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VIRTUAL ASSETS

REGULATORY FRAMEWORK | AN EVOLVING LANDSCAPE

UAE | BAHRAIN | SWITZERLAND
LIECHTENSTEIN | UK | USA

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DISCLAIMER

INSIGHTS

“Concisely summarizing the U.S.’s digital asset regulatory framework is a challenge, but I hope this report will help readers get a high-level perspective from which they can build. ”

- Eric Hess, Founder and Managing Counsel of Hess Legal Counsel

“With so much evolving in digital asset regulation in the U.S., it’s great to have a resource like KARM’s publication on virtual assets regulatory framework.”

-Greg Xethalis, General Counsel to Multicoin

“After a volatile period throughout 2022, the crypto asset regulatory space is about to enter a very dynamic period. Jurisdictions are increasingly focussed on getting to grips with newer innovations such as NFTs, as well as securing investor protection. At the same time, the sector remains a high catalyst for growth and innovation so those jurisdictions that can find the right balance to encourage activity but guard against excesses, can reap major reward.”

-Jonathan Geen, Director at Geen Services Limited

"Bracing the wave of virtual asset revolution has led jurisdictions across the world to adopt formal frameworks. Consequently, countries like UAE, Switzerland, UK, and US are cementing their positions as global hubs in the digital ecosystem with robust regulatory infrastructure. Heading the innovation and legal landscapes, KARM's report presents a binding perspective of the virtual assets economy to foster a deep understanding!"

-Kokila Alagh, Founder at KARM Legal Consultants

“The Liechtenstein Blockchain Act is an innovative piece of regulation which was one of the first attempts globally to address the key issues that arise in the token economy, providing unique levels of legal protection for customers wishing to invest in digital assets as well as for entrepreneurs in the space. As other jurisdictions around the world, including the EU, start to take the regulation of crypto seriously, the Token Container Model established in the Liechtenstein Blockchain Act is a natural starting point for many.”

-Oliver Linch, CEO of Bittrex Global GmbH

“The Token Economy deserves a proper legal framework, Liechtenstein’s TVTG not only covers service providers, but also provides a civil law framework for tokenization of assets!”

-Thomas Nägele, Managing Partner at NÄGELE Attorneys at Law

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INTRODUCTION

While 'web' has witnessed evolution into a third generation (colloquially betrothed as Web 3.0) over few decades, blockchain and its use cases – digital assets, have seen generations evolve in a short span of a decade. Starting from the launch of Bitcoin in 2009 to varied forms of tokenization, including advent of NFTs, this ecosystem has gone through a multiverse!

While the cross-border nature of digital assets and anonymity offered by blockchain solutions pose risks to the financial economy, the ease of access and outreach of tokenised products have also revamped many sectors globally. Consequently, it has become imperative that tokenised products and the associated services be well-defined and classified within a regulatory framework. With this objective in mind, few countries and international organizations (such as FATF) have attempted to provide a formal nomenclature for these tokenised products.

In June 2014, FATF had published a guidance for all its member countries in relation to digital assets and VASPs. This guidance was further updated in October 2021 wherein, a 'Virtual Asset' was defined as "a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes". Prior to this, FATF had recommended that VASPs be regulated for AML / CFT purposes, and be subject to effective licensing, monitoring and supervision.

Following the command, many jurisdictions have either amended their existing regulatory framework to recognize digital assets and VASPs or implemented new regulations to cater to the needs of this sector. Ranging from the nomenclature of digital assets to AML / CFT regulations, the sophisticated jurisdictions have tried to tackle everything within and beyond.

The collapse of algorithmic stable coin TerraUSD (UST) in May 2022 followed by the FTX crypto exchange exposed the need for regulatory oversight. In the aftermath of these collapses, policy makers and legislators across the globe are actively pushing for formal regulations to address and mitigate risks associated with digital assets.

On the other hand, what has helped the growth of regulations in this sector is the willingness of regulators to engage in conversations around use and misuse of technology. Gone are the days when regulators would unilaterally sermonize the masses on use of law for various sectors. Today's regulators are a lot more woke in terms of their exposure to technology and sometimes- pure willingness to admit that 'We know that we don't know'.

With this publication, we intend to keep that conversation alive by identifying the key developments in the virtual assets sector in UAE, Bahrain, Switzerland, Liechtenstein, UK and USA.

Though the nature of regulatory licenses vary among these jurisdictions, the key focus is to create a regulatory environment that fosters growth, without compromising on customer protection or AML concerns.

We hope that you enjoy reading as much as we enjoyed compiling this report.

Team KARM

"Technology is best when it brings people together."

- Matt Mullenweg

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ABBREVIATIONS

ADGM	The Abu Dhabi Global Market
AED	United Arab Emirates Dirham or Emirati Dirham
AML	Anti-Money Laundering
ATS	Alternative Trading System
BD	Bahraini Dinar
B.S.C.	Bahraini Joint Stock Company
CBB	The Central Bank of Bahrain
CBDC	Central Bank Digital Currency
CBUAE	The Central Bank of the UAE
CFT	Combating the Financing of Terrorism
CFTC	Commodity Futures Trading Commission of the United States
CHF	Confoederatio Helvetica franc or Swiss Franc
DeFi	Decentralised Finance
DFSA	The Dubai Financial Services Authority
DIFC	The Dubai International Financial Centre
DLT	Distributed Ledger Technology
DMCC	Dubai Multi Commodities Centre
DNFBP	Designated Non-Financial Businesses and Professionals
EEA	European Economic Area
E-money	Electronic Money
FATF	The Financial Action Task Force
FCA	The Financial Conduct Authority of the United Kingdom
FinCEN	The Financial Crimes Enforcement Network of the United States
FINMA	The Financial Market Supervisory Authority of Switzerland
FinTech	Financial Technology
FMA	The Financial Market Authority of Liechtenstein
FSP	Financial Services Permission
FSRA	The Financial Services Regulatory Authority of ADGM
ICO	Initial Coin Offering

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ABBREVIATIONS

IFZA	International Free Zone Authority
IPA	In-Principle Approval
KYC	Know Your Customer
MENA	Middle East and North Africa
MTF	Multilateral Trading Facility
NFA	The National Futures Association of the United States
NFT	Non-Fungible Token
P2P	Peer-to-Peer
SCA	The Securities and Commodities Authority of the UAE
SEC	The Securities and Exchange Commission of the United States
SVF	Stored Value Facility
UAE	The United Arab Emirates
United States or USA	The United States of America
USD	United States Dollar
VARA	The Dubai Virtual Assets Regulatory Authority
VASP	Virtual Asset Service Provider

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BROAD DEFINITIONS

In this report, the following terms are used commonly. The broad meanings of these terms are provided in the table below.

Blockchain	Blockchain can be broadly described as a distributed ledger that can record transactions in a verifiable and permanent manner. In most blockchains, each new block contains cryptographically hashed data and is built upon the previous block in the chain.
Digital Assets	Digital assets shall mean all virtual or digital assets or tokens operating on a blockchain and protected by cryptography including those defined as 'Virtual Asset' by FATF.
Virtual Assets	FATF defines 'Virtual Asset' as "a digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes. Virtual assets do not include digital representations of fiat currencies, securities and other financial assets that are already covered elsewhere in the FATF Recommendations"[1] .
VASPs or Virtual Assets Service Providers	VASPs refers to all types of digital assets service providers including persons falling within the below mentioned definition provided by FATF. FATF defines the term 'virtual asset service provider' to include "any natural or legal person who as a business conducts one or more of the following activities or operations for or on behalf of another natural or legal person: a. Exchange between virtual assets and fiat currencies; b. Exchange between one or more forms of virtual assets; c. Transfer of virtual assets; d. Safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets; e. Participation in and provision of financial services related to an issuer's offer and/or sale of a virtual asset."[2]
Stablecoins	Stablecoins can be broadly described as digital assets that aim to "maintain a stable value relative to a specified asset, or a pool or basket of assets to other assets."[3]
Tokens	The term Token can be defined broadly as a cryptographically secured digital representation of value, rights or obligations, which may be issued, transferred and stored electronically, using DLT or other similar technology.

[1] Glossary – FATF; https://www.fatf-gafi.org/glossary/u-z/

[2] Glossary–FATF; https://www.fatf-gafi.org/glossary/u-z/

[3] FSB, Addressing the regulatory, supervisory and oversight challenges raised by "global stablecoin" arrangements: Consultative document, April 2020; https://www.fsb.org/2020/04/addressing-the-regulatory-supervisory-and-oversight-challenges-raised-by-global-stablecoin-arrangements-consultative-document/

UNITED ARAB EMIRATES

Authored by Praveena Pechetti and Kabir Hastir Kumar, KARM Legal Consultants

MENA is the world's fastest growing cryptocurrency market. As per a 2022 report by Chainalysis, MENA based users received USD 566 billion in cryptocurrency from July 2021 to June 2022, with a 48% increase compared to USD 272 billion cryptocurrency value received in the previous year. Within the MENA region, UAE is the fifth largest cryptocurrency market. Particularly, the Emirate of Dubai has become a hub for VASPs that serve customers across Asia and Africa, not just in the Middle East.[4]

The growth of the crypto market within UAE has acted as a driving force for the UAE regulators to take significant steps towards developing a regulatory framework for the digital assets sector. The openness of the regulators to technological innovation is reflected in their key policy and licensing initiatives launched at a national level as well as Emirate level, such as:

a. Emirate Blockchain Strategy (**"EBS"**);

b. Establishment of the Abu Dhabi Blockchain and Virtual Assets Committee;

c. Dubai Blockchain Strategy (**"DBS"**);

d. Dubai Metaverse Strategy (**"DMS"**); and

e. The regulatory sandbox regimes that allow innovative FinTech companies to test their products in controlled environments.

Specifically, the following regulatory developments have played a key role in catapulting UAE as a preferred destination for VASPs:

a. Regulatory framework of CBUAE in relation to SVFs and digital assets backed by fiat currency and used for payment purposes (referred to as 'Payment Tokens' under CBUAE rules);

b. The forward-looking initiatives and statements of SCA;

c. Comprehensive regulatory frameworks issued by ADGM and DIFC to regulate VASPs;

d. Establishment of VARA, an independent regulator exclusively for the digital assets sector for the Emirate of Dubai; and

e. Licenses offered by DMCC and IFZA in relation to certain specified digital assets activities.

While the regulatory developments in the digital assets space warrant a more detailed study, this chapter provides a brief overview of the relevant regulatory positions in UAE in relation to digital assets.

[4] Chainalysis - The 2022 Geography of Cryptocurrency Report;
https://blog.chainalysis.com/reports/middle-east-north-africa-cryptocurrency-geography-report-2022-preview/

REGULATORY FRAMEWORK

UAE - a federation of seven Emirates, has been a frontrunner in developing strong regulations in relation to digital assets. UAE's federal financial regulators, CBUAE and SCA embraced the developments and growing interest in digital assets within UAE, early on. With forward-looking statements and specialised regulatory licenses, these regulators have paved the way for a robust digital assets ecosystem in UAE.

UAE has multiple free zones, many of which have their own commercial laws and rules. Among the free zones, the two financial free zones, i.e., ADGM and DIFC have implemented comprehensive regulations that enable digital assets intermediaries and MTFs to procure appropriate authorisation / permissions. Parallelly, free zones like DMCC and IFZA have introduced crypto-specific activities within their list of permitted activities.

Being a federation, in addition to the federal laws that bind the nation as a whole, each Emirate has the power to introduce its own laws on matters outside the exclusive domain of the federation. In exercise of these powers, the Emirate of Dubai has promulgated the 'Law No. [4] of 2022 Regulating Virtual Assets in the Emirate of Dubai,' with the objective of enabling a safe market within the Emirate for digital assets adoption.

The varied yet promising regulatory developments within UAE are evidence of its continuous efforts to encourage innovation without compromising on customer protection. A snapshot of the key regulators / authorities is provided in the diagram below.

Diagram 1 – Financial Regulators / Licensing Authorities in UAE for Digital Assets Activities

UAE

Mainland-Federal Authorities	**CBUAE** Regulates Payment Tokens and SVF in UAE that accept *inter alia* crypto assets or Virtual Assets
	SCA Issued regulatory framework for digital assets activities, but has since confirmed that further revised regulations will be introduced
Financial Free Zones	**ADGM** Introduced comprehensive regulatory framework for digital assets activities in 2018
	DIFC Introduced comprehensive regulatory framework for digital assets activities in 2022
Mainland - Emirate of Dubai	**VARA** Established in early 2022. As of November 2022, VARA is operating the Minimum Viable Product ("**MVP**") program whereunder MVP permits are being issued to select VASPs
Other Free zones	**DMCC and IFZA** DMCC and IFZA have introduced crypto-specific activities

1. ADGM

ADGM introduced a comprehensive regulatory framework regulating digital assets activities in 2018, becoming one of the first regulators globally to design a bespoke framework specifically designed for VASPs. Since the introduction of the regulations, ADGM has transformed into a preferred jurisdiction for various types of VASPs.[5] As of March 2022, ADGM confirmed in its media announcements that it housed 11 fully licensed and approved in-principle VASPs inclusive of MTFs and market intermediaries such as broker-dealers, custodians and asset managers.

[5] ADGM Media Announcements, https://www.adgm.com/media/announcements/adgm-fsra-publishes-consultation-paper-to-advance-its-capital-markets-framework-and-ecosystem (accessed March 21, 2022)

1.1. Regulatory approach

ADGM's regulatory framework for digital assets is specified under *inter alia* : (i) Financial Services and Market Regulations, 2015 ("**FSMR**") and the related rulebooks; (ii) Guidance on Regulation of Virtual Asset Activities ("**Virtual Assets Guidance**"); (iii) Guidance on Regulation of Digital Securities Activity in ADGM ("**Digital Securities Guidance**"); and (iv) Guidance on Regulation of Digital Security Offerings and Virtual Assets ("**Offering Guidance**").

FSRA, the financial services regulator of ADGM, has adopted a technology-agnostic approach for regulation, with a focus on the activities conducted, as opposed to the underlying technology. In its 'Guiding Principles for the FSRA's Approach to Virtual Asset Regulation and Supervision' released in September 2022, FSRA has reiterated this stance and stipulated that FSRA will take the following guiding principles into consideration while regulating and licensing VASPs:

a. a robust and transparent risk-based regulatory framework;

b. high standards for authorisation;

c. prevention of money laundering and other financial crimes;

d. risk-sensitive supervision;

e. commitment to adopt enforcement actions against regulatory breaches; and

f. international cooperation.

1.2. Types of Digital Assets

Under the Virtual Assets Guidance, FSRA has classified digital assets into the following categories:

Digital Securities: Digital / virtual tokens that exhibit the features and characteristics of securities[6] under the FSMR.

Virtual Assets: 'Virtual Asset' is defined under FSMR as "A digital representation of value that can be digitally traded and it functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status in any jurisdiction. A Virtual Asset is neither issued nor guaranteed by any jurisdiction and fulfils the above functions only by agreement within the community of users of the Virtual Asset; and distinguished from Fiat Currency and E-money."

Examples of Virtual Assets include non-fiat virtual currencies and crypto-exchange tokens.

c. Utility Tokens: Tokens that may be redeemed for access to a certain product or service, typically offered utilising a DLT platform, but do not exhibit the features and characteristics of a regulated investment / instrument.

d. Fiat Tokens: Stablecoins whose value is fully backed by underlying fiat currency.

e. Derivatives and Collective Investment Funds of Virtual Assets, Digital Securities, and Utility Tokens

[6] Securities, as set out in Schedule 1 of FSMR, include the following: Shares; Instruments creating or acknowledging indebtedness; Sukuk; Government and public Financial Instruments; Instruments giving entitlements to investments; Certificates representing certain Financial Instruments; and Units in a Collective Investment Fund.

Diagram 2 – The diagram below explains how FSRA's regulatory approach varies according to the type of the digital asset

Digital Securities

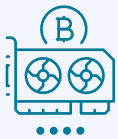
Deemed to be Securities under FSMR. All financial services activities in relation to Digital Securities are subject to relevant regulatory requirements of FSRA. Market intermediaries (such as brokers, dealers, custodians and asset managers) dealing in or managing Digital Securities and MTFs using Digital Securities must be licensed by FSRA

Virtual Assets

Treated as commodities under FSMR. Market intermediaries (such as brokers, dealers, custodians and asset managers) dealing in or managing Virtual Assets and MTFs using Virtual Assets must be licensed by FSRA

Derivatives and Collective Investment Funds

Treated as 'Specified Investments' under FSMR. Market intermediaries and market operators dealing in such Derivatives and Collective Investment Funds must be licensed by FSRA



Utility Tokens

Treated as commodities under FSMR. Unless such Utility Tokens qualify as 'Accepted Virtual Assets', spot trading and transactions in Utility Tokens do not constitute regulated activities

Fiat tokens

Treated as a form of digital representation of fiat currency. Where used as a payment instrument for the purposes of money transmission, the activity will be licensed and regulated as money services business (i.e., (payment services

Specifically, in relation to Fiat Tokens, the Virtual Assets Guidance clarifies the following:

a. FSRA permits only a fully backed 1:1 Fiat Token, that is backed by the same fiat currency that it purports to tokenise;

b. Issuers of Fiat Tokens for the purposes of facilitating or effecting payments are required to obtain an FSP to engage in the regulated activity of 'Providing Money Services'; and

c. An MTF using its own Fiat Tokens as a payment / transaction mechanism solely within its own platform / ecosystem is not required to take an additional FSP for the use of Fiat Tokens, provided that the Fiat Token is not transferred / transacted outside the MTF's platform / ecosystem.

1.3. License requirements for undertaking financial activities involving Virtual Assets

Any entity that wishes to conduct a regulated financial activity by way of business in and from ADGM must procure an FSP from FSRA to conduct such activity. Part 2 of Schedule 1 of FSMR stipulates the regulated activities that are permitted in relation to Virtual Assets.

A diagrammatic representation of the permitted regulated activities involving Virtual Assets and the applicable prudential category is provided below.

Diagram 3 – Virtual Assets Activities and Prudential Category for VASPs - ADGM

Category 2

Dealing in Investments as Principal (not as Matched Principal)

Buying or selling of Virtual Assets as a principal

Category 3A

Dealing in Investments as Agent or Matched Principal

- Buying or selling of Virtual Assets as agent
- Buying or selling of Virtual Assets as matched principal

Category 3C

Managing Assets

Managing assets belonging to another person, including any Virtual Assets, on a discretionary basis

Providing Custody

Safeguarding of Virtual Assets belonging to another

Category 4

Arranging Deals in Investments

Making arrangements with a view to another person (whether as a principal or agent) buying or selling Virtual Assets

Advising on Investments or Credit

Advising on the merits of buying or selling Virtual Assets

Operating a MTF

Operation of an MTF on which Virtual Assets are traded

FSRA permits regulated activities only in relation to 'Accepted Virtual Assets'. For a Virtual Asset to qualify as an Accepted Virtual Asset, it must meet, to the satisfaction of FSRA, certain key requirements with respect to the following aspects:

a. Maturity;
b. Security;
c. Traceability / monitoring;
d. Exchange connectivity;
e. Type of DLT;
f. Innovation / efficiency; and
g. Practical application / functionality.

Under FSRA's regulatory framework, an 'Accepted Virtual Asset' is specific to each FSP holder. FSRA will undertake a case-by-case study of the applicant's technological and operational readiness vis-à-vis each Accepted Virtual Asset.

1.4. Licensing process

An applicant is required to work closely with FSRA during the application process. The licensing procedure broadly comprises the following steps:

a. Providing in-depth technical demos covering all areas of planned Virtual Assets operations;

b. Submission of requisite regulatory forms and fees;

c. Grant of an IPA by FSRA subject to FSRA being satisfied with the application;

d. Grant of final approval subject to satisfaction of all IPA conditions by the applicant; and

e. Operational launch testing and independent third-party verification of the applicant's systems.

1.5. Licensing requirements

In order to be authorised to conduct a regulated activity in relation to Virtual Assets in and from ADGM, the applicant must fulfil the licensing requirements of FSRA including submission of detailed processes, policies and measures that would be implemented by the applicant when the FSP is granted.

These processes, policies and measures are intended to ensure that the applicant will have strong systems and controls for technology governance, prevention of market abuse, risk management, transaction monitoring and reporting, safe custody of customer's assets, corporate governance, consumer protection, AML and CFT. Upon receipt of FSP, the FSP holder must implement these systems and controls and ensure ongoing compliance with them.

1.6. Minimum capital requirements

The minimum capital requirements are as follows:

Table 1: Capital Requirements for VASPs – ADGM

Category	Minimum capital required
For operating a MTF using Virtual Assets	Minimum capital equivalent to 12 months' operational expenses
Other regulated activities in relation to Virtual Assets	Minimum capital equivalent to 6 months' operational expenses

FSRA may, if it perceives that the conduct of the activities by an applicant results in a high-risk exposure, require applicants to maintain a higher minimum capital.

1.7. Fees

The initial authorisation fees and annual supervision fees payable to FSRA is as follows:

Table 2: Fees for VASPs – ADGM

Category	Initial authorisation fees	Annual supervision fees
For operating an MTF on which Virtual Assets are traded	USD 125,000	USD 60,000
Other regulated activities in relation to Virtual Assets	USD 20,000	USD 15,000

Additionally, an MTF on which Virtual Assets are traded is required to pay a monthly trading levy which ranges from 0.0006% to 0.0015% of daily trading value.

For conducting multiple regulated activities in relation to Virtual Assets, the authorisation fees payable will be cumulative. For instance, an MTF that undertakes custody of Virtual Assets, is obligated to pay an authorisation fee of USD 145,000 and annual supervision fee of USD 75,000.

1.8. Regulatory framework for Digital Securities

As explained in paragraph 1.2 above, Digital Securities are deemed to be securities under FSMR. All financial services activities in relation to Digital Securities, such as operating primary / secondary markets, dealing, broking, trading, managing investments or advising are regulated activities under FSMR and require licenses from FSRA.

The Digital Securities Guidance clarifies that the regulatory treatment applicable to an offer of Digital Securities, whether through a DLT platform or other means, is similar to the regulatory treatment of a conventional issue of securities. At present, FSRA does not permit listings of Digital Securities on a secondary listing basis, where the primary listing is undertaken outside of ADGM, and in a jurisdiction that is not deemed suitable by FSRA.

Issuers / market participants seeking to raise funds using new business models or technologies such as DLT may engage with FSRA at the early stages of the fund-raising process.

Market intermediaries (e.g., broker-dealers, investment managers, custodians) and primary / secondary market operators dealing in Digital Securities and /or their derivatives, will need to be approved by FSRA.

1.9. Regulatory framework for offering of Digital Securities

A person wishing to make an offer of Digital Securities to the public is required to comply with various requirements relating to the public issue of securities, including publishing a prospectus under Section 61 of FSMR (unless exempted). FSRA decides on a case-by-case basis on whether an offering of a Virtual Asset in and from ADGM will be permitted.

1.10. Current developments

With a view to transition to Virtual Assets Framework 2.0, in October 2022, FSRA amended its regulatory framework and issued, *inter alia*, an updated Virtual Assets Guidance wherein it recognized the growing prevalence of NFT markets. Through these amendments, FSRA introduced the following changes:

a. FSRA may permit a regulated and active MTF, with the permission to act as a Virtual Asset custodian, to undertake specified NFT activities (such as allowing trading of NFTs on its platform) from ADGM, provided that both MTF and custody activities are being undertaken from ADGM.

b. In the aforementioned scenario, the MTF is required to set up a separate corporate entity within ADGM ("**NFT Entity**"), that engages with NFT issuers and market participants. Legally, the NFT Entity must be ring-fenced from the MTF such that the liabilities, resources and funding of both businesses remain separate. The NFT Entity will not be licensed and regulated by FSRA.

c. The NFT Entity must outsource all trading, auction and custody activities to the MTF.

d. All NFT activities would require to be undertaken in compliance with the applicable AML / KYC requirements.

e. Both the NFT Entity and the MTF must satisfy FSRA of their processes relating to NFT issuers.

It is noteworthy that FSRA has not established a comprehensive regulatory framework for NFTs at this stage.

In addition to the above, FSRA has also released a discussion paper in April 2022 (Discussion Paper No. 1 of 2022) seeking public comments on its high-level policy considerations for regulating DeFi activities within ADGM.

2. DIFC

DIFC is a financial free zone within the Emirate of Dubai with DFSA as its financial services regulator. The regulatory developments in DIFC in relation to digital assets are summarised below:

a. In October 2021, DFSA issued a regulatory framework for 'Investment Tokens' (i.e., security tokens).

b. In March 2022, DFSA published the Consultation Paper No. 143 titled 'Regulation of Crypto Tokens' proposing a regulatory regime for financial services and activities in relation to digital assets ("**CP143**").

c. Effective November 1, 2022, DFSA amended its rulebooks (in line with the proposals made in CP143) to introduce a regulatory regime for financial services and activities (such as financial promotion and offering) in relation to digital assets.

With DFSA's digital assets regulatory regime coming into effect, DIFC has emerged as a new hub within UAE that has a comprehensive regulatory framework for digital assets activities.

2.1. Regulatory framework for Crypto Tokens

Overview

DFSA's regulatory framework for digital assets is provided under, *inter alia*, the Regulatory Law 2004 and the rulebooks issued thereunder, including the General Module ("**DFSA's GEN Module**"). The feedback statement released by DFSA on the public comments received on CP143 provides guidance on DFSA's regulatory approach towards digital assets ("**Feedback Statement**").

Under Regulatory Law, 2004, the definition of the term 'Financial Product' has been expanded to include 'Crypto Tokens'.

In October 2021, while implementing the regulatory framework for Investment Tokens, DFSA introduced a definition for the term 'Token' under DFSA's Glossary. 'Token' is defined as "a cryptographically secured digital representation of value, rights or obligations, which may be issued, transferred and stored electronically, using DLT or other similar technology".

Under its regulatory framework, DFSA has noted that there are varied types of Tokens, including 'Crypto Token' (which refers to digital assets), 'Non-Fungible Tokens', 'Fiat Crypto Tokens' and 'Prohibited Tokens'. The table below sets out DFSA's regulatory approach towards these Tokens:

Table 3: Types of Tokens – DIFC

Category of Token	Crypto Tokens
Definition	Defined under DFSA's GEN Module as "a Token that (a) is used, or is intended to be used, as a medium of exchange or for payment or investment purposes, or (b) confers a right or interest in another Token that meets the requirements in (a). A Token is not a Crypto Token if it is: (a) an Excluded Token; or (b) an Investment Token or any other type of Investment." A Token qualifies as an Excluded Token if it is (a) a Non-Fungible Token (NFT); (b) a Utility Token; or (c) a digital currency issued by any government, government agency, central bank or other monetary authority.
Regulatory approach	Financial services and activities are permitted only in relation to Recognised Crypto Tokens.

Table 3: Types of Tokens – DIFC

Category of Token	**Fiat Crypto Token (i.e., fiat stablecoins)**
Definition	Defined under DFSA's GEN Modules as: "A Crypto Token is a Fiat Crypto Token if, to stabilise its price or reduce volatility in its price, the value of the Crypto Token purports to be determined, in whole or in part, by reference to a fiat currency or a combination of fiat currencies."
Regulatory approach	Financial services and activities are permitted only in relation to Fiat Crypto Tokens that are Recognised Crypto Tokens. Fiat Crypto Tokens must satisfy certain additional requirements to qualify as Recognised Crypto Tokens such as adequacy and independent third-party verification of reserves and the stability of the Tokens relative to the reference currency.

Category of Token	**Prohibited Tokens**
Definition	Comprises Privacy Tokens and Algorithmic Tokens. 'Privacy Token' is defined under DFSA's GEN Module as: "a Crypto Token where the Crypto Token or the DLT or other similar technology used for the Crypto Token, has any feature or features that are used, or intended to be used, to hide, anonymise, obscure or prevent the tracing of any of (i) a Crypto Token transaction; (ii) the identity of the holder of a Crypto Token; (iii) the cryptographic key associated with a person; (iv) the identity of parties to a Crypto Token transaction; (v) the value of a Crypto Token transaction; or (vi) the beneficial owner of a Crypto Token." 'Algorithmic Token' is defined under DFSA's GEN Module as "Crypto Token which uses, or purports to use, an algorithm to increase or decrease the supply of Crypto Tokens in order to stabilise its price or reduce volatility in its price."
Regulatory approach	Financial services and activities relating to Prohibited Tokens are prohibited.

Category of Token	**Non-Fungible Tokens (NFT) and Utility Tokens**
Definition	'Non-Fungible Token' is defined under DFSA's GEN Module as follows: "A Token is a Non-Fungible Token (NFT) if it: (a) is unique and not fungible with any other Token; (b) related to an identified asset; and (c) is used to prove the ownership or provenance of the asset." 'Utility Token' is defined under DFSA's GEN Module as follows: "A Token is a Utility Token if: (a) it can be used by the holder only to pay for, received a discount on, or access a product or service (whether current or proposed); and (b) the product or service referred to in (a) is provided by the issuer of the Token or of another entity in the issuer's Group."
Regulatory approach	Both NFTs and Utility Tokens fall under the definition of 'Excluded Tokens'. Hence, they fall outside of DFSA's regulatory regime. Consequently, DFSA regulated firms are not permitted to provide services relating to NFTs or Utility Tokens (except for provision of custody solutions by licensed custodians). However, issuers of NFTs and Utility Tokens and persons who are providing services in relation to NFTs or Utility Tokens (e.g., auction houses, issuance platforms, safekeeping services) are required to register with DFSA as a Designated Non-Financial Businesses and Professions ("**DNFBP**") and comply with the AML regime of DIFC and UAE. This requirement does not apply to service providers providing only technology support or technology advice to NFT or Utility Token issuers. Further, the registration requirement does not apply if all issues of NFTs or Utility Tokens involve transactions of USD 15,000 or less. Persons wishing to offer services in relation to NFTs and Utility Tokens must establish a separate legal entity (that may require registration as DNFBP) to ensure proper separation of these activities from the regulated activities. In the Feedback Statement, DFSA has clarified that "fractionalisation" of NFTs may result in the NFTs qualifying as a Crypto Token or may constitute a collective investment fund, with the token being considered as a unit of the fund. Further, NFTs which track the price of a commodity (for example, precious stones or gold) may qualify as Investment Tokens.

Table 3: Types of Tokens – DIFC

Category of Token	CBDCs
Definition	Digital currencies issued by any government, government agency, central bank or othei monetary authority.
Regulatory approach	Fall under the definition of 'Excluded Tokens' and therefore fall outside of DFSA's regulatory regime. However, unlike NFTs and Utility Tokens, CBDCs are not prohibited for use by DFSA licensed firms.

Category of Token	Investment Token
Definition	Defined as: "(a) a cryptographically secured digital representation of rights and obligations that is issued, transferred and stored using DLT or other similar technology and: (i) confers rights and obligations that are substantially similar in nature to those conferred by a 'Security' or 'Derivative'; or (ii) has a substantially similar purpose or effect to a 'Security' or 'Derivative'; or (b) a Security or Derivative in the form of a cryptographically secured digital representation of rights and obligations that is issued, transferred and stored using Distributed Ledger Technology (DLT) or other similar technology instrument declared as a 'Security' or 'Derivative' pursuant to DFSA's regulations.[7] The terms 'Security' and 'Derivative' are defined by the DFSA in its regulations."
Regulatory approach	Financial services and activities relating to Investment Tokens are permitted.

b. License requirements and Recognised Crypto Tokens

All firms which are currently providing or wish to provide financial services relating to Crypto Tokens, in and from DIFC, are required to obtain appropriate authorisation or license from DFSA. Existing DFSA licensed firms which have already been engaging in Crypto Token activities before November 01, 2022 must within 6 months from November 01, 2022, transition to the new regime by applying for the requisite authorisation or license.

Similar to FSRA, DFSA permits financial services and activities (such as promotions and public offers) only in relation to 'Recognised Crypto Tokens'. However, DFSA has published an initial list of Recognised Crypto Tokens which do not require separate recognition from DFSA ("**Public List**"). As of November 2022, the Public List comprises: (i) Bitcoin (BTC); (ii) Ethereum (ETH); and (iii) Litecoin (LTC).

Under DFSA's GEN Module, a person is prohibited from engaging in any of the following activities in or from DIFC in relation to a Crypto Token unless it is a 'Recognised Crypto Token':

(i) carrying on a financial service relating to the Crypto Token (except where the entity provides custody for Crypto Tokens);

(ii) making or approving a financial promotion relating to the Crypto Token;

(iii) public offering of the Crypto Token;

(iv) carrying on an activity referred to in (i), (ii) or (iii) in relation to a fund that invests in the Crypto Token; or

(v) carrying on an activity referred to in (i), (ii) or (iii) in respect of a derivative or instrument relating to the Crypto Token.

A Crypto Token will qualify as a Recognised Crypto Token (i) if it is included in the Public List; or (ii) is otherwise specifically recognised by DFSA as a Recognised Crypto Token.

[7] Rule A2.1.1 (3), DFSA Rulebook, General Module available at https://dfsaen.thomsonreuters.com/sites/default/files/net_file_store/DFSA1547_1843_VER630.pdf

It is noteworthy that under Rule 3A.4.1 of DFSA's GEN Module, DFSA may amend the Public List if it is necessary (i) due to a change in the name of any listed Crypto Token; or (ii) if there is a fork affecting a listed Crypto Token and DFSA is satisfied that one or more Crypto Tokens resulting from the fork should be included in the Public List. Except for the reasons stated herein, DFSA is not to add any additional Crypto Tokens to the Public List. Any further Crypto Tokens will only be recognised if an application is made to DFSA for recognition under GEN Section 3A, as elucidated upon below.

To be included as a Recognised Crypto Token, a request can be submitted to DFSA by an existing authorised person, an applicant or an issuer or developer of the Crypto Token. DFSA will consider, amongst others, the following criteria while assessing whether a Crypto Token qualifies as a Recognised Crypto Token:

(i) regulatory status of the Crypto Token in other jurisdictions;
(ii) location of technology;
(iii) location of issuer, founders and other key persons;
(iv) jurisdiction in which the Crypto Token was established;
(v) the adequacy of governance arrangements;
(vi) level of transparency relating to the Crypto Token, including its technology, protocols, key persons and significant holders; and
(vii) adequacy of systems and controls.

c. Types of financial services and activities

The types of financial services and activities permitted by DFSA are similar to those permitted within ADGM by FSRA. It must be highlighted that DFSA's Islamic Finance Rules permit offering of financial services relating to Crypto Tokens, either as an Islamic Financial Institution[8] or through an Islamic Window[9], subject to the views of the Shari'a supervisory board.

Each regulated activity is assigned a specific prudential category under DFSA's Prudential – Investment, Insurance Intermediation and Banking Module (**"DFSA's PIB Module"**). Depending on the prudential category, the applicant would have to meet one or more of the base capital, risk capital, capital buffer, expenditure based minimum capital requirements, all of which are explained and listed in DFSA's PIB Module.

A quick snapshot of the relevant activities, prudential categories and base capital requirements for VASPs is included hereinbelow:

Table 4: Regulated Activities for Crypto Tokens, Prudential Category and Base Capital Requirements for VASPs in DIFC

Permitted regulated activity	Applicable prudential category	Base capital requirement (in USD)
Dealing in Investments as Principal	Category 2	2,000,000
Dealing in Investments as Agent	Category 3A	500,000
Arranging Deals in Investments	Category 4	10,000
Managing Assets	Category 3C	500,000
Advising on Financial Products	Category 4	10,000
Providing Custody	Category 3B	1,000,000
Arranging Custody	Category 4	10,000
Operating a Multilateral Trading Facility while holding Client Assets	Category 4	140,000

In addition to the above, DFSA has recognised that certain financial services may indirectly relate to a Crypto Token. For example, management by a fund manager of a fund that invests in a Crypto Token, a DFSA licensed firm providing credit to or arranging credit for non-retail Crypto Token investors or payment service providers using Crypto Tokens as permitted.

[8] The term 'Islamic Financial Institution' is defined under DFSA's Glossary as "An Authorised Person which has, on its Licence, an endorsement authorising it to conduct its entire financial business in accordance with Sharia'a."

[9] The term 'Islamic Window' is defined under DFSA's Glossary as "That part of an Authorised Person, other than an Islamic Financial Institution, which conducts Islamic Financial Business." Further, the term 'Islamic Financial Business' is defined under DFSA's Glossary as "Any part of the financial business of an Authorised Person which is carried out in accordance with Shari'a."

d. Prohibitions relating to financial services involving Crypto Tokens

DFSA has specified express prohibitions in relation to certain financial services relating to Crypto Tokens. The prohibited activities are specified below:

(i) A crowdfunding operator is prohibited from operating a crowdfunding platform that facilities investments in Crypto Tokens through the platform.

(ii) Payment service providers (**"PSPs"**) are not permitted to use Crypto Tokens in connection with its payment services or other financial services. However, PSPs may use recognised Fiat Crypto Tokens only for the purposes of money transmission or execution of payment transactions, provided the Fiat Crypto Token is sent, held or received in the name of the PSP and not in the client's name.

(iii) A person cannot operate a representative office that markets a Crypto Token or a financial service relating to a Crypto Token.

e. Licensing Process

As of November 2022, DFSA has not released any application forms. The Feedback Statement provides the following overview with respect to the license application process:

(i) Applicants are required to submit a 'General Enquiries Contact Form' that will be reviewed by DFSA as a pre-application stage submission. Applicants seeking a license from DFSA must be incorporated in DIFC.

(ii) At the pre-application stage, DFSA will assess, *inter alia*, the following in relation to the applicant: understanding of DFSA's regulatory framework for Crypto Tokens; business model; human and financial resources; and readiness to engage in a regulated Crypto Token business, including AML procedures and controls.

(iii) DFSA aims to process majority of applications within 120 days. However, this may vary depending on the nature, scale and complexity of the proposed Crypto Token business.

f. Conduct of business obligations

Applicants seeking to provide financial services in and from DIFC in relation to Crypto Tokens must comply with various licensing and conduct of business requirements which includes implementation of processes and policies relating to technology governance and controls, prevention of market abuse, risk management, transaction monitoring and reporting, safe custody of customer's assets, corporate governance, consumer protection and AML and CFT.

g. Fees

Table 5: Fee Requirements – DFSA

Category	Application fees	Annual fees
For operating an MTF on which (i) Crypto Tokens are traded; or (ii) Security Tokens that are not admitted to trading on an authorised market institution or other regulated exchange are traded	USD 150,000 Additional application fee of USD 10,000 is payable for operating an exchange or alternate trading system on which Investment Tokens or Crypto Tokens are traded and that has direct access members	Ranges from USD 150,000 to USD 800,000 depending on the average daily trading volume on the trading venue
Other regulated activities in relation to Crypto Tokens	Ranges from USD 10,000 to USD 40,000 depending on the type of financial service proposed to be provided	Ranges from USD 10,000 to USD 70,000 depending on the type of financial service provided

2.2. Regulatory framework for Investment Tokens

DFSA's regulatory framework for Investment Tokens came into effect in October 2021. Upon a reading of the definition of Investment Tokens provided under DFSA's GEN Module (provided above in Table 3: Types of Tokens – DIFC), it is apparent that, under the Investment Tokens framework, DFSA only regulates cryptographically secured tokens that have features akin to traditional securities or derivatives.

a. Financial services

DFSA's regulatory framework for Investment Tokens is designed with a focus on investor protection, market integrity risks and AML / CFT compliance[10]. The framework applies to firms proposing to market, issue, trade, or hold Investment Tokens in or from DIFC and firms wishing to undertake financial services activities relating to Investment Tokens (including dealing, broking, arranging transactions involving, or managing discretionary portfolios or collective investment funds investing in, Investment Tokens).

A person wishing to undertake financial services activities in or from DIFC in relation to Investment Tokens must obtain an approval or authorisation from DFSA.

b. Application procedure for conduct of financial service

For providing a 'financial service' related to Investment Tokens, the applicant will have to undergo an extensive authorisation process. Broadly, the authorisation process entails:

(i) Engaging with DFSA at every stage of the application process;

(ii) Submission of the requisite forms and supporting documents including a regulatory business plan;

(iii) Grant of IPA upon DFSA being satisfied with the application. The IPA is typically valid for 3 months and specifies conditions to be fulfilled for grant of full license; and

(iv) Grant of final approval by DFSA once DFSA is satisfied that all the requirements have been fulfilled by the applicant.

c. Minimum capital requirement

As per DFSA's PIB Module, the base capital requirement ranges from USD 10,000 to USD 4 million, depending on the applicable prudential category. The applicant is required to satisfy one or more of the base capital, risk capital, capital buffer or expenditure based minimum capital requirements, all of which are explained and listed in DFSA's PIB Module.

d. Regulatory framework for issuance of Investment Tokens

To issue an Investment Token from DIFC, an assessment must be made as to which type of security or derivative the Investment Token would qualify as, and the relevant rules and regulations for the public offer. To make an offer of Security Tokens in DIFC or admitting such securities to an exchange or trading platform in DIFC, a prospectus must be published (unless the offer qualifies as an exempt offer) in accordance with DFSA's Markets Law 2012 and related rules.

3. MAINLAND UAE

CBUAE and SCA regulate the financial sector in mainland UAE. CBUAE is the supervisory and regulatory authority of the banking and financial services sector and is entrusted with:

a. preparing and implementing UAE's monetary policy and issue of currency; and

b. monitoring the credit condition and managing foreign reserves.

SCA is authorised to regulate, supervise and monitor UAE's financial markets for securities and commodities, and regulates financial activities undertaken in relation to securities and commodities within the mainland UAE.

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[10] https://www.dfsa.ae/alerts/statement-crypto-assets

3.1. Regulatory framework of CBUAE

a. Payment Token Services

CBUAE regulates Payment Token Services under the 'Retail Payment Services and Card Schemes Regulation' ("**RPSCS**") which was introduced in June 2021.

The term 'Payment Tokens' has been defined under RPSCS as "a type of Crypto-Asset that is backed by one or more Fiat Currencies, can be digitally traded and functions as (i) a medium of exchange; and/or (ii) a unit of account; and/or (iii) a store of value, but does not have legal tender status in any jurisdiction. Payment Token is neither issued nor guaranteed by any jurisdiction and fulfils the above functions only by agreement within the community of users of the Payment Token. For the avoidance of doubt, a Payment Token does not represent any equity or debt claim".

Table 6: Payment Token Services - CBUAE

Scope of Payment Token Services	The term 'Payment Token Services' has been defined under RPSCS to include (i) payment token issuance; (ii) payment token buying; (iii) payment token selling; (iv) facilitating exchange of payment tokens; (v) enabling payments to merchants and / or enabling peer-to-peer payments; and (vi) custodian services.
License category	A person wishing to provide Payment Token Services must obtain a Category 1 license from CBUAE under RPSCS.
Minimum capital	The minimum capital requirement for a Category 1 license ranges from AED 1.5 million to AED 3 million, depending on the monthly average value of payment transactions.

b. SVF

CBUAE issued the 'Stored Value Facilities Regulation' in September 2020 ("**SVF Regulation**") which replaced the erstwhile 'Regulatory Framework for Stored Values and Electronic Payment Systems' issued in December 2016.

SVF Regulation defines SVF as "facility (other than cash) for or in relation to which a Customer, or another person on the Customer's behalf, pays a sum of money (including Money's Worth such as values, reward points, **Crypto-Assets** or **Virtual Assets**) to the issuer, whether directly or indirectly, in exchange for: (a) the storage of the value of that money (including Money's Worth such as values, reward points, Crypto-Assets or Virtual Assets), whether in whole or in part, on the facility; and (b) the Relevant Undertaking".

A person seeking to provide a SVF must obtain an appropriate license from CBUAE. The minimum capital requirement for an SVF license is AED 15 million.

Following the issuance of SVF Regulation, CBUAE issued a statement on December 06, 2020, clarifying that CBUAE does not accept (or acknowledge) Crypto-Assets or Virtual Assets as legal tender in UAE and reiterated that only legal tender in UAE is the AED.

c. General requirements under RPSCS and SVF Regulation

Under both, RPSCS and SVF Regulation, the applicant is required to satisfy various licensing and compliance requirements including maintenance of financial and capital resources, implementation of corporate governance measures, risk management framework, internal controls, mechanisms to ensure customer protection and compliance with AML and CFT rules.

3.2. Regulatory framework of SCA

SCA issued 'SCA Decision No. 23 of 2020 concerning Crypto Assets Activities Regulation' ("**CAAR**") in November 2020 to regulate the offering, issuing, listing, promoting and trading of digital assets and related financial services in UAE. The CAAR was further supplemented with the 'Administrative Decision No. (11) of 2021 concerning Guidance for Crypto Asset Regulations' ("**Crypto Assets Guidance 2021**") in March 2021. However, as of September 2022, SCA has not issued any licenses pursuant to CAAR.

Latest Developments

On March 08, 2022, SCA released a statement ("**SCA Statement**") clarifying that it has "come closer to issuing the regulatory and supervisory framework related to virtual assets issued for investment purposes". SCA had further clarified that it is the sole authority in the UAE mainland for licensing, supervising and overseeing activities and services pertaining to Virtual Assets issued for investment purposes. SCA also stated as follows:

a. any person wishing to conduct a VASP business in the mainland must obtain initial approval from SCA, in accordance with the Regulations Manual of the Financial Activities (or the Licensing Rulebook); and

b. the VASPs who have commercial licenses and are providing any digital asset services should apply to SCA to obtain the necessary license to practice such activity.

Considering the SCA Statement, further changes to SCA regulatory framework are anticipated, and consequently the legal position surrounding digital assets issued for investment purposes could vary from the framework presently included under the CAAR.

3.3. Regulatory Framework of VARA

The Emirate of Dubai issued 'Law No. (4) of 2022 Regulating Virtual Assets in the Emirate of Dubai' ("**Dubai Virtual Assets Law**" or "**DVAL**") on February 28, 2022, which came into force on March 11, 2022. DVAL regulates digital assets services provided across the Emirate of Dubai, including the free zones (such as DMCC and IFZA), except for DIFC. However, DVAL applies only to the Emirate of Dubai and does not apply at a federal level.

DVAL paved way for establishment of VARA, an independent regulator authorised to exclusively regulate digital assets activities and VASPs. VARA was established with, *inter alia*, the following objectives:

a. to position the Emirate of Dubai as a regional and international hub for virtual assets and related services and to develop a digital economy in the Emirate to boost its competitive edge locally and internationally;

b. to empower investors and increase awareness about virtual asset services and products and encourage innovation;

c. to promote the new sector of virtual assets and attract investments and businesses to set up their base in the Emirate; and

d. create an advanced legal framework to protect investors and formulate international standards for governance to promote responsible business growth under prudential regulations.

DVAL defines 'Virtual Assets' under Article 2 as "a digital representation of value that may be digitally traded, transferred, or used as an exchange or payment tool, or for investment purposes. This includes Virtual Tokens, and any digital representation of any other value as determined by VARA." Furthermore, 'Virtual Tokens' is defined as "a digital representation of a set of rights that can be digitally offered and traded through a Virtual Asset Platform".

Article 15 of DVAL prohibits a person from conducting any activity in relation to virtual assets in the Emirate of Dubai without obtaining a permit from VARA. As per Article 16 of DVAL, the following activities require a permit and will be subject to VARA's oversight:

a. provision of virtual assets platform[11] operation and management services;

b. provision of services for the exchange between virtual assets and national or foreign currencies;

c. provision of services for the exchange between one or more forms of virtual assets;

d. provision of virtual assets transfer services;

e. provision of virtual assets safekeeping, management, or control services;

f. provision of services related to virtual asset wallets[12]; and

g. provision of services related to offering, and trading in, virtual tokens[13].

As of September 2022, VARA is operating a Minimum Viable Product ("**MVP**") program, whereunder it is issuing limited number of MVP permits to select VASPs operating across the virtual assets value chain (including crypto exchanges, broker-dealers, virtual assets managers, DeFi platforms and custodians). VARA has provisionally issued certain comprehensive licensing conditions for obtaining an MVP operational license. VASPs that fulfil these licensing conditions will transition to the MVP operational license, allowing them to provide the authorised virtual assets services in and from Dubai.

VARA has been entrusted with the responsibility of issuing the executive rules under DVAL, which are expected to provide more clarity with respect to *inter alia* the licensing process, costs, capital requirements, conduct of business obligations and the compliance requirements applicable to VASPs.

Separately, VARA has issued an administrative order regulating marketing, advertising, and promotion of Virtual Assets across Dubai ("**Marketing Guidelines**"). An entity that proposes to conduct any form of marketing activities in relation to virtual assets must first seek authorization from VARA if such activities are targeted at residents or customers within Dubai. Furthermore, the Marketing Guidelines mandate that all marketing materials must be fair, clear and not misleading. Failure to comply with the Marketing Guidelines may result in a cease-and-desist warning from VARA as well as financial penalties ranging from AED 50,000 to AED 200,000. Further, violations may also attract immediate suspension or revocation of licenses.

3.4. Other Free Zones – DMCC and IFZA

DMCC, a free zone established pursuant to 'Decision No. 4 of 1st May 2002 on Establishing Dubai Metals and Commodities Centre' was set up with a view to enhance commodity trade flows through Dubai. DMCC is home to the DMCC Crypto Centre, a hub for development and application of crypto and blockchain technologies within the free zone.

DMCC has included certain crypto and blockchain activities within its permitted activities list. Following the lead of DMCC, another free zone within the Emirate of Dubai, IFZA, has also included certain crypto and blockchain activities within its list of its permitted activities.

Companies incorporated in DMCC and IFZA are required to comply with the licensing framework of the free zone as well as the financial regulations applicable at the UAE federal level (issued by regulators such as SCA and CBUAE) and Emirate level (issued by regulators such as VARA).

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[11] Defined under Article 2 of the Dubai Virtual Assets Law as "A centralised or decentralised digital platform which is managed by a Virtual Asset Service Provider; on which Virtual Assets are sold, purchased, traded, offered, issued, and safekept; and through which the clearing and settlement of traded Virtual Assets are made, using the Distributed Ledger Technology."

[12] Defined under Article 2 of the Dubai Virtual Assets Law as "A digital application, or any other digital or electronic medium, through which the Virtual Assets owned by a Beneficiary are managed and transferred, and through which all the transactions conducted on behalf of the Beneficiary to transfer Virtual Assets between accounts are made."

[13] Defined under Article 2 of the Dubai Virtual Assets Law as "A digital representation of a set of rights that can be digitally offered and traded through a Virtual Asset Platform."

Licenses issued by DMCC and IFZA

VASPs may consider obtaining any of the following licenses from DMCC or IFZA:

Table 7: Licenses from DMCC and IFZA

S. No.	License category	Description	Minimum capital requirements
1	**Proprietary Trading in Crypto-Commodities**	Buying and selling (proprietary trading) of crypto commodities developed on DLT applications. Companies with this activity are not permitted to operate an exchange, provide brokerage services (i.e., act on behalf of the client as an agent), financial services, banking services or payment processing or storage services (i.e., custody). This activity permits only the use of own funds for trading.	**AED 50,000**
2	**NFTs E-Marketplace Provider**	Includes firms engaged in providing an online platform that facilitates buying and selling of third parties' unique digital assets (i.e., NFTs) and commercial interactions between buyer and seller, in return for a commission or remuneration. The online platform cannot be used to trade or promote crypto-commodities, cryptocurrencies or NFTs covering any regulated products or securities.	**AED 50,000**
3	**Distributed Ledger Technology Services**	Includes firms engaged in the development and hosting of digital / virtual environments, which enable simulated interactions between individuals. Companies with this activity are not permitted to issue tokens which are traded on exchanges or trade in crypto commodities.	**AED 50,000**
4	**Distributed Ledger Technology Services**	Includes firms providing database management solutions and ancillary services based on DLTs such as blockchain. Companies with these activities are not permitted to trade in, or setup an exchange for, currencies or crypto currencies / commodities or provide any financial services including brokerage or payment processing.	**AED 50,000**
5	**Proprietary Crypto Mining**	Includes firms engaged in verifying and adding new transactions to the blockchain (using methods such as proof-of-work and proof-of-stake) in order to generate crypto assets and trade those assets on a proprietary level on exchange platforms. Companies with this activity are not permitted to provide services to third parties, act as an exchange, provide brokerage services, financial services, banking services or peer to peer trades.	**AED 50,000**

4. Conclusion

Proactiveness of the UAE's regulators coupled with a favourable ecosystem has contributed to UAE becoming a promising jurisdiction for VASPs. Overall, the regulatory framework continues to undergo advancements to cater to the ever-evolving needs of the sector, without compromising on AML/CFT compliance and consumer protection. The recent measures reflect UAE's commitment to creating a bespoke ecosystem for digital assets activities, while growing UAE into a global hub for the sector.

KINGDOM OF BAHRAIN

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CBB was one of the first regulators globally to issue a comprehensive regulatory framework governing digital assets services. CBB issued the Crypto Assets Module ("**CRA Rules**") under its Capital Markets Rulebook in February 2019. The introduction of CRA Rules was in line with Bahrain's goal to develop a FinTech ecosystem that bolsters Bahrain's position as a financial hub in the MENA region. CBB also launched the FinTech Regulatory Sandbox (the "**CBB Sandbox**") in December 2021 which enables start-ups and FinTech firms (including VASPs) to test their technology-based innovative solutions / services, before scaling up their operations in Bahrain and across the region.

REGULATORY FRAMEWORK

The CRA Rules regulate various digital assets services conducted in and from Bahrain, including dealing, broking, advisory, portfolio management, providing custody and operating a digital assets exchange. The CRA Rules specify, *inter alia*, the licensing requirements, the conditions for issuance and holding of CBB license, minimum capital requirements, measures to safeguard client assets, technology standards, cyber security requirements, risk management requirements, reporting, notifications and approval requirements, conduct of business obligations and rules for prevention of market abuse and manipulation.

1. DEFINITION OF 'CRYPTO-ASSET'

The term 'Crypto-Asset' is defined under CRA Rules as "virtual or digital assets or tokens operating on a blockchain platform and protected by cryptography". The definition is inclusive and covers broadly four types of Crypto-Assets, namely: (i) Payment Tokens; (ii) Utility Tokens; (iii) Asset Tokens; and (iv) Hybrid Tokens.

Table 8: Types of Tokens - CBB

Tokens recognised by CBB	Definition under CRA Rules
Payment Tokens	Tokens (synonymous with cryptocurrencies) that are virtual currencies which are intended to be used, now or in the future, as a means of payment for acquiring goods or services or as a means of money or value transfer. Payment Tokens give rise to no claims on their issuer and are usually decentralised. For example, Bitcoin.
Utility Tokens	Tokens that are intended to provide access to a specific application or service but are not accepted as a means of payment for other applications.
Asset Tokens	Tokens that represent assets such as a debt or equity claim on the issuer. Asset Tokens promise, for example, a share in future company earnings or future capital flows. In terms of their economic function, Asset Tokens are analogous to equities, bonds or derivatives. Tokens which enable physical assets to be traded on the blockchain also fall into this category.
Hybrid Tokens	Tokens that have features of one or more of the above three types of tokens.

2. ACTIVITIES PERMITTED

Rule 1.1.1 of CRA Rules stipulates that "no person may market or undertake, by way of business, regulated Crypto Asset services within or from Bahrain, without obtaining a license from the CBB". Rule 1.1.6 of CRA Rules recognises the following activities as regulated activities that require a license from CBB:

a. Reception and transmission of order[14];

b. Execution of orders on behalf of clients[15];

c. Dealing on own account[16];

d. Portfolio management[17];

e. Crypto-Asset custodian[18];

f. Investment advisory[19]; and

g. Crypto-Asset exchange[20].

Activities such as creating or administering Crypto-Assets, publishing or using software for the production or mining of Crypto-Assets and running a loyalty programme are not considered a regulated activity.

3. CATEGORIES OF LICENSE

Applicants may seek to be licensed by CBB under any of the following four categories of licenses:

Table 9: VASP Activities - CBB

Category	Activities permitted	Activities not permitted
Category 1	• Reception and transmission of orders; and • Investment advisory in relation to Crypto-Assets	• Holding client assets or client money; • Receiving fees or commissions from any party other than the client; and • Operating a Crypto-Asset exchange

[14] Defined under CRA 1.1.6 as "the reception from a client of an order to buy and/or sell one or more accepted crypto-assets and the transmission of that order to a third party for execution."

[15] Defined under CRA 1.1.6 as "acting to conclude agreements to buy and/or sell for one or more accepted crypto-assets on behalf of the clients."

[16] Defined under CRA 1.1.6 as "trading against proprietary capital resulting in conclusion of transactions in one or more accepted crypto-assets."

[17] Defined under CRA 1.1.6 as "managing or agreeing to manage accepted crypto-assets belonging to a client and the arrangement for their management are such that the licensee managing or agreeing to manage those accepted crypto-assets has a discretion to invest in one or more accepted crypto-assets."

[18] Defined under CRA 1.1.6 as "safeguarding, storing, holding, maintaining custody of or arranging on behalf of clients for accepted crypto-assets."

[19] Defined under CRA 1.1.6 as "giving, offering or agreeing to give, to persons in their capacity as investors or potential investors or as agent for an investors or potential investor, a personal recommendation in respect of one or more transactions relating to one or more accepted crypto-assets. A "personal recommendation" means a recommendation presented as suitable for the client to whom it is addressed, or which is based on a consideration of the circumstances of that person, and must constitute a recommendation to buy, sell, exchange, exercise or not to exercise any right conferred by a particular accepted crypto-asset, or hold a particular accepted crypto-asset. A recommendation is not a "personal recommendation" if it is issued exclusively through distribution channel or to the public".

[20] Defined under CRA 1.1.6 as "crypto-asset exchange, licensed by the CBB and operating in or from the Kingdom of Bahrain, on which trading, conversion or exchange of: (i) accepted crypto-assets for fiat currency or vice versa; and/or (ii) accepted crypto-assets for another accepted crypto-asset, may be transacted in accordance with the Rules of the crypto-asset exchange."

Table 9: VASP Activities - CBB

Category	Activities permitted	Activities not permitted
Category 2	• Trading in Crypto-Assets as agent; • Portfolio management; • Crypto-Assets custody; and • Investment advisory in relation to Crypto-Assets. Category 2 licensees are permitted to hold or control client assets or client money	• Dealing from own account (i.e., dealing as principal); and • Operating a Crypto-Assets exchange
Category 3	• Trading in Crypto-Assets as agent; • Trading in accepted Crypto-Assets as principal; • Portfolio management; • Crypto-Assets custody; and • Investment advisory in relation to Crypto-Assets. Category 3 licensees are permitted to hold or control client assets and client money. Further, category 3 licensees are also permitted to deal on their own account	Operating a Crypto-Assets exchange
Category 4	• Operating a licensed Crypto-Asset exchange; and • Crypto-Assets custody service. Category-4 licensees are permitted to hold or control client asset and client money	Licensees offering Crypto-Assets exchange service (licensed Crypto-Asset exchange) must not execute client orders against proprietary capital, or engage in matched principal trading

Licensees are permitted to provide regulated Crypto-Asset services only in 'Accepted Crypto-Assets', after seeking prior written approval of CBB. Accepted Crypto-Assets are separately approved for each licensee. The applicants are obligated to provide details of each Crypto-Asset that is proposed to be used for their activity.

CBB will consider several factors while approving Accepted Crypto-Assets, including the following:

a. Technological experience, track record and reputation of the issuer and its development team;

b. The protocol and the underlying infrastructure;

c. AML / CFT and cybersecurity systems and controls;

d. Traceability;

e. Innovation;

f. Scalability;

g. Geographical reach;

h. Exchange connectivity;

i. Market reach; and

j. Type of distributed ledger.

4. APPLICATION FEES AND ANNUAL FEES

Under CRA 1.5.1 of CRA Rules, applicants seeking a license from CBB must pay a non-refundable license application fee of BD 100 at the time of submitting their formal application to CBB. Further, under CRA 1.6.3 of CRA Rules, the variable annual license fees payable by licensees is 0.25% of their relevant operating expenses, subject to a minimum and a maximum as per the table below:

Table 10: Fees to CBB

Category	Minimum fees (BD)	Maximum fees (BD)
Category-1	2,000	6,000
Category-2	3,000	8,000
Category-3	4,000	10,000
Category-4	5,000	12,000

5. LICENSING PROCEDURE

The licensing procedure before CBB is as elaborated in the Table below:

Table 11: Licensing Procedure

Particulars	Description
Due diligence and discussions with CBB team(s)	The applicant must contact CBB at an early stage to discuss their plans, for guidance on CBB's license categories and associated requirements.
Initiate application	Following discussions with CBB, and upon CBB having reasonable comfort that the applicant's proposed business processes, technologies and capabilities are at a sufficiently advanced stage, the applicant must submit the following forms along with relevant supporting documents: • Form 1 (Application for a license); • Form 2 (Application for authorisation of shareholders); and • Form 3 (Application for approved person status). The supporting documents include a detailed business plan covering the specific matters listed in CRA Rules along with financial projections.
Compliance with licensing conditions	In order for a license to be granted, applicants must demonstrate their ability to comply with the minimum criteria for licensing conditions specified under CRA Rules. CBB has set out licensing conditions in relation to the following aspects: • Legal status • Mind and management • Substantial shareholders • Board and employees • Financial resources • Systems and controls • External auditor • Other requirements.
In-principle confirmation (IPC)	CBB permits applicants to first submit an unsigned Form 1 in draft, together with certain mandatory supporting documents. Based on the information submitted at this stage, CBB may provide an initial 'in principle' confirmation ("**IPC**") that the applicant appears likely to meet CBB's licensing requirements, subject to the remaining information and documents being assessed as satisfactory.

Particulars	Description
Granting of final approval	Subject to being satisfied that the applicant has met all conditions applicable to at the IPC, CBB will grant the applicant with final approval for the relevant regulated activity.
Post final approval	Prior to the commencement of operations, a new licensee must, after obtaining CBB's prior written approval, appoint an independent third-party to undertake a readiness assessment and submit a readiness assessment report.
Steps post approval	Within 6 months of the license being issued, the new licensee must provide to CBB (if not previously submitted) certain specified information and documents, including: • The registered office address and details of premises to be used to carry out the business of the proposed licensee; • A copy of its business continuity plan; • Notarized memorandum and articles of association; and • Copy of the auditor's acceptance to act as auditor for the licensee.

6. LEGAL STATUS / CORPORATE FORM

The legal status / corporate form of the licensee must be as follows:

Table 12: Corporate Forms – VASP Applicants in CBB

License category	Permitted corporate form
Category-1, Category-2 and Category-3	• Bahraini Company with Limited Liability (W.L.L.); • B.S.C.; or • A branch resident in Bahrain of a company incorporated under the laws of its territory of incorporation.
Category 4	• B.S.C.; or • A branch resident in Bahrain of a company incorporated under the laws of its territory of incorporation.

7. MINIMUM CAPITAL REQUIREMENTS

The minimum capital requirements comprising of paid-up share capital, unimpaired by losses, for the respective category of licensees are indicated in the table below:

Table 13: VASP Applicants in CBB – Capital Requirements

Licensing category	Minimum capital (BD)
Category-1	25,000
Category-2	100,000
Category-3	200,000
Category-4	300,000

CBB may, at its discretion, require licensees to hold additional capital in an amount and form as CBB determines, should this be necessary (in CBB's view), to ensure the financial integrity of the licensee and its ongoing operations.[21]

8. CURRENT DEVELOPMENTS

In August 2022, CBB proposed various amendments to CRA Rules with a view to further enhance its regulatory framework for Crypto-Assets, in line with developments in the sector and international best practices. The proposed amendments include, amongst others, addition of a new chapter on digital token offerings whereunder offer of digital tokens which exhibit the characteristics of a security are proposed to be regulated by CBB. The digital token issuer will need to meet the eligibility criteria and other requirements proposed in the amendments. As of September 2022, CBB was in the process of soliciting public comments on the proposed amendments.

[21] Crypto Assets Module of Volume 6 of Central Bank of Bahrain's Rulebook, CRA 3.1.3

SWITZERLAND

Authored by Dr. Andreas Glarner, Tanja Müller and Lars A. Fischer, MME Legal AG

Switzerland enacted its comprehensive DLT legislative package in August 2021. The legislative changes include creation of so-called ledger-based securities in the Swiss Code of Obligations, segregation provisions for digital assets in the Debt Enforcement and Bankruptcy Act and the creation of new financial market infrastructures (for e.g., the DLT-trading facility) or special license conditions (for e.g., the 'bank light' license) in financial market laws.

Switzerland has established itself globally as a tier 1 jurisdiction for DLT and FinTech projects, and convinces, in particular, in the following areas:

Reputation:	Switzerland has a trusted reputation for financial and DLT services, international organizations and innovation.
Certainty:	Swiss authorities have been exposed to DLT based business models since 2014 and have developed a clear and reliable practice with regard to the relevant legal, tax, and regulatory questions.
Regulatory framework:	Switzerland has amended the existing laws and regulations in more than 20 Acts and Ordinances to establish an appropriate legal framework for the creation, custody, and transfer of digital assets.
Ecosystem:	Switzerland has a uniquely developed ecosystem of service providers and banks focusing on digital assets.

REGULATORY FRAMEWORK

1. TOKEN CLASSIFICATION AND THEIR LEGAL TREATMENT

FINMA issued the ICO Guidelines on 16 February 2018, where FINMA categorized tokens into three types, based on their underlying economic function:

a. **Utility Tokens** are tokens which are intended to provide access digitally to an application or service by means of a blockchain-based infrastructure.

b. **Payment Tokens** are tokens which are intended to be used, now or in the future, as a means of payment for acquiring goods or services or as a means of money or value transfer.

c. **Asset Tokens** represent assets such as a debt or equity claim on the issuer. Asset Tokens promise, for e.g., a share in future company earnings or future capital flows. In terms of their economic function, therefore, these tokens are analogous to equities, bonds, or derivatives. Tokens which enable physical assets to be traded on the blockchain may also fall into this category.

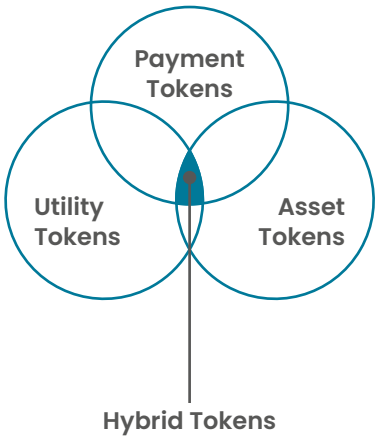


Diagram 4: Classification of Tokens

The individual token classifications are not mutually exclusive. Depending on the functionalities and characteristics associated with the tokens, it is possible for an Asset or Utility Token to also satisfy the criteria for a Payment Token, in which case such tokens will qualify as Hybrid Tokens. In these cases, the regulatory requirements are cumulative. In other words, the tokens may be deemed to be both securities and means of payment. It needs to be noted that non-functional Utility Tokens may, depending on the functionalities and characteristics associated with such tokens, be treated as securities.

2. TOKEN ISSUANCE AND SECONDARY MARKET TRADING FROM A REGULATORY PERSPECTIVE

2.1. Utility Tokens

In general, the issuance and trading of a Utility Token is not subject to regulations. Nonetheless, if a Utility Token fulfils purposes other than only conferring digital access rights, the respective legal consequences must be thoroughly assessed.

2.2. Payment Tokens

The issuance of a Payment Token qualifies as the issuance of a means of payment under Swiss AML regulations. Therefore, the issuer of such a token qualifies as a financial intermediary and must accordingly perform KYC checks on the buyers of the tokens, register with a self-regulatory organization and comply with further AML duties (source of funds, source of wealth, compliance officer, etc.). These requirements can also be fulfilled by cooperating with a financial intermediary regulated in line with Swiss AML regulations.

The secondary market trading of Payment Tokens is also subject to Swiss AML regulations.

2.3. Asset Token

The primary market sale of Asset Tokens by the issuer does not require a license. However, as security regulations apply, it requires the issuance of a key information document unless it is sold only to professional clients. Furthermore, the sale of Asset Tokens requires the issuance of a prospectus if it is offered for sale to the public unless an exemption (for e.g., sold only to professional clients, less than CHF 8 million in revenue, etc.) applies.

The secondary market trading of Asset Tokens is highly regulated and requires different licenses depending on the service provided (for e.g., securities firm license, stock exchange license, MTF license and DLT trading system license).

2.4. Stable coins

On September 11, 2019, FINMA published the 'Supplement to the guidelines for enquiries regarding the regulatory framework for ICOs' ("**Supplement Guidelines**"). Therein, FINMA specifies the treatment of the most common types of stable coin ICO projects under Swiss financial market regulations. A high-level overview is provided below:

a. 1:1 link to underlying asset:
If the token is linked to a specific fiat currency (or other asset) with a fixed redemption claim (e.g., 1 token = CHF 1), banking regulations likely apply.

b. Link to price development of underlying asset:
In case there is a redemption claim dependent on price developments of the underlying asset, regulations for collective investment schemes are likely to apply. Stable coins linked to real estate or properties with a value-dependent redemption entitlement , therefore generally qualify as a collective investment scheme with the consequence of (project) falling under the purview of the Collective Investment Scheme Act of Switzerland.

c. Link to commodities:
(i) in case of a contractual claim to bank precious metals, banking regulations are likely to apply; (ii) in the case of a contractual claim to other commodities, the token may qualify as a security or derivative; (iii) if the stable coin is linked to a commodity basket (including precious metals) with a value-dependent redemption entitlement, collective investment scheme regulations may apply; and (iv) if the stable coin represents property (ownership) to the underlying asset, the token may fall outside regulations.

d. Financial market infrastructure:
If there is no redemption claim for a stable coin, the Financial Market Infrastructures Act ("FinMIA"), amongst others, may be relevant for the operation of payment systems.

e. Link to securities:
If the link is to a single security with a contractual claim of the token holder, then the stable coin either may qualify as a security or a derivative. If the stable coin is linked to a basket of securities with a value-depended redemption claim of the token holder to a share of the basket, it probably qualifies as a collective investment scheme.

3. FURTHER ACTIVITIES RELATED TO WEB3 / TOKENS

When it comes to further activities, it must be distinguished between (i) activities that are excluded from any licensing or approval requirements; (ii) activities that are subject to AML regulations; and (iii) activities that require a formal license from FINMA. The following high-level overview is not exhaustive:

3.1. No license requirement

a. Activities related to Utility Token:
Generally speaking, the issuance and trading of a Utility Token is usually not subject to regulations. Nonetheless, if a Utility Token fulfils purposes other than only conferring digital access rights, the respective legal consequences must be thoroughly assessed.

b. Fully decentralized setups:
Business concepts which are completely decentralized may fall outside the requirement to obtain a license, as complete decentralization removes the link to a central counterparty or a responsible party. However, careful technical design and legal assessment is necessary.

c. Market making:
Market making for Utility Tokens may fall outside the scope of regulations.

3.2. Applicability of AML Regulations

Generally, business concepts involving Payment Tokens result in the applicability of the Anti-Money Laundering Act ("**AMLA**"), at least. This means that such projects must comply with various due diligence requirements, such as an orderly KYC process, including identification of the contracting party and the source of funds. Furthermore, the company must seek a Self-Regulatory-Organization ("**SRO**") membership prior to starting any business activities. Such activities may include:

a. Trading / Brokerage:
Companies active in the secondary trading of tokens already in circulation act as "simple" exchanges and may either serve directly as counterparties (two-party relationship), or they may buy and sell tokens on behalf of their clients. Such services involving Payment Tokens trigger Swiss AML regulation. Trading tokens which may qualify as financial instruments, for e.g. Asset Tokens, will also trigger FINMA licensing requirements.

b. Custody:
The custody of (segregated) third-party assets on a professional basis is generally at least subject to AML regulations.

c. Asset management/portfolio management:
According to FINMA's practice, 'portfolio/asset management' means the management of a client's securities and financial instruments under a portfolio/asset management agreement and on the basis of a power of attorney. An asset manager is authorized to manage or invest assets in financial instruments. The management of assets that are not financial instruments is not subject to AMLA. However, the management of Payment Tokens is. If companies or individuals manage virtual assets of third parties based on a power off attorney, for e.g., by holding a PIK or a password, such an activity might be subject to the Financial Institutions Act ("**FinIA**") / Financial Services Act ("**FinSA**"), if the token qualifies as a financial instrument.

d. Investment advice:
Investment advice includes the provision of advice and recommendations regarding an investment decision relating to financial instruments within the meaning of FinSA. Unlike asset management, investment advice does not involve third-party management. The sole activity of investment advisory (without involvement in execution of transactions) does not trigger a FINMA licensing requirement but falls under the definition of financial services according to FinSA. Therefore, an investment advisor might still have to register in the register of client advisors and affiliate with an ombudsman's office. As soon as investment advisors are involved in the execution of transactions based on a power of attorney, their activity is likely to become subject to a portfolio manager license if financial instruments are involved, or they may be required to join an SRO if other assets (such as fiat and Payment Tokens) are involved and they are exercising this activity on a professional basis.

e. Staking:
Staking of tokens must be thoroughly assessed as AML regulations may apply.

f. Money and value transfer/assistance in transfer of Payment Tokens:
Generally speaking, carrying out the transfer of Payment Tokens is subject to AML regulation. Also, the assistance in transfer of Payment Tokens is subject to AMLA if the party assisting maintains a permanent business relationship with the contracting party or if it exercises power of disposal over the Payment Tokens on behalf of the contracting party and it does not provide the service exclusively to appropriately supervised financial intermediaries. Smart contract-based infrastructures designed for P2P transactions must therefore be carefully designed and assessed with regard to a possible application of AML regulations.

3.3. FinTech / Banking license

Generally speaking, the acceptance of deposits from the public of more than CHF 1 million may be subject to a banking license unless one of the narrowly defined exemptions applies (for e.g., transaction accounts). In case the acceptance of deposits from the public is limited to CHF 100 million in fiat or (without limit) in crypto assets without on-chain segregation and the public deposits or assets are neither invested nor interests are paid, the 'banking license light', or so called 'FinTech license' may be sufficient.

3.4. Security firm license

Issuance of Asset Tokens for third parties, trading Asset Tokens in its own name for the account of clients, and market making or trading Asset Tokens for its own account on a short-term basis on the financial market are subject to a security firm license (see Article 41 of FinIA with further references).

3.5. Security token exchange license

Multilateral trading of DLT securities (Asset / Security Token) with the purpose of simultaneous exchange of bids between several participants and the conclusions of contracts based on non-discretionary rules, may be conducted by an entity holding a DLT trading facility license.

4. REQUIRED REGULATORY APPROVALS

Depending on the business concept, different regulatory approvals may be applicable. In this regard, Switzerland took a very practical approach and introduced an authorization chain in Article 6 of FinIA. This means that the next higher license category also covers the lower-ranking activities.

Consequently, if a company is able to obtain a bank license or a bank light license, it may carry out almost any activity on the financial market permitted by law. The company can therefore offer custody services of digital assets or may accept funds from the public. The company may also accept stable coins and offer white label banking services such as payment services, fiat management tools, wealth management and more.

However, a bank license does not authorize a company to run and operate a DLT trading facility. To operate a DLT trading facility, a company must obtain a separate license.

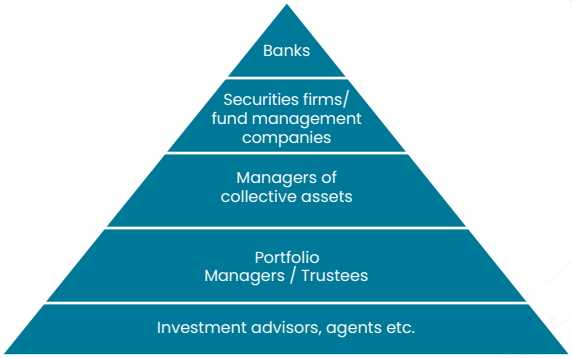
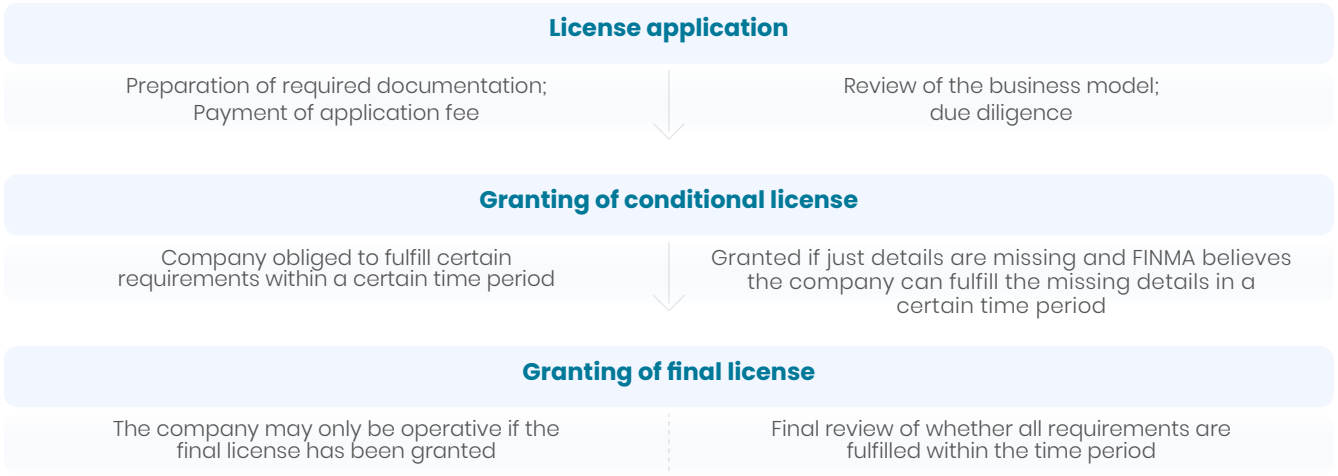


Diagram 5: License Activities

5. PROCESS AND CAPITAL REQUIREMENT IN ORDER TO OBTAIN THE RELEVANT APPROVALS

With regard to the aforementioned authorization chain, the requirements for the respective licenses obviously differ. A company that applies for a bank license must consequently fulfill more and stricter requirements than a company that applies for an approval of a portfolio manager. However, the individual steps of the licensing process are roughly similar and can be described as follows:

Diagram 6: Application Process



In terms of setup costs, it strongly depends on the complexity of the business concept. The capital requirements for each license differ as well:

Table 14: Capital Requirement

License	Min. capital requirement	Duration
Bank	CHF 10 million	Depends on complexity
Bank light / FinTech license (Article 1b of Banking Act)	Min. 3% of accepted retail deposits and digital assets; at least CHF 300,000	Depends on complexity
Securities firm	CHF 1.5 million	Depends on complexity
DLT trading facility	CHF 5 million or 1 million	Depends on complexity
Managers of collective assets	CHF 200,000	Depends on complexity and an affiliation with an SRO is required

6. PRACTICAL INSIGHTS FOR THOSE OPERATING IN THE VIRTUAL ASSET SPACE

6.1. Practical insights with regard to enforcement proceedings

If FINMA determines that an activity requiring a license is being carried out without the corresponding license, enforcement proceedings are immediately initiated. The best-case scenario is the payment of a fine and the subsequent granting of the license, provided that the respective requirements are fulfilled. However, generally, carrying out an activity requiring a license without actually having a license leads to the liquidation and deletion of the company under supervisory law.

Similar proceedings must be expected from the tax authority if taxes relating to digital assets are not, or wrongfully declared. Even criminal liabilities may become applicable.

Consequently, the involvement of a law firm with the required expertise and track-record is strongly recommended to avoid any enforcement proceedings and accompanying reputational damage. Law firms maintain a close exchange with the relevant authorities and can help the company to obtain a ruling or a non-action letter.

6.2. Practical insights with regard to the corporate structuring

Swiss corporate law provides different legal forms to set up a company. Depending on the specific project, one legal form is more suitable than the other. It is therefore strongly recommended to determine at an early stage, which legal form suits the project best, as it has great influence on the taxation of the company and the individuals controlling the company. A later change of the legal form is possible in most cases. However, such changes have associated costs.

6.3. Practical insights with regard to doing business in Switzerland

Swiss legal forms generally require that at least one managing person is a resident of Switzerland, and all Swiss legal forms require that the company's legal seat and domicile is located in Switzerland. In Zug, there are many service providers offering Swiss management persons or a domicile address in Switzerland. This makes the incorporation process very simple, as the founders usually do not need to come to Switzerland to incorporate the company.

With regard to license holders or companies subject to AMLA, it must be mentioned that a compliance officer is required. In some cases, dependent upon the license of the company, the company may outsource its compliance to service providers and thereby appoint an external compliance officer. Many service providers offer such services.

KARM

LIECHTENSTEIN

Authored by Thomas Nägele and Anna Puritscher, NÄGELE Attorneys at Law

Liechtenstein's government and regulatory authorities are open to innovation and new technologies in the blockchain and DLT sector. Together, they maintain an active dialogue with market participants. For this reason, a remarkable blockchain ecosystem has emerged in Liechtenstein over the last few years. To monitor developments and recognise opportunities, the Liechtenstein government has, for e.g., established the Office for Financial Market Innovation, which supports financial service providers and financial market related companies in their private innovation process. Further, the Financial Market Authority of Liechtenstein ("**FMA**") has set up a regulatory laboratory, an internal knowledge centre focussing on regulation of and innovations in the field of financial technologies. The regulatory laboratory enables, *inter alia,* an open communication with the relevant supervisory authorities.

REGULATORY FRAMEWORK

1. SCOPE OF TVTG

Liechtenstein's regulatory framework for virtual assets services is provided under the 'Tokens and Trusted Technology Service Providers Law' ("**TVTG**") (commonly referred to as the Blockchain Act) that was first published in January 2020. TVTG applies to all Trustworthy Technologies ("**TT**") (defined below) service providers including token issuance entities. The scope of TVTG is as follows:

a. **Supervisory part:**
Contains provisions relating to registration and supervision of 'TT Service Providers', i.e., a person who provides one or more of the TT services specified in paragraph 5 below ("**TT Services**"); and

b. **Civil law part:**
Contains provisions relating to civil law basis of tokens, such as the legal definition of the token, representation of rights through tokens, right of ownership and disposal of tokens, effects of disposal of the token (e.g., the transfer and disposal of tokenized assets).

The term 'Trustworthy Technology' is defined under Article 2 of TVTG as "technologies through which the integrity of Tokens, the clear assignment of Tokens to TT Identifiers[22] and the disposal over Tokens is ensured". For e.g., Ethereum or Bitcoin blockchains.

The Liechtenstein government stated as follows in its report titled 'Report and Application of the TVTG':

"It is essential to draft a law abstractly enough to ensure that it remains applicable for subsequent technology generations. That is why the term "transaction systems based on trustworthy technologies (TT Systems)" is used for blockchain systems in this law".

To ensure that TVTG does not become outdated from a technical perspective, it has been drafted in a technology-neutral manner. Further, for the same reason, TVTG does not classify tokens into categories such as stable coin, security token, property-based token (e.g., gold) or NFTs. Instead, the term 'Token' has been defined broadly as a "piece of information on a TT[23] System[24] which can represent claims or rights of memberships against a person, rights to property, or other absolute or relative rights, which is assigned to one or more TT Identifiers (= a public key)".

[22] Defined under Article 2 of TVTG as "an identifier that allows for the clear assignment of Tokens"

[23] TT stands for trustworthy technologies aka selected blockchains

[24] Defined under Article 2 of TVTG as "Transaction systems which allow for the secure transfer and storage of Tokens and the rendering of services based on this by means of trustworthy technology"

Defining the term 'Token' broadly enabled Liechtenstein to adopt a 'Token Container Model', which allows for a multitude of rights to be tokenized, where the Token serves as a container for the digitally represented right.

Dr. Thomas Dünser, Director of the Office for Financial Market Innovation, Government of Liechtenstein, stated the following in relation to the Token Container Model:

"During our internal blockchain working group discussions, we agreed that the scope of the token act should not be limited to regulating specific categories of tokens like Bitcoin or security tokens. The scope should be on the entire future token economy, and that called for a new and highly flexible token model."

Under Liechtenstein's regulatory framework, tokenisation of a right does not change the underlying right associated with the Token (substance over form). Thus, the claim for the fulfilment of an obligation represented by, for e.g., a security token, or all claims resulting from the ownership based on the law of property, for e.g., physical gold or a physical painting, as well as the right of use of works represented by a unique NFT, are treated without distinction to such claims in the analogue world. Liechtenstein is so far the only civil law framework which provides legal enforceability for blockchain based transactions.

With the enactment of the TVTG, an amendment of the Persons and Companies Act ("**PGR**") has also taken place, which builds the legal ground for tokenised equity finance instruments. These instruments are, in accordance with Article 81a SchlT PGR, referred to as "uncertified rights". Corresponding to the possibility of dematerialised uncertified rights, the book-entry security registry, which grants the status of, for e.g., a shareholder, could be managed on the blockchain.

As Liechtenstein is also part of the European Economic Area ("**EEA**") since 1995, the harmonised capital market regulations are implemented in the national regulatory framework. Every right represented via Token has to therefore be analysed with regards to whether it qualifies as E-Money or as a financial instrument under the Electronic Money Directive II ("**EMD2**") (i.e., Directive 2009/110/EC) or under Markets in Financial Instruments Directive II ("**MiFID II**") (i.e., Directive 2014/65/EU), in which case it could trigger further approvals under the capital markets law which are the gateway to the European financial market by means of passporting.

The FMA allows submission of legal opinions (opinions containing an assessment of possible licensing, prospectus, or due diligence obligations under special laws, including the laws mentioned above). The purpose of such legal opinion is to elaborate upon the right represented by the Token and to ascertain that such Tokens do not fall within the regulatory ambit of the harmonised EEA laws. The filing of such legal opinion enables fulfilment of the proposed business models as it helps avoid uncertainties at a later stage regarding the legal framework applicable to the business model or the Token.

2. REGISTRATION REQUIREMENT

All persons that are headquartered or reside in Liechtenstein and provide TT Services on a professional basis in Liechtenstein are required to register with the FMA. Once the registration process is completed, their names are entered in a publicly accessible TT Service Provider register.

3. REGISTRATION CONDITIONS

The TVTG stipulates various licensing conditions for TT Service Providers, which ensures the reliability and technical suitability of such TT Service Providers to provide the relevant service effectively. In general, an applicant must satisfy the following conditions:

a. be capable of action, reliable and technically suitable;

b. have headquarters or place of residence in Liechtenstein;

c. have the necessary minimum capital (ranging between CHF 50,000 - CHF 250,000 depending on the TT Service proposed to be provided) as applicable;

d. have special internal control mechanisms where appropriate;

e. have a suitable organisational structure with defined areas of responsibility and a procedure to deal with conflicts of interest;

f. have written internal proceedings and control mechanisms that are appropriate in terms of the type, scope, complexity and risks of the TT Services Provider;

g. where applicable, have specific internal control mechanisms in place;

h. have an authorization according to Article 5, paragraph 1 of the Financial Market Authority Act if they intend to pursue an activity that requires such an additional authorization; and

i. market reach.

As part of the registration process, the applicant is required to provide *inter alia* description of the business model and the corporate structure, as well as a short description of the used TT Systems. Further, the persons entrusted with the TT Service should be fit and proper to carry out the service.

4. ESTIMATE OF TIMELINES

The application documents can be submitted in English electronically to the FMA. Preparation of registration application typically takes 1-3 months. Additionally, FMA generally takes 3 months to process the application.

5. CATEGORIES OF TT SERVICE PROVIDERS

5.1. Token Issuer

These are persons offering Tokens (primary issuance) to the public in the name of third parties. In addition, persons carrying out their own issuances must also register if the value of the Tokens issued in one year exceeds or will exceed CHF 5 million. A Token Issuer, according to the TVTG, is anyone who does not only sell Tokens for its own / third parties account but who offers Tokens to the public.

The minimum capital requirements for Token Issuers (as a service for third parties) are:

a. CHF 50,000, if Tokens with a total value of up to and including CHF 5 million are issued within a period of 12 months;

b. CHF 100,000, if Tokens with a total value of more than CHF 5 million are issued within a period of 12 months; or

c. CHF 250,000, if Tokens with a total value of more than CHF 25 million are issued within a period of 12 months.

5.2. TT Exchange Service Providers

These are persons who exchange fiat (legal tender) for Tokens and vice versa, as well as Tokens for Tokens, against own inventory.

The minimum capital required for TT Exchange Service Providers is:

a. CHF 30,000, where transactions with a total value of more than CHF 150,000 up to and including CHF 1 million are carried out during 1 calendar year; or

b. CHF 100,000, where transactions with a total value of more than CHF 1 million are carried out during 1 calendar year.

5.3. TT Key Depositaries

The TT Key Depositary keeps the TT key on behalf of the customer, for e.g., to better protect it from misuse. Thus, the TT Key Depositary has the de facto power of disposal over the Token and also the authorisation to store the TT key. This gives him / her a limited power of disposal. Another form of limited power of disposal is the right to initiate transactions on behalf of the customer.

The minimum capital requirement for TT Key Depositaries is CHF 100,000.

5.4. TT Token Depositories

These are persons who safeguard Tokens for third parties, for e.g., in a safe or a collective wallet. This also includes the execution of transactions for third parties. These services are typically provided by crypto exchanges or wallet providers.

The minimum capital required for TT Token Depositaries is CHF 100,000.

5.5. TT Protector

TT Protectors assign the Tokens of customers to one of their TT identifiers and act in their own name to the benefit of the user, therefore ensuring the privacy of the user.

5.6. Physical Validator

The Physical Validator ensures the connection between the object (for e.g., an artwork-painting) and the Token that represents rights to it (ownership-right). The Physical Validator must also ensure that the goods stored in a warehouse are contractually regulated, for e.g., so that no one may have access to the object of value without the legitimation of the Token. Only the person authorised to dispose of the Token may remove the object from the warehouse with the knowledge of the physical validator. The Physical Validator thereby is the link between the digital and the real world.

The minimum capital required to act as a Physical Validators is:

a. CHF 125,000, if the value of the property whose contractual enforcements is guaranteed by the Physical Validator does not exceed CHF 10 million; or

b. CHF 250,000, if the value of the property whose contractual enforcements is guaranteed by the Physical Validator exceeds CