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Bite-size Briefings

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A series of briefings that take a "bite-size" look at international trends in different jurisdictions, drawing on Baker McKenzie's expert financial services practitioners.

Cryptoasset regulation

This edition takes a bite-size look at the regulation of crypto (or digital assets) and, in this context, the development of anti-money laundering (AML) supervision in the UK, the US, Hong Kong SAR, Singapore and Thailand.

While each jurisdiction follows its own approach taking into account its existing regulatory frameworks and risk appetites for customer protection and financial crime etc., these are consistent with the principles set out by international standard-setting bodies. The G20-established Financial Stability Board (FSB) has published a number of reports, including its May 2019 **work** on the regulatory approaches toward cryptoassets and the potential gaps, for example, with respect to investor protection, market integrity and AML, and, more recently (referenced below), enhancing cross-border payments with stablecoin. For its part, in June 2019, the Financial Action Task Force (FATF) published **guidance** on a risk-based approach to virtual assets and asset service providers, having clarified in 2018 that its Recommendations apply to financial activities involving these types of assets. The guidance seeks to help regulators develop effective regulatory and supervisory responses, and help businesses understand their AML-related obligations, including how they can best comply.

Content

The UK

Regulators continue to grapple with finding a balance between fostering innovation and competition, and seeking to ensure customer and market protection against the risks of increased use of technology. Against this backdrop, the cryptoasset market continues to grow, accompanied by increasingly greater levels of regulatory scrutiny, and the UK is set to expand its regulatory perimeter in the next few years to include cryptoassets.

Following work undertaken by the Cryptoassets Task Force and its October 2018 **report** on the UK's approach to cryptoassets and distributed ledger technology (DLT) in financial services, in 2019 the Financial Conduct Authority (FCA) published its **guidance** on cryptoassets setting out details on where different types of cryptoassets might fall in the UK regulatory perimeter. The FCA's ban on retail sales of crypto derivatives took effect on 6 January 2021 and, in Q1 2021, HM Treasury (HMT) is expected to issue a response to its July 2020 **consultation** on expanding the financial promotions regime to cryptoassets.

Against the backdrop of these developments both in the UK and globally, on 7 January 2021, HMT published a **consultation** and call for evidence on the regulatory approach to cryptoassets and stablecoins. The consultation represents the first stage in HMT's consultative process on the broader regulatory approach to cryptoassets and stablecoins, and aims to establish a regulatory regime for cryptoassets guided by the objectives of protecting financial stability, delivering consumer protections, and promoting competition and UK competitiveness. To achieve these objectives, and in keeping with the Future Regulatory Framework **Review**, HMT's consultation sets out a framework of requirements underpinned by the high-level principles of technology agnosticism and "same risk, same regulatory outcome," proportionality and incremental change, and agility and alignment to broader reforms to regulation. The detailed package of regulation is left to the regulators.

The consultation closed on 21 March 2021. Although HMT has not indicated a specific target date by which it will respond or set out legislative measures, the FSB's **roadmap** to enhance cross-border payments targets completion of international standard-setting work on global stablecoins by December 2021 and the establishment of national regulatory frameworks by July 2022. In the longer term, HMT will consider bringing a broader set of cryptoasset market actors or tokens into an authorizations regime. For further details on HMT's consultation and how it compares to similar EU proposals, see our alert **here**.

More broadly, the UK's fintech sector is due to get a major boost in reforms suggested as part of the Kalifa **Review** of UK fintech. These reforms are part of a suite of legislative reviews launched by the UK government to enhance the competitiveness of the UK market in the area of digital finance post-Brexit. The review is intended to catalyze growth in the UK fintech sphere and provides recommendations to ensure the UK maintains its position as a world leader in financial services as the sector undergoes a technological revolution and it remains the "best place" in the world to start and grow a fintech business. While HMT's recent consultations have sought to implement individual regulatory changes, the Kalifa Review is a high-level strategic document seeking to identify threats and opportunities for the UK fintech sector, and to create a facilitative and permissive environment for the industry to thrive.

The review notes that the UK has the potential to be a leading global center for the issuance, clearing, settlement, trading and exchange of crypto and digital assets. It cites that other jurisdictions are developing their own propositions for crypto, such as the EU's proposed Regulation on Markets in Crypto-Assets (MiCA), and suggests that the UK acts quickly to preserve its strong position in the crypto market, for example by developing a bespoke regime that is more innovation driven and adopts a functional and technology-neutral approach. This regime could be tailored to the specific risks arising from the cryptoasset-related activities. To that end, the review has welcomed HMT's

consultation on cryptoasset regulation, as well as its proposal to investigate a wider-ranging crypto regulation.

