LEGAL ANALYSES

The Treatment of Stablecoins Under the UK's Financial Collateral Arrangements Regulations

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Abstract

Stablecoins are among the fast-growing innovations in money and payments that have emerged in recent years. They are a type of digital assets that purport to maintain a stable value by holding a pool of backing assets or by algorithmic means. Some types of stablecoins have the potential to be used by many people in the UK and elsewhere for everyday payments and other financial transactions, including collateral arrangements. The provision of financial collateral is an important factor contributing to the cost-efficiency and stability of the financial system. To support the smooth functioning of the provision of such financial collateral, legislative measures, in particular the Financial Collateral Arrangements (No.2) Regulations 2003, have modified certain requirements that might otherwise create issues for the use of financial collateral. This article examines the application of the 2003 Regulations to stablecoins—in particular the extent to which stablecoins may qualify as "cash" for these purposes—concluding that at least some types of stablecoins should constitute "cash" and, therefore, benefit from the special regime for financial collateral arrangements.

The provision of financial collateral, such as cash or transferable securities, is an important factor contributing to the cost-efficiency and stability of the financial system. To support the smooth functioning of the provision of such financial collateral, legislative measures have modified certain requirements—e.g. formality requirements or the operation of insolvency procedures—that might otherwise create issues for the use of financial collateral.

While a number of different types of questions have arisen over the years in respect of these legislative measures, the increasing importance of digital assets raises a new type of question: whether such assets constitute "financial collateral" and, accordingly, benefit from the protections that legislative measures have introduced.

This article focuses on one specific issue in this context: whether stablecoins—digital assets designed to maintain a stable value by pegging them to assets or baskets of assets, such as a fiat currency—may constitute "financial collateral" under the Financial Collateral Arrangements (No.2) Regulations 2003, SI 2003/3226 (FCARs).

FCARs

Background

In 2002, the EU enacted Directive 2002/47/EC on financial collateral arrangements (the FCD). The aim of the FCD was to contribute to the integration and cost-efficiency of the EU financial market as well as to the stability of the financial system in the EU, thereby supporting the freedom to provide services and the free movement of capital in the single market in financial services.[1] The legislation that implemented the FCD in the UK is the FCARs.

The FCARs introduced several measures aiming to facilitate the provision of financial collateral under bilateral transactions. For example, they prevent certain legislative provisions and common law rules which require formalities before an agreement is perfected and enforceable, from applying to financial collateral arrangements. The FCARs also modify certain provisions of UK insolvency law, including in connection with restrictions on enforcement of security, avoidance of property dispositions, power to disclaim onerous property, limitations and avoidance of floating charges, and the effectiveness of close-out netting provisions. The FCARs also ensure that where a security financial collateral arrangement provides a right of use for the collateral-taker over the collateral, that term is enforceable.

[1] See Recital (3) of the FCD.

Scope—the meaning of "financial collateral"

These protections are granted to "financial collateral arrangements" meaning either "title transfer financial collateral arrangements" or "security financial collateral arrangement". Both types of collateral arrangements have in common that they relate to "financial collateral", which means either cash, financial instruments or credit claims. Accordingly, to fall within the scope of the FCARs, stablecoins would need to qualify as either cash, financial instruments or credit claims. This article focuses on the first of these concepts, i.e. the question whether stablecoins could satisfy the FCAR definition of "cash".

For FCAR purposes, "cash" means money in any currency, credited to an account, or a similar claim for repayment of money and includes money market deposits and sums due or payable to, or received between the parties in connection with the operation of a financial collateral arrangement or a close-out netting provision.

Do stablecoins qualify as "cash"?

The first question in the analysis is whether stablecoins could be treated as "cash" for FCAR purposes. This requires analysis of whether they might be considered "money in any currency".

One challenge in this respect is that "money" was not only left undefined both in the FCD and the FCARs, but there exists more broadly a lack of consensus as to how "money" should be defined for purposes of English law.

