

CHARLTONS
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**2022 Hong Kong
Crypto Regulation**

Webinar Series

Webinar 1



APPROACHES TO CRYPTO REGULATION

- Severe restrictions on use (eg China)
- Specific regulatory framework (eg Malta, Gibraltar & Dubai)
- Regulation within existing categories of regulated financial instruments (eg US & UK)



COORDINATED APPROACH

- International Monetary Fund (IMF) has called for greater international coordination to address regulatory gaps and reduce potential for regulatory arbitrage
- Financial Action Task Force (FATF) requires member countries (incl. Hong Kong) to subject entities conducting specified activities involving crypto to same AML/TF obligations as traditional financial institutions
- Financial Stability Board (FSB) Report “Regulation, Supervision and Oversight of ‘Global Stablecoin’ Arrangements” (Oct 2020) – high level recommendations for regulation of global stablecoins
- Global stablecoins = widely adopted payment-related stablecoins with potential reach & use across multiple jurisdictions





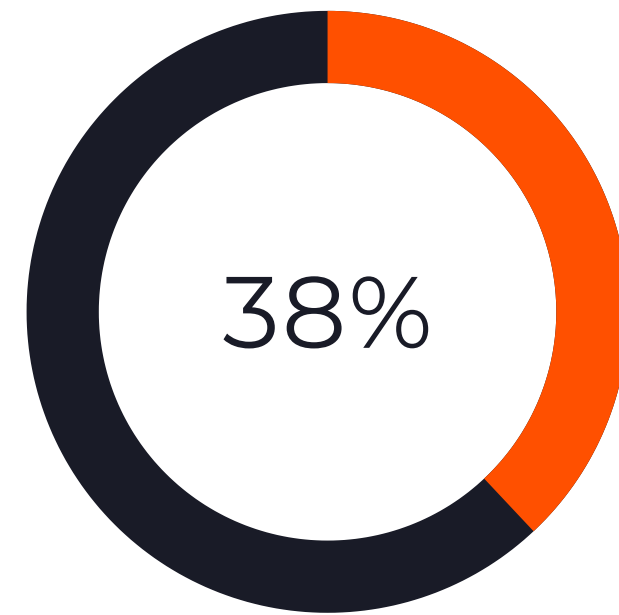
*As at 8 Sept. 2022 (Source CoinMarketCap)

CRYPTO ADOPTION

- Gemini 2022 Global State of Crypto Report
 - 45% of crypto owners in the US, Latin America and Asia Pacific first bought crypto in 2021
 - Inflation was primary driver of crypto adoption in developing countries
 - Adult crypto adoption highest in Brazil & Indonesia (41%) compared to 20% in US and 17% in Europe

INSTITUTIONAL INTEREST

Traditional hedge funds investing in crypto



300

Number of specialist crypto hedge funds

Source: PwC's 4th Annual Global Crypto Hedge Fund Report 2022



INTEREST OF TRADITIONAL FINANCIAL PLAYERS

MAY 2021

DBS Private Bank launches Asia's 1st bank-backed crypto trust service

JULY 2021

State Street offers administration capabilities for funds investing in crypto

APRIL 2022

Goldman Sachs offers 1st Bitcoin-backed loan

AUGUST 2022

Blackrock links its Aladdin platform to Coinbase to allow institutional clients access to Bitcoin

CRYPTO ETFs

- In Oct 2021, ProShares Bitcoin futures ETF commenced trading on NYSE
- US SEC has not approved any spot Bitcoin ETFs
- Toronto Stock Exchange trades several spot Bitcoin ETFs



COUNTRIES ADOPTING BITCOIN AS LEGAL TENDER

Sept 2021 El Salvador

April 2022 Central African Republic



DeFi & STABLECOINS

- Substantial increase in decentralised finance and use of stablecoins in 2021
- DeFi = peer-to-peer financial services provided on public blockchains, principally Ethereum
- Yield-farming = reward scheme for locking up crypto
- Stablecoins = crypto purporting to address volatility of “traditional” crypto
- Stablecoins can be asset-linked (eg link value to fiat currency) or algorithmic (seek to maintain stable value through protocols that increase or decrease supply in response to demand)
- Tether (USDT) and USD Coin (USDC) – most widely circulated stablecoins