Interestingly, the review also supports the introduction of a UK Central Bank Digital Currency (CBDC) — a concept currently under **consultation** by the Bank of England. This would be a major driver for the uptake of cryptocurrencies and could be a catalyst for cryptoassets to be adopted by mainstream businesses.

Given the review's recommendations, HMT's consultation and the fledgling status of the UK's crypto regulatory regime, there will be impetus for HMT to bring forward its consultation on regulating other cryptoassets to capitalize on its strong position in the fintech world and forge the global path toward regulating crypto with a bespoke regime. However, this will require extensive regulatory reform to bring crypto within the regulatory sphere, and with challenges to ensure the balance between innovation, competition and market safety, it remains to be seen how ambitious the UK is willing to be in this regard.

The US

In late 2020, the Financial Crimes Enforcement Network (FinCEN) — the US financial regulator charged with combating terror financing and administering AML procedures — issued a proposed **new rule** extending information collection and reporting requirements to certain cryptocurrency transactions. FinCEN had previously extended its AML-driven requirements for fiat currency under the Funds Travel Rule to its regulated entities (known as money service businesses, or MSBs) whose customers transact cryptocurrency over certain threshold amounts.

Under the new proposed Crypto Wallet Rule, MSBs would be required to collect and store transaction information for all crypto transactions over USD 3,000 with unhosted wallets. Although the term is not defined in the proposed rule, "unhosted wallets" are generally understood to mean wallets that are not hosted by an MSB, such as a crypto exchange. FinCEN envisaged this rule as merely closing the gap between large cash and large crypto reporting requirements, and did not intend to open it to public comment. After industry complaints over a lack of transparency, the public was given a limited 15-day period to comment on the proposed rule. FinCEN received over 7,500 comments during this window and has extended the comment period to 29 March 2021.

The proposed Crypto Wallet Rule would require MSBs to collect and store the names and addresses of customers transferring more than USD 3,000 to unhosted wallets, as well as the type of cryptocurrency, the time of the transaction, the assessed value of the transaction in US dollars, and the name and physical address of each counterparty involved in the transaction. Where an MSB's customer transfers cryptocurrency with a value in excess of USD 10,000 in a single day to an unhosted wallet, the MSB must file a virtual currency transaction report providing this information to FinCEN.

What has alarmed some in the cryptocurrency community is the impact this rule would have on financial privacy. Transactions in fiat currency, under the Funds Travel Rule, require the MSB to collect and store substantial information on the sender, including name, account number, physical address, its financial institution, and the amount and date of the transaction, as well as the recipient's financial institution. Under the proposed Crypto Wallet Rule, MSBs will be required to capture the

recipient's name and physical address when crypto is sent to an unhosted wallet. Unlike transactions in fiat currency, when this information collection, storage and reporting is applied to cryptocurrency transactions, the wallet address is connected to the identity of an individual, and the MSB and the government will have that individual's entire transaction history (as well as future transactions) with respect to that virtual currency. This has caused some detractors to refer to the proposed rule as the "surveillance rule."

Compliance with the proposed Crypto Wallet Rule also presents practical problems for MSBs. Crypto exchanges and other MSBs would need to accommodate manual processes for their customers to input required information, and those customers may not have all of the required counterparty information. Certain virtual currency transactions on a blockchain, for example, smart contracts, may not be associated with any individual or have a physical address. This may prevent customers of MSBs from engaging with smart contracts, including participation in the growing decentralized finance market.

It is unclear how FinCEN will respond to the comments it receives on the proposed Crypto Wallet Rule, given the hostile reception to the proposed rule in the crypto community. FinCEN will need to assess the impact of the proposed rule on emerging financial technologies, as well as balance its legitimate interest in combating terror financing against the rights of individuals to financial privacy.

Hong Kong SAR

In 2019, the Hong Kong Securities and Futures Commission (SFC) began an opt-in licensing regime for virtual asset trading platforms. A year later, the Financial Services and the Treasury Bureau (FSTB) launched a **consultation** on proposals to enhance AML and counter-terrorist financing regulation in Hong Kong under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO). One of the key proposals includes a new wide-ranging licensing regime for virtual asset services providers (VASPs), which will also be regulated by the SFC. The changes are intended to align Hong Kong's regulations with the latest requirements and recommendations of FATF, among other things. A license will need to be obtained within 180 days from the start date of the new regime, and licensees will be subject to AML/CTF obligations under the AMLO. We summarize the key proposals in the consultation as follows:

What products and services will be regulated and require a license?

A new regulated activity ("**Regulated VA Activity**") will cover the operation of a trading platform ("**VA Exchange**") that:

- is operated for the purpose of allowing an offer or invitation to be made to buy or sell any virtual assets (VA) in exchange for any money or any VA; and
- comes into custody, control, power or possession of, or over, any money or any VA at any point in time during its course of business.