Theories of money

In attempting to lay down a convincing definition of "money", commentators have used as bases different theories of money. Two particularly important theories for present purposes are the "functional" approach and the "State Theory of Money".[2]

The functional approach seeks to define money by reference to its economic functions. While there have been slight shifts over time in what these functions have been perceived to be, key functions of money may be: (i) as a medium of exchange; (ii) as a measure of value or as a standard for contractual obligations; (iii) as a store of value or wealth; and (iv) as a unit of account.[3]

The "State Theory", on the other hand, places particular emphasis of the role of the state in relation to money. Under this theory, key hallmarks of money are that it is: (i) issued under the authority of the law in force within the state of issue; (ii) under the terms of that law, denominated by reference to a unit of account; and (iii) under the terms of that law, to serve as the universal means of exchange in the state of issue.[4]

Case law—focus on functional aspects

While many commentators favour the State Theory, it seems that at least a significant part of case law dealing with the question on what constitutes "money" has focused on functional aspects.

The leading judicial account of "money" is the definition cited by Darling J in *Moss v Hancock* as:

> "that which passes freely from hand to hand throughout the community in final discharge of debts and full payment for commodities, being accepted equally without reference to the character or credit of the person who offers it and without the intention of the person who receives it to consume it or apply it to any other use than in turn to tender it to others in discharge of debts or payment for commodities."[5]

This definition focuses entirely on functional aspects.

A similar tendency is apparent in more modern case law (from other jurisdictions) dealing with questions on whether Bitcoin falls within the scope of money for the purposes of various legislative and regulatory frameworks.

For example, in 2015, the European Court of Justice (ECJ) gave judgment on a request for a preliminary ruling on several questions of Directive 2006/112/EC (the VAT Directive), including the question on whether services consisting of the exchange of traditional currencies for Bitcoin and vice versa are exempt from VAT.[6] The ECJ concluded that the services in question were exempt on the basis of art.135(e) of the VAT Directive, which relates to transactions concerning currency, bank notes and coins used as legal tender. In reaching this conclusion, the ECJ placed emphasis on the fact that Bitcoin has no other purpose than to be a means of payment and that it is accepted for that purpose by certain operators.[7]

Similarly, in 2016, the US District Court of the Southern District of New York held that Bitcoin fell within the scope of "monetary value" for the purposes of Florida law.[8] Again, the court focused on functional considerations here, highlighting that Bitcoin "plainly is 'a medium of exchange, whether or not redeemable in currency' (though Bitcoin is in fact redeemable in currency)".[9]

Emerging regulation of stablecoins in the UK

With this in mind, it is relevant to consider the emerging regulatory regime for certain types of stablecoins in the UK.

The Financial Services and Markets Act 2023 (FSMA 2023) introduced the concept of "digital settlement assets" (DSAs). DSAs are defined as a digital representation of

[2] See Charles Proctor, *Mann and Proctor on the Law of Money*, 8th edn (Oxford University Press, 2023), Ch.1.
[3] Proctor, *Mann and Proctor on the Law of Money*, 8th edn (2023), para.1.07.
[4] Proctor, *Mann and Proctor on the Law of Money*, 8th edn (2023), para.1.18.
[5] *Moss v Hancock* [1899] 2 Q.B. 111, 116.
[6] *Skatteverket v Hedqvist* (C-264/14) EU:C:2015:718; [2016] S.T.C. 372.
[7] *Skatteverket* (C-264/14) EU:C:2015:718; [2016] S.T.C. 372 at [52].
[8] *United States v Murgio*, 209 F. Supp. 3d 698 (SDNY 2016).
[9] *Murgio*, 209 F. Supp. 3d 698 (SDNY 2016) 713.

value or rights, whether or not cryptographically secured, that: (a) can be used for the settlement of payment obligations; (b) can be transferred, stored or traded electronically; and (c) uses technology supporting the recording or storage of data (which may include distributed ledger technology). This definition is designed to capture stablecoins used as a means of payment, albeit that it has been drawn broader than that to ensure future flexibility.

FSMA 2023 empowers HM Treasury to introduce regulations for payments and payment systems that include DSAs and DSA service providers. HM Treasury, in turn, has stated its intention to focus on fiat-backed stablecoins, i.e. cryptoassets that seek or purport to maintain a stable value by reference to a fiat currency and by holding fiat currency, in whole or in part, as backing. This will not be limited to particular currencies or single-currency stablecoins.