CBDCs

- CBDCs = digital form of a country's fiat currency issued by its central bank
- Potential to improve efficiency and reduce costs of payments and improve financial inclusion
- 4 live retail CBDCs – in the Bahamas, Eastern Caribbean, Nigeria & Jamaica
- >80% of central banks considering launching a CBDC or have already done so
- China is conducting pilot programmes of its digital yuan in 23 cities
- US President Biden issued an Executive Order on Ensuring Responsible Development of Digital Assets in March 2022 ordering urgent research into the benefits and risks of a digital US\$

2022 CRYPTO MARKET CRASH

During the first half of 2022

- crypto market cap fell to US\$890 billion, down by $>2/3$ from a peak of US\$3.2 trillion in November 2021
- Bitcoin's price dropped $>70\%$

- May 2022 - the largest algorithmic stablecoin, TerraUSD, lost its dollar peg which led to the collapse of TerraUSD and its sister token, Luna
- Knock-on effects for Three Arrows Capital, one of the world's largest crypto hedge funds, which had significant exposure to Luna and suffered heavy losses on its collapse
- Three Arrows Capital declared bankruptcy in July 2021
- Crypto lenders Celsius and Voyager Digital filed for bankruptcy protection in July 2022

2022 CRYPTO MARKET CRASH

JAN 2022 - IMF's GLOBAL FINANCIAL STABILITY NOTES ON CRYPTIC CONNECTIONS: SPILLOVERS BETWEEN CRYPTO AND EQUITY MARKETS

- Growth in interconnection of crypto with regulated financial system
- Risks to financial stability
- Need for global standards to address risks to financial system posed by crypto assets

FEB 2022 - FSB's ASSESSMENT OF RISKS TO FINANCIAL STABILITY FROM CRYPTO-ASSETS

- Despite tremendous growth, crypto assets remain a small portion of the broader global financial system
- Direct connections between crypto assets and traditional financial markets are growing rapidly but remain limited
- Given fast evolving nature of crypto asset markets, may come to represent a threat to global financial stability due to their scale, structural vulnerabilities and increasing interconnection with traditional financial markets



FEB 2022 - FSB's **ASSESSMENT OF RISKS TO** **FINANCIAL STABILITY** **FROM CRYPTO-ASSETS**

DeFi

Challenges to regulation presented by:

- supposed decentralisation
- global nature
- failures to verify counterparties' identities
- privacy enhancement techniques



FEB 2022 - FSB's ASSESSMENT OF RISKS TO FINANCIAL STABILITY FROM CRYPTO-ASSETS

Stablecoins

- Difficulties in ensuring price stability
- Significant variance in composition and amount of reserve assets backing stablecoins
- Lack of standards for composition of reserve assets
- Not yet used as widespread means of payment
- Most frequent use cases currently include acting as a bridge between traditional fiat currencies and various cryptocurrencies, facilitating lending and borrowing and acting as collateral on DeFi platforms and serving as collateral in crypto derivative transactions
- Concerns re. future crash of a major stablecoin



- Need for crypto assets and markets to be subject to effective regulation and oversight commensurate to the risks they pose
- Cryptocurrency activities posing risks similar to traditional financial activities should be subject to the same regulatory outcomes
- Need for robust regulation of stablecoins that enter the mainstream financial system and are widely used as a means of payment and/or store of value in multiple jurisdictions
- Need for high standards on transparency and the maintenance of reserves that preserve the value of stablecoins

JULY 2022 – FSB STATEMENT ON INTERNATIONAL REGULATION & SUPERVISION OF CRYPTO-ASSET ACTIVITIES

DEC 2021 – BANK FOR INTERNATIONAL SETTLEMENTS – DeFi RISKS AND THE DECENTRALISATION ILLUSION

- While DeFi has the potential to complement traditional financial activities, it currently has few real-economy uses and largely acts to support speculation and arbitrage across different crypto assets
- If DeFi were to become widely adopted, it would need to be properly regulated and public authorities would need to address DeFi's governance structures to ensure that measures are in place to maintain financial stability and protect investors' interests

JULY 2022 BIS COMMITTEE ON PAYMENTS AND MARKET INFRASTRUCTURE AND IOSCO GUIDANCE

- Confirmed that Principles for Financial Market Infrastructures (PFMI) apply to systemically important stablecoin arrangements that transfer stablecoins
- Extends the international standards for payment, clearing and settlement systems to systemically important stablecoin arrangements



- Proposes global tax transparency framework for crypto assets

- Seeks to increase transparency for global tax authorities by requiring VASPs to better identify users and report certain transactions



**MARCH 2021 – OECD
CONSULTATION ON
CRYPTO-ASSET
REPORTING
FRAMEWORK AND
AMENDMENTS TO THE
COMMON REPORTING
STANDARD**

- Fraud
- Financial crime
- Security breaches
- Misselling and market abuse
- Volatility

RISKS ASSOCIATED WITH CRYPTO

BENEFITS OF CRYPTO

- More efficient & cheaper transactions
- Potential alternative to traditional banking sector
- Financial access for the world's unbanked

FATF STANDARDS ON AML AND CFT

Revised Recommendation 15 – Member countries must:

- regulate virtual asset service providers or VASPs for AML and CFT purposes
- license or register VASPs
- subject VASPs to effective systems for monitoring and supervision

Member countries can also prohibit virtual asset activities or VASPs to support other policy goals (eg consumer protection/ monetary policy)

- Requires VASPs to obtain, hold and transmit information relating to the originator and beneficiary when transferring virtual assets

- Extends to virtual asset transfers the requirements that already apply to wire transfers

FATF REVISED TRAVEL RULE (RECOMMENDATION 16)

FATF DEFINITION OF VIRTUAL ASSETS

- a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes
- excludes digital representations of fiat currencies, securities and other financial assets that are covered elsewhere in the FATF Recommendations

FATF DEFINITION OF VIRTUAL ASSET SERVICE PROVIDERS (VASPs)

Any natural or legal person who is not covered elsewhere in the Recommendations and conducts any of the following activities or operations as a business for or on behalf of another natural or legal person:

- i. exchanges virtual assets and fiat currencies
- ii. exchanges different forms of virtual assets
- iii. transfers virtual assets (i.e. conducts a transaction that moves a virtual asset from one virtual asset address or account to another)
- iv. provides safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets
- v. takes part in and provides financial services related to an issuer's offer and/or sale of a virtual asset

OCTOBER 2021 FATF UPDATED GUIDANCE

Provides additional guidance on:

- the definitions of virtual assets and VASPs
- how the FATF Standards apply to stablecoins
- countering ML/TF risks for peer-to-peer transactions
- the licensing and registration of VASPs
- the implementation of the “travel rule”
- information-sharing and cooperation among VASP supervisors



DECENTRALISED FINANCE

- Creators, owners, operators or others who maintain *control* or *sufficient influence* in DeFi arrangements may be within the definition of a VASP if they provide or actively facilitate VASP services
- Non-exhaustive factors for identifying owners and operators include:
 - whether the person has control or sufficient influence over assets or other aspects of the service's protocol
 - whether there is an ongoing business relationship between the person and users, even if this is executed through a smart contract or voting protocols
 - whether the person makes profits from the service
- FATF standards do not apply to developers who create software or protocols for DeFi platforms

PEER-TO-PEER TRANSACTIONS

- FATF will not extend AML/CFT obligations applicable to intermediaries to individuals who engage in peer-to-peer transactions for the time being
- Peer-to-peer transactions are virtual asset transfers not involving a VASP or another obliged entity (eg transfers between two unhosted wallets)
- Update recommends countries to monitor ML/TF risks relating to peer-to-peer transactions and if they consider the risks to be high, to consider adopting optional measures

- Entities that issue, offer and maintain the reserve of stablecoins and those that distribute and trade stablecoins, including exchanges and custodians, may be subject to AML/CFT requirements

- Central governance bodies of stablecoins will generally be covered by FATF Standards either as a financial institution or a VASP

STABLECOINS

NON-FUNGIBLE TOKENS (NFTs)

- NFTs and other digital assets that are unique, non-interchangeable and generally used as collectibles rather than as payment or investment instruments, generally fall outside the FATF definition of virtual asset

CBDCs

- CBDCs are not regarded as virtual assets BUT FATF standards apply to CBDCs in the same way they apply to any other form of fiat currency issued by a central bank

- A VASP should be licensed or registered at least in the jurisdiction in which it is created (i.e. incorporated or registered)
- Jurisdictions can also require licensing/registration of VASPs that offer products or services to customers in their jurisdiction, or conduct operations from their jurisdiction
- Only competent authorities, and not self-regulatory bodies, can supervise VASPs



LICENSING AND REGISTRATION OF VASPS

TRAVEL RULE

- October 2021 guidance requires virtual asset transfers between VASPs and non-obliged entities (eg unhosted wallets) to be subject to the Travel Rule requirements
- VASPs are now required to determine whether a transaction involves a VASP or an unhosted wallet, and to apply the relevant measures
- For virtual asset transfers to or from unhosted wallets, the obliged entity has to comply with the Recommendation 16 requirements in relation to its customer (the originator or the beneficiary). The obliged entity is not required to submit the required information to non-obliged entities

TRENDS IN USE OF VIRTUAL ASSETS FOR ML/TF PURPOSES

- Generally, only one type of virtual asset was used
- Where more than one type of virtual asset was used, this typically involved the layering of illicit proceeds
- Most prevalent offences involving virtual assets were narcotics-related and fraud offences
- Significant increase in the value of virtual assets obtained through ransomware payments
- Virtual assets were also used to evade financial sanctions

RISK LANDSCAPE

Dominant trends in virtual asset ML/TF risk landscape include

- use of VASPs registered or operating in jurisdictions that lack effective AML/CFT regulation
- use of tools and methods to increase the anonymity of virtual asset transfers (eg tumblers, mixers etc)

FATF June 2020 Report to the G20 Finance Ministers & Central Bank Governors on so-called Stablecoins

- Key FATF concern that mass-adoption could lead to a substantial increase in the number of anonymous peer-to-peer virtual asset transactions occurring via unhosted wallets, since peer-to-peer transactions not involving a VASP or other AML/CFT-obliged entity are not explicitly covered by the FATF Recommendations and can potentially be used to avoid the AML/CFT controls
- Various options can mitigate the risks presented by anonymous peer-to-peer transactions if national regulators consider the ML/TF risks posed to be unacceptably high (eg mandating that transactions involve a VASP or financial institution)

FATF AND STABLECOINS

FATF RECOMMENDATIONS APPLICABILITY TO STABLECOINS

- Entities within stablecoin arrangements have AML/CFT obligations under the FATF Recommendations if they meet the definition of a financial institution or a VASP
- central governance bodies within a stablecoin arrangement will generally be obliged entities under the FATF

STABLECOIN REGULATION

- Discussions triggered by Meta's (then Facebook) plans to launch Libra (renamed Diem) – an internationally available cryptocurrency for retail payment
- October 2020 FSB report "Regulation, Supervision and Oversight of 'Global Stablecoin' Arrangements" set out 10 high level recommendations for the regulation of global stablecoins (GSC) intended for retail use including:
 - regulatory authorities should regulate GSC arrangements proportionately to their risks
 - GSC arrangements should be required to have effective risk management frameworks in relation to reserve management, operational resilience and AML and CFT measures
 - GSC arrangements should provide users with the information necessary to understand the stablecoin's stabilisation mechanism and provide legal clarity on the nature and enforceability of any redemption rights

HONG KONG – HKMA DISCUSSION PAPER ON CRYPTO-ASSETS AND STABLECOINS (JAN 2022)

- Proposes to regulate payment-related stablecoins – those crypto assets most likely to become widely accepted as a means of payment and thus most likely to intersect with mainstream finance
- Regulation to apply to asset-linked stablecoins, such as those whose value is linked to a specific fiat currency, rather than algorithm-based stablecoins
- Certain activities relating to stablecoins will require authorisation and licensing by the HKMA
- Any entity wanting to conduct any of the regulated stablecoin-related activities in Hong Kong will need to be incorporated in Hong Kong

HONG KONG – HKMA DISCUSSION PAPER ON CRYPTO-ASSETS AND STABLECOINS (JAN 2022) (CONT'D)

- Proposed regulated activities include:
 - issuing or destroying stablecoins
 - managing reserve assets to ensure stabilisation of the stablecoin's value
 - storing the private keys providing access to stablecoins
 - executing transactions in stablecoins
- Since stablecoin arrangements typically involve > one entity, multiple entities in a stablecoin arrangement may require authorisation and licensing

JAPAN

- Introduced a regulatory framework for stablecoins when it amended its Payment Services Act in June 2022
- Issue of stablecoins will be restricted to banks, trust companies and certain licensed fund transfer agents
- Law defines stablecoins as digital currencies



JAPAN (CONT'D)

- Stablecoins must be linked to the yen
- Stablecoins must have a guaranteed right to redemption
- Brokers trading and managing stablecoins will need to be registered with Japan's Financial Services Agency and apply more stringent AML measures
- Law will not apply to asset-linked stablecoins from overseas issuers or algorithmic stablecoins
- New regime will be implemented in 2023

US PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS' REPORT ON STABLECOINS

- The President's Working Group on Financial Markets and two other bodies issued a Report on Stablecoins in November 2021
- Recommended the enactment of legislation to subject stablecoins to a federal prudential framework
- Recommendations include that stablecoin issuers should be insured depository institutions

UK's FINANCIAL SERVICES AND MARKETS BILL

- Financial Services and Markets Bill (expected to be enacted in early 2023) will include regulatory regime for digital settlement assets (DSAs)
- DSAs to be defined as a digital representation of 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 can include distributed ledger technology)
- It's expected that the UK government will use the definition to implement plans to regulate stablecoins used as a means of payment

UK's FINANCIAL SERVICES AND MARKETS BILL (CONT'D)

- Bill will give the Treasury broad powers to regulate DSAs
- Powers to amend legislation to regulate payments involving DSAs and payment systems involving arrangements using DSAs, as well as their service providers
- Treasury will be able to introduce insolvency arrangements for payment systems using DSAs

UK's FINANCIAL SERVICES AND MARKETS BILL (CONT'D)

- Treasury will have the power to apply existing legislation regulating electronic money and payments to DSAs
- Amendments to the Financial Services (Banking Reform) Act 2013 will allow the Treasury to designate a payment system using DSAs as a regulated payment system
- Part 5 of the Banking Act 2009 will be expanded to cover payment systems using DSAs and DSA service providers
- Treasury will be able to specify a DSA payment system or service provider as a recognised entity if it is likely to threaten the stability of or confidence in the UK financial system
- Entities will be regulated by the Bank of England

EU MiCA

- The EU Council made an announcement on 30 June 2022 of provisional agreement with the European Parliament on the Markets in Crypto-assets regulation (MiCA)
- MiCA will implement a strong framework for stablecoins aimed at protecting investors and preserving financial stability
- Requirements for stablecoins to include an obligation to maintain a sufficiently liquid reserve, with a 1/1 ratio and be partly in the form of deposits
- Stablecoin issuers will need to have a presence in the EU and provide redemption rights to holders
- Stablecoin reserves will be protected in the event of insolvency



MCQs

Question 1

China's digital yuan, currently on trial in major cities, will be an example of what when it is formally launched?

- (A) A cryptocurrency similar to Bitcoin
- (B) A stable coin similar to Tether (USDT)
- ✓ (C) A central bank digital currency
- (D) A fiat currency

Question 2

Under the revised FATF Recommendations, the conduct of which of the following activities would NOT make an entity a Virtual Asset Service Provider?

- (A) Exchanging crypto assets for fiat currencies
- (B) Exchanging one type of crypto asset for another
- (C) Providing safekeeping of crypto assets
- ✓ (D) Exchanging fiat currencies only

Question 3

What does the FATF's Travel Rule broadly require?

- (A) Governments to designate an authority to license/register VASPs operating in their jurisdiction
- (B) Legislation regulating the issue and exchange of stablecoins
- ✓ (C) The collection and transfer of information relating to the originator and beneficiary of virtual asset transfers
- (D) Reporting of suspicious transactions to FATF

Question 4

Which of the following statements regarding the HKMA's proposals for stablecoin regulation is FALSE?

- ✓ (A) It would apply to both asset-linked and algorithmic stablecoins
- (B) It would require issuers of stablecoins to be licensed by the HKMA
- (C) It would initially only apply to payment-related stablecoins
- (D) Only Hong Kong-incorporated entities would be eligible for licensing

Question 5

Which of the following is not a requirement for VASPs under the FATF Recommendations?

- (A) They must be subject to the same anti-money laundering and counter-financing of terrorist obligations as traditional financial institutions
- ✓ (B) They need to be supervised by an appropriate self-regulatory body
- (C) They should be subject to a licensing or registration regime
- (D) They are required to comply with the FATF's travel rule



Q&A

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<https://cutt.ly/JVcVi7X>