Subject to various exemptions, VA would be defined as a digital representation of value that:

- is expressed as a unit of account or a store of economic value;

- functions as a medium of exchange accepted by the public as payment for goods or services or for the discharge of a debt, or for investment purposes; and
- can be transferred, stored or traded electronically.

Do the licensing requirements only apply when the regulated activity is undertaken in Hong Kong?

Licensing requirements apply in the following circumstances:

- conducting the Regulated VA Activity in Hong Kong; or
- actively marketing (whether in Hong Kong or from elsewhere) to the public of Hong Kong a Regulated VA Activity or a similar activity elsewhere (i.e., services associated with a VA Exchange).

Are there any carve-outs or exemptions?

A number of services and assets will fall outside the scope of VA:

- digital representations of fiat currencies (including digital currencies issued by central banks)
- financial assets (e.g., securities and authorized structured products) already regulated under the Securities and Futures Ordinance (SFO)
- closed-loop, limited-purpose items that are non-transferable, non-exchangeable and non-fungible (e.g., air miles, credit card rewards, gift cards, customer loyalty programs, gaming coins, etc.)

Operating the following platforms will not require a separate VASPs license under the new regime:

- a peer-to-peer trading platform where the platform only provides a forum for the buyers and sellers of VA to post bids and offers for the parties to trade at an outside venue. This is provided that the actual transaction is conducted outside the platform and the platform is not involved in the underlying transaction by coming into possession of any money or any VA at any point in time
- a VA Exchange that is already regulated by the SFC as a licensed corporation under the SFO

Are there any incorporation or personnel requirements to be eligible for a license?

For a local entity, the licensee must be a Hong Kong incorporated company with a permanent place of business in Hong Kong. In any event, there must be at least two responsible officers (ROs), with all executive directors approved by the SFC as ROs.

Will there be licensing conditions imposed?

Licensing conditions and regulatory requirements may be imposed, which will cover areas including the following:

- serving professional investors only, i.e., no retail clients allowed (at the initial stage)
- adequate financial resources
- proper corporate governance structure
- prudent and sound business operations
- appropriate risk management policies and procedures
- proper segregation and management of client assets
- robust VA listing and trading policies
- financial reporting and disclosure
- prevention of market manipulation, abusive activities and conflicts of interest

Singapore

The innovative Payment Services Act 2019 ("**PS Act**"), which came into force last year, has recently been amended by the Payment Services (Amendment) **Bill**, although the amendments are not yet in force. Broadly speaking, they will expand and align the Monetary Authority of Singapore's (MAS) regulation of VASPs in line with the revised FATF Standards, which address money laundering and terrorism financing risks inherent to VASPs. They also introduce additional requirements to mitigate the ML/TF and proliferation financing risks arising from certain business models where entities in Singapore carry on cross-border money transfer transactions. Finally, they further define the ambit of the PS Act and MAS' powers.

Specifically, the amendments widen the key PS Act definitions over Digital Payment Token (DPT) activities and cross-border and domestic money transfer services. Specific to DPT activities, VASPs conducting the following activities will be regulated under the PS Act:

- accepting (either as principal or agent) DPTs from one DPT account (in Singapore or abroad) to transmit or to arrange to transmit the DPT to another DPT account (in Singapore or abroad)
- inducing or attempting to induce any person to agree to, or to make an offer to, buy or sell any DPT for money or other DPT
- where the DPT is under the service provider's control, carrying out a customer's instructions relating to that DPT or an associated DPT
- safeguarding the DPT or the DPT instrument

This sector continues to evolve and, in recognition of the fact that the development of new DPTs, including stablecoins, could lead to user adoption gaining traction quickly, MAS' powers will be expanded to allow it to impose additional requirements on DPT licensees. These encompass the following:

- user protection measures on certain DPT service providers to ensure the safekeeping of customer assets held by the DPT service provider, where necessary
- the imposition of measures on certain DPT service providers where MAS considers it necessary or expedient in the public interest, or the interests of the stability of the financial system in Singapore or the monetary policy of MAS

These new powers may include prescribing the following:

- the extent to which assets belonging to a customer may be commingled with other assets also held by that licensee
- maintenance of a specified amount or percentage of assets
- safeguards in the event of insolvency, including insurance against this risk
- the manner of dealing with customers for the purposes of safeguarding customers' assets, protecting data and safeguarding DPT instruments
- disclosure of information to customers
- monitoring of customers' DPT accounts and assets
- standards and processes to safeguard against unauthorized use of customers' assets and DPT instruments, and to protect against unauthorized use and disclosure of data
- the amount of DPTs that can be contained or transferred from a DPT account and which a licensee can hold or transfer
- the exchange of DPTs for Singapore currency
- the use of moneys collected in exchange for DPTs for any of the licensee's business activities
- the use of DPTs for any of the licensee's business activities
- any other requirements relating to matters that MAS considers necessary or expedient in the public interest, and taking into account the stability of Singapore's financial systems or MAS' monetary policies

The regulator will also be able to require particular classes of licensees or payments services to safeguard money received from customers. In respect of a prescribed payment service, the amendments will allow MAS to prescribe a Major Payment Institution (MPI), instead of the present application to every MPI. The obligation to ensure that information provided to MAS is not false or misleading will be extended to apply to corporate entities, and not just individuals as is currently the case.

Thailand

The advent of cryptocurrencies and digital tokens has resulted in different regulations in various jurisdictions around the world. The key law in Thailand regulating cryptocurrencies and digital token offerings is the Emergency Decree on Digital Asset Businesses, B.E. 2561 (2018), which took effect on 14 May 2018.

The main regulator for the Digital Asset Decree is the Securities and Exchange Commission (SEC), which periodically issues sub-regulations that are binding on those involved in digital asset activities.

In March 2021, the SEC amended regulations on the supervision of digital token offerings backed by real estate or real estate income streams (a real estate-backed ICO) to make them more comparable with real estate investment trusts regulations. The amended regulations aim to enhance investor protection and better support certain business models. In summary, the key requirements to offer real estate-backed digital tokens are:

Offer requirements

Generally, the issuance of digital tokens to the public will be subject to the SEC's approval. To obtain approval, the issuer of real estate-backed tokens must comply with the following additional requirements:

- Real estate: The construction of the underlying real estate must be completed and ready for use without being subject to any property rights or disputes. There is an exception where the token issuer has considered and issued an opinion in writing to the effect that these will not materially affect its use, and that the terms on which the real estate is acquired will be beneficial for digital tokens holders in general.
- Investment value: The amount or value of the investment in real estate must not be less than 80% of the project's amount or value, or the aggregate value of the real estate to be invested must not be less than THB 500 million.
- Due diligence: This must have been conducted on the real estate so as to comply with specified requirements, with complete and sufficient information on risk factors disclosed in the registration statement and draft prospectus.
- Appraisal: There must have been a full appraisal of title documents for disclosing information to investors. This must be carried out by at least two appraisers whom the issuer and ICO Portal consider to be appropriate and capable of reliably and sufficiently appraising the assets to reflect their actual value, who have been approved by the Office of the SEC, or who fulfill specific requirements if the real estate to be invested is located overseas.
- Legal formalities: The contract to acquire the real estate must not contain any agreement or obligations that may prevent the sale of the real estate at a fair price. A draft trust deed must be prepared and fulfil the requirements in the relevant regulations. There must be a mechanism to ensure that the issuer will transfer assets to the trustee as an asset pool of the trust.
- Types of tokens: If there are different types of digital tokens, the same type of digital token must have equal rights and benefits, while each type of digital token can have different rights and benefits but only in respect of the following:

  i. benefits or return of capital to holders of digital tokens

  ii. fees or expenses to be claimed from holders of digital tokens

  iii. other differences that the issuer may demonstrate as the practical categorization of digital tokens considering the benefits of holders of digital tokens in general and possible impacts on holders of digital tokens

Establishment of a trust

An issuer may set up a trust with any of the following elements:

- Trust for the holding of ownership or right of possession over real estate.
- Trust for investment in leasehold rights in a real estate.
- Trust which holds shares in a special purpose vehicle (SPV) that holds the ownership or right of possession over real estate, whereby:
    i. the shareholding is at least 75% of the total number of issued shares representing at least 75% of the total voting rights of the SPV
    ii. the shareholding is for the benefit of token holders to prevent assets of the SPV from being distributed, sold, transferred or encumbered without the trustee's approval, which must comply with the trust deed

Requirements for a trustee

The trustee must be appointed with the following roles and qualifications: the trustee must be confident that it can efficiently and independently perform the duty as a trustee. They must be independent from the token issuer and not connected with them, and cannot hold more than a prescribed number of digital tokens as a trustee. The trustee must monitor and supervise compliance of the token offering in accordance with the registration statement, prospectus, business plans and relevant laws, as well as the compliance of the trust deed with relevant laws. They must not do anything that is not in line with the trust's benefits or that may jeopardize its independence. Finally, the trustee must vote and act in good faith and in the best interests of the digital token holders.

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One Global Financial Services Regulatory Team

The financial services industry is undergoing sweeping changes driven by regulatory developments, rapidly advancing technology and continued consolidation in the sector. The far-reaching impact of financial reforms, intricacies in their implementation, and conflicting regulations in different jurisdictions can expose businesses to unforeseen risk.

Our global team provides financial institutions guidance on navigating through regulatory complexities in both established and emerging markets. Our lawyers have long-standing relationships with financial services regulators, and are experienced in helping financial institutions deliver financial services efficiently and cost-effectively in a compliant manner.

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