For these purposes, HM Treasury intends to: (i) regulate issuance and custody activities of fiat-backed stablecoins issued in or from the UK (through amendments to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544); (ii) regulate the provision of payment services in relation to fiat-backed stablecoins by firms in the UK and transactions where at least one leg takes place in the UK (through amendments to the Payment Services Regulations 2017); and (iii) empower the Bank of England and the Payment Systems Regulator to supervise "systemic" DSA payment systems (by amending the Banking Act 2009 and the Financial Services (Banking Reform) Act 2013).

The FCA plans to introduce backing requirements for DSAs to ensure that they maintain their value relative to their reference currency or currencies (i.e. "peg") and can be promptly redeemed at par value by any holder of the stablecoin. The proposed requirements would allow DSAs to be backed with government treasury debt instruments that mature in one year or less, along with short-term cash deposits. However, the FCA would not allow the use of money market funds when investing in treasury bills to back stablecoins. The scope of possible backing assets is, thus, restricted to low-risk, high-liquidity assets.

Regarding systemic DSA payment systems, the Bank of England intends to focus its supervision of systemic payment stablecoins on stablecoins which are: (i) retail-focused; (ii) sterling-denominated; and (iii) widely used for payments in the UK.

Stablecoins as "cash"—a conclusion?

While not all types of stablecoins will be equally likely to qualify as "cash" for FCAR purposes, at least some types should in our view. In particular, there are good arguments that stablecoins that reference fiat currency, such as fiat-referencing DSAs, should be considered "cash", and the developing regulatory framework for DSAs is helpful in this regard.

From a functional perspective, the analysis is as follows:

Medium of exchange: while many digital assets are recognised by some actors as a medium of exchange, an important question is how wide such recognition must be in order for the medium to be recognisable as money. However, UK regulators clearly seem to assume that certain DSAs will be used on "systemic levels", so as to merit regulation by the UK central bank (and the Payment Systems Regulator). The Bank of England emphasised in a November 2023 Discussion Paper that systemic payment stablecoins "should … be generally accepted as a means of payment and be interchangeable … with all other forms of money used in the economy".[10] There would therefore be good arguments that systemic DSAs would sufficiently function as medium of exchange.

Store of value: this quality of money has been the reason why many courts have refused to recognise Bitcoin as money, given Bitcoin's volatility. However, in the case of stablecoins, this concern might be less warranted. For example, the Bank of England contemplates that systemic DSAs will need to be interchangeable without loss with all other forms of money used in the economy, meaning that all forms of "money" would have the same store-of-value qualities as fiat currencies.

Unit of account: this aspect requires the existence of a standard numerical unit for the measurement of value and costs of goods, services, assets and liabilities. There is no reason generally why stablecoins should not satisfy this criterion.

On this basis, at least systemic DSAs are good candidates to qualify as "cash" for FCAR purposes.

There are also good arguments that non-systemic stablecoins could be considered "cash". This is on the basis that these assets would still be used for the settlement of certain payment obligations (i.e. would still be recognised by some actors at least as a medium of exchange). Naturally, the more widely a DSA is used for payments the stronger the analysis.

It may also be worth considering two further assets: first, central bank digital currencies (CBDCs) such as the digital pound of the digital euro. CBDCs are very likely to be considered money, as they would satisfy relevant criteria not only under functional theories of money but also the state theory. Secondly, tokenised bank deposits: the government has indicated that it intends to treat these like traditional deposits from a regulatory licensing perspective. Therefore, they should be considered money (commercial bank money) as well.

It may be worth noting two further points. First, the FCAR definition of "cash" also includes "similar claims for repayment of money". Arguably, this condition is met if the redemption is in fiat currency, which, once more,

[10] Bank of England, discussion paper, "Regulatory regime for systemic payment systems using stablecoins and related service providers", *https://www.bankofengland.co.uk/paper/2023/dp/regulatory-regime-for-systemic-payment-systems-using-stablecoins-and-related-service-providers*.

makes fiat-referencing DSAs a good candidate for constituting "cash" (assuming that these would be redeemable in fiat currency) in contrast to, for instance, algorithmic stablecoins, which have no right of redemption or payment against any issuer at all. Secondly, the definition of "cash" envisages money "credited to an account". This condition is arguably satisfied where relevant stablecoins are held through custodians (where either the custodian holds the stablecoin on trust for the client or owns the stablecoin and the client merely has a personal obligation against the custodian). The Law Commission has observed, in similar vein, that to "the extent that they qualify at all, crypto-token entitlements held via holding intermediaries such as crypto-token exchanges are comparatively more likely to be characterised as cash than directly controlled 'on chain' crypto-tokens".[11]

Possession or control

When considering whether digital assets can give rise to "security financial collateral arrangements", another important aspect to consider is that the relevant collateral must be in the possession or under the control of the collateral-taker.

The FCARs provide limited guidance on this notion of possession of control, except that they clarify that "possession" of financial collateral includes the case where financial collateral has been credited to an account in the name of the collateral-taker or a person acting on his behalf (whether or not the collateral-taker, or person acting on his behalf, has credited the financial collateral to an account in the name of the collateral-provider on his, or that person's, books) provided that any rights the collateral-provider may have in relation to that financial collateral are limited to the right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral.

Case law has sought to somewhat clarify this notion of possession or control. In particular, in *Re Lehman Brothers*,[12] Briggs J considered that the kind of control that is necessary is negative, legal control, meaning having the right to prevent the removal of the financial collateral from the relevant account by the collateral-provider.

More recently, Edwin Johnson J suggested that the question whether a charge will be characterised as fixed or floating requires a nuanced consideration of the degree of control[13]—a potential read-across from this suggests that in the FCAR context too, the notion of possession or control may be more nuanced than previously thought.

The reason why this may matter in the context of stablecoin collateral arrangements is that certain collateral arrangements incorporate automated technological and/or operational processes which share control between parties, or make it conditional on specified conditions. This may involve, for example, arrangements whereby collateral is subject to a deterministic holding arrangement, such as an "escrow smart contract" (not practically controllable by either collateral taker or provider), shared control or deterministic arrangements regarding excess withdrawal and collateral substitution facilities, the sharing with third parties of practical positive/negative control, situations where a third party acts as technology service provider or co-signer under a multi-signature/multiparty computation wallet, or situations where the collateral provider retains the practical capacity to dispose of, or extract value from, crypto-asset collateral in a way that goes beyond the excess withdrawal and substitution rights expressly recognised in the FCARs.[14]

Pending clarification in statute or by the courts, there will be some doubt whether such arrangements would qualify as financial collateral arrangements for FCAR purposes. That being said, similar debates exist in relation to traditional financial collateral arrangements, and many stablecoin related arrangements will not raise any such questions regarding possession or control.

A look to the future

The Law Commission's Digital Assets project

In its very detailed project on digital assets, the Law Commission has also given consideration to the treatment of digital assets under the FCARs.

As an immediate step, the Law Commission recommends statutory amendments and associated guidance to clarify the extent to which, and under what holding arrangements, cryptoassets can satisfy the definition of cash, including potentially by providing additional guidance as to the interpretation of "money in any currency", "account" and "similar claim to the repayment of money".

However, as far as crypto-asset collateral arrangements more broadly are concerned, the Law Commission is sceptical about extending the FCAR framework to accommodate cryptoassets. Instead, the Law Commission would prefer the development of a bespoke legal framework.[15] This might be a unified, undifferentiated collateral regime, or it might be a distinct regime which provide a separate framework equivalent to that for mainstream markets. If a distinct framework is developed, its application could be limited to those collateral arrangements not otherwise capable of satisfying the definition of financial collateral under the FCARs. While detailed consideration of potential requirements is beyond the scope of the Law Commission's report, the Law Commission did note that, as regards perfection

[11] Law Commission, *Digital Assets—Final Report* (LC 412), para.8.61(4).
[12] *Re Lehman Brothers International (Europe) (In Administration)* [2012] EWHC 2997 (Ch); [2014] 2 B.C.L.C. 295.
[13] *Re Avanti Communications Limited (In Administration)* [2023] EWHC 940 (Ch); [2023] B.C.C. 873.
[14] Law Commission, *Digital Assets—Final Report* (LC 412), para.8.96.
[15] Law Commission, *Digital Assets—Final Report* (LC 412), paras 8.104–8.126.

requirements, “possession or control” are not a satisfactory basis (albeit that some form of factual control would be an important element of perfection requirements). Instead, the Law Commission would favour the concept of “provision”.