoasset hub. The Government and industry alike are focusing on how to update and expand the UK's regulatory framework to support innovation while protecting consumers and managing risks. This is a delicate balancing act. The Government's overall approach to making the UK a hub of activity is on the right track, but it is important to maintain momentum and drive these efforts forward in the coming months.

Kraken has made a significant commitment to the UK, with a Financial Conduct Authority (FCA) registered cryptoasset firm, an FCA authorised futures trading platform, and an FCA regulated benchmark administrator. We stand ready to work with the Committee, the UK Government, and the UK's regulatory authorities as new rules come into focus. We have participated in the FCA's recent 'Crypto Sprint' exercise and look forward to further work with policy-makers as UK regulation is developed. On that basis, we have identified a number of positive policy goals to underpin a comprehensive and competitive UK regulatory framework for cryptoassets.

We hope these views are helpful to the Committee as it considers the UK's next steps around cryptoasset regulation. Please do not hesitate to get in contact if it would be helpful to discuss these points and related issues in more detail.

About Kraken

As one of the world's largest and most trusted digital asset exchanges, Kraken is consistently named one of the best places to buy and sell cryptoassets online. For example in March 2022 Forbes Magazine ranked Kraken as the best global crypto exchange, based on a broad range of criteria including cyber security, trading fees, institutional backing and regulatory compliance.

A global platform

Kraken offers a global spot market covering over 200 cryptoassets, including five stablecoins and 8 fiat currencies, through its mobile app and state-of-the-art online trading platform. Kraken has earned the trust of over 9 million people around the world due to its excellent service, low fees, versatile funding options and rigorous security and compliance standards. With clients in most countries and over 3300 team members spanning more than 70 countries, Kraken is at the forefront of driving mainstream adoption globally by making sure crypto is understood by both customers and policy-makers.

Our UK presence

Kraken currently has more than 350 team members in the UK and a substantial UK client base. In the UK, Kraken offers spot trading and custody of cryptoassets via Payward Ltd (an FCA registered cryptoasset exchange provider and custodian wallet provider, FRN: 928768), and trading in futures products via Crypto Facilities Ltd (an FCA authorised investment firm, FRN: 757895). Crypto Facilities Ltd is one of the few pure crypto derivatives platforms in the world. Our other UK subsidiary, CF Benchmarks Ltd (an FCA authorised benchmark administrator, FRN: 847100), provides indices that benchmark the majority of all regulated crypto derivatives trading globally today. Our indices serve as the reference benchmark for major derivatives exchanges, asset managers, and other institutional investors.

Industry-leading security
Kraken's security protocols are world leading and we have never experienced a hack or security breach which resulted in clients losing funds. Just recently, Kraken was recognised by the CSO50 awards for its advanced security protocols and efforts to improve consumers' understanding of their personal security. In July, Kraken also completed its second Proof of Reserves audit for 2022, which included seven of its most traded assets. This process empowers clients to cryptographically verify for themselves that Kraken holds their reported account balance for those assets. We have committed ourselves to twice yearly auditing and will expand the number of assets in these audits over time. These combined efforts demonstrate how seriously Kraken takes the responsibility of being a facilitator of secure trading. We make every effort to ensure both our institutional and retail clients feel confident that their assets and personal data are safe with us.

Commitment to compliance
Kraken has invested in a strong financial crime programme by hiring experienced personnel across our global footprint. Our team consists of more than 280 professionals in the UK, the United States, Europe and other jurisdictions in which Kraken operates who are dedicated to anti-money laundering/combating the financing of terrorism (AML/CFT) and sanctions compliance. Kraken makes significant investments in training and professional development through various industry certifications and memberships. This investment ensures that our compliance professionals use cutting-edge technology, data, systems and vendors to implement robust controls and proactively anticipate risks in the constantly evolving AML/CFT and sanctions regulatory landscape.

Kraken proactively engages with law enforcement and policy-makers to help them strengthen the response to crypto-related financial crime. This includes contributing to intelligence sharing initiatives and providing industry perspectives to inform policy choices. Kraken also chairs the National Crime Agency's Crypto Currency Working Group, which brings together many of the main industry players in the UK to discuss trends (e.g., emerging money laundering activities and techniques) and operational issues while working to continually improve the quality of Suspicious Activity Reports from the sector.

Cryptoassets and the UK

We agree with the Government that it is important to unlock the innovative potential of crypto to improve consumer choice and attract jobs and investments to the UK. In the same vein, Kraken is committed to accelerating the mainstream adoption of crypto by consumers and institutions in the UK and globally.

The benefits of cryptoassets include but go beyond their increasingly established use as speculative instruments and stores of value. Crypto is an accessible and transparent alternative to traditional financial services that can open new forms of financial participation and inclusion, providing an ecosystem that individuals can participate in and use to store value and ultimately improve their lives.

In addition, crypto is facilitating practical innovations around transacting and value transfer that can improve convenience and cost efficiency in everyday life. For example, crypto enables peer-to-peer (P2P) transacting which avoids costly intermediaries. P2P transactions can make remittance payments faster and cheaper, ensuring content creators retain royalties from art resales (via non-fungible tokens or NFTs), and enabling smart contracts to efficiently implement traditional agreements between parties - to name a few examples.

In line with our commitment to growing crypto, we strongly support HM Treasury's stated intention to make the UK a hub of cryptoasset investment and activity. Ongoing policy making efforts will provide regulatory clarity and tax certainty and help the UK realise this ambition. Engagement with industry through consultation exercises and new industry forums will enable rulemaking that is sensitive to commercial and competitive impacts. We look forward to continuing this engagement into the Autumn and beyond.

Building a comprehensive and competitive regulatory framework

To achieve the goal of making the UK a global hub for cryptoasset activity the UK's policy and regulatory frameworks should deliver a number of important outcomes:

a. *A level playing field for UK and offshore platforms*

To secure the UK's position as a cryptoasset hub it is important that firms that support UK customers while complying with UK regulations are not at a commercial disadvantage to offshore firms.

Kraken currently has a substantial UK presence and complies with UK regulatory requirements. However, offshore firms are offering services to local customers without registrations under the FCA's anti-money laundering rules or authorisations for regulated products such as derivatives. The result is competitive distortions as well as conduct and compliance risks in the UK, negative impacts which will worsen as the UK's regulatory framework becomes more comprehensive and complex.

A level playing field is needed to guard against these impacts. Moreover, protecting the integrity of the local, regulated market and its participants will incentivise further investment and growth in the UK cryptoasset industry. To achieve this level playing field, the UK's regulatory authorities should incentivise firms who comply with UK regulatory requirements by granting expanded discretion as compared to offshore firms that offer services in the UK without the requisite oversight. These foreign firms should be enforcement priorities over those who voluntarily "come in from the cold" to comply with UK rules. In addition to enforcement, regulation should also be calibrated to ensure firms with existing UK regulatory permissions face proportionate requirements relative to offshore firms without the same permissions. For example, pending FCA rules that introduce new positive frictions into customer onboarding processes could distinguish between firms that are registered (and have had their onboarding processes scrutinised by the FCA) and those that are not.

b. *Robust controls against financial crime*

Combating financial crime and ensuring compliance with sanctions restrictions rightly remain policy priorities for cryptoasset markets. The UK continues to make adjustments to its regulatory framework in line with updated international guidance, and we commend the ongoing commitment to consistent implementation of the Financial Action Task Force's standards.

The industry must keep pace and do its part to ensure that cryptoassets are used for socially beneficial rather than illicit purposes. Kraken has invested in a world class compliance programme to help combat financial crime and comply with sanctions restrictions. It is important that strict adherence to financial crime mitigation requirements will remain as a minimum requirement for authorisation as a service provider under any future UK regulatory framework.

It is also important that these requirements are applied in a proportionate and ultimately practical manner. For instance, custodians can and should impose risk-based controls as consumer-facing service providers. In contrast, software publishers, coders, miners and other entities that are designing and validating the underlying architecture of crypto rather than onboarding and managing consumer flows should not be included in scope of these requirements.

c. *A high standard of safety and security*

At Kraken we are proud of our industry-leading security protocols. Customers deserve to know that their assets and personal data are safe. This means crypto trading platforms and ecosystems need to be backstopped by robust measures to maintain cyber security and operational continuity.

Regulation should therefore set out rigorous standards and catalyse an industry-wide 'race to the top' to meet high expectations around safety and security. In addition to protecting existing customers' assets and data, the application of strong security requirements across service providers will support innovation by building trust and driving further mainstream adoption.

In this regard, the UK has a unique opportunity to be descriptive, as opposed to prescriptive, in its new regulatory framework. Rather than prescribe hopeful standards for market participants, the UK can describe, in law, what has actually worked for consumers and investors in crypto over the last decade. For example, Proof of Reserve Audits, pioneered by Kraken, could be standardized across the industry. The UK can use the unique characteristics of cryptoassets – in this case their transparency and verifiability – to control for their unique risks and protect the public.

d. *Clear and practical regulatory requirements*

Many jurisdictions globally including the EU are establishing new regulatory frameworks to ensure cryptoasset activity is subject to comprehensive rules and oversight, while also enabling existing businesses to move forward into the frameworks with certainty. We agree with HM Treasury that now is the time to develop similar new rules for the UK. This will drive innovation and growth by establishing guardrails and expectations for cryptoasset business in the UK.

A tailored regime for cryptoassets as a new type of 'specified investment' under the Financial Services and Markets Act (2000) is one possible way to move forward. This will set the stage for a comprehensive authorisation regime for cryptoasset trading, intermediation, issuance and related services like custody, which, if regulated, should be subject to clear and proportionate rules.

In designing a regulatory framework it will be important to carefully calibrate its scope and detailed requirements to avoid discouraging innovation. In practice, this means that:

1. <u>*Different types of cryptoassets should be treated in a proportionate and forward-looking manner*</u>. As UK policy-makers consider the scope and application of new rules, it is important to assess the different risk profiles and uses of different types of cryptoassets at a granular level. Two overarching principles can guide this assessment and the subsequent approach to designing rules: I) regulation should be <u>proportionate</u>, i.e., calibrated to the risks in a specific market or ecosystem; and II) regulation should be <u>forward-looking</u>, i.e., designed to enable future use cases.

    - **Not all fungible cryptoassets (e.g., bitcoin or ether) are alike**, and their different risk profiles and use cases merit distinct and granular treatment. Some fungible cryptoassets are intended to be used as currencies or for value transfer and could be regulated accordingly. Other fungible cryptoassets are designed to unlock services and uses in decentralised ecosystems. To enable these latter, forward-looking uses it is especially important that these cryptoassets are treated as utility enablers rather than currencies or investments.

    - **Further distinctions will need to be drawn between fungible cryptoassets and NFTs, as well as between different types of NFTs**. While both can be traded and held as property, there are fundamental differences in the purpose and intent in holding these assets, as well as differences in the underlying processes by which value is assigned and transactions are completed. Any rules for NFTs will therefore need to be carefully drawn up to be proportionate to the risks they present, in order to avoid disruption or impractical implementation challenges.

2. *Focused rules should apply to specific activities*. Some obligations such as governance and conduct requirements can be standardised across cryptoasset service providers, which will ensure a level playing field and enhance customer confidence. Specific services will also need focused rules, including:

- **Exchanges:** The approach to listing tokens will need to be harmonised across exchanges to protect consumers and promote competition. This can be achieved through outcomes-based rules rather than granular process-heavy requirements. New rules should therefore outline the expectations and responsibilities of exchanges, the desired consumer outcomes, and the approach to decentralised tokens (without issuers) as well as tokens issued outside the UK. Importantly, disclosure requirements for token issuers will need to be defined, and liability for any errors or misstatements in those disclosures should be allocated at the issuer level as per traditional financial instruments.

- **Custody**: Customers need to know that their assets are safe and secure. Custody is a technology-intensive service requiring strong cyber security and operational resilience measures. A high bar for custody service providers is therefore appropriate to make sure the necessary expertise, systems and investments are in place. It is also important that UK regulation enables the use of global custodians that maintain these same high standards rather than mandating the exclusive use of local entities. Little benefit is achieved by “localizing” custody for a digital asset, and doing so would often exclude the most appropriate custodian for the asset.

- **Staking:** Staking is a way for consumers to use their assets to secure blockchain networks and earn a return on the assets in exchange. By staking their tokens consumers can support or even directly participate in the governance of cryptoasset ecosystems, and in so doing validate and strengthen these new systems while also receiving compensation for the use of their staked assets. Staking is a novel form of economic participation and inclusion, and it will need to be carefully defined and regulated under new rules. As a result, it is important to avoid simply applying existing rules for borrowing and lending securities or collective investments.

3. *Transitional provisions will be needed to avoid disruption*. When new rules enter into force, existing cryptoasset service providers with established regulatory permissions (such as registration under the UK's anti-money laundering rules or authorisation under broader financial services frameworks) will need clear pathways for moving into the new framework. As an example, the EU's near-final Markets in Crypto Assets Regulation (or 'MiCA') will provide time-limited grandfathering for firms that are already providing services in accordance with the relevant local laws, and a simplified application process that leverages the existing information flow and dialogue between firms and their regulators. This is a sound approach that avoids disrupting existing activity and will enable business continuity as new rules come into force. For these reasons, similar transitional provisions should be included in the UK's approach.

e. *Strong consumer protections*

HM Treasury and the FCA have announced their intention to bring cryptoassets into scope of the FCA's 'financial promotions' rules; the industry is awaiting final rules pending the necessary legislative changes. The opportunities and risks of investing should be accurately conveyed to consumers, and requiring that cryptoasset marketing materials are approved by FCA authorised firms with the requisite expertise is one way to help ensure this. As a firm with an FCA authorisation for its cryptoasset futures business, Kraken intends to review and approve its financial promotions materials to a high standard before they are made public.

Consumer protections must apply equally and evenly to achieve their intended outcomes. As noted above, it will be important to ensure that offshore firms are held to the same standard as UK registered firms when marketing to UK consumers. This will create a level playing field for UK cryptoasset businesses while guarding against risks to consumers.

f. Incorporation of cryptoassets into the broader economy's Net Zero roadmap

The UK Government has established the target of achieving Net Zero by 2050. The cryptoasset industry will need to meet this target on the same time frame and alongside every other energy-consuming sector. This means that the transition paths to net zero will need to include cryptoassets, including regulatory disclosures and related policy frameworks under development, as well as physical measures to support decarbonisation such as the development of a green power grid. To continue to encourage and unlock innovation in the UK, it is important that the cryptoasset industry is treated like any other energy-consuming sector rather than singled out for punitive treatment in the near term.

The cryptoasset industry can contribute to Net Zero by promoting grid stability, contributing to the use of renewables, and mining off-grid with stranded resources - e.g. stranded natural gas, often released as an unsaleable byproduct of oil extraction. By applying sustainable power models and with the ability to calculate future energy and emissions profile, the cryptoasset industry can move beyond simply calculating the power use which would risk missing the benefits of building a robust, resilient and sustainable cryptoasset infrastructure.

CAI0078

September 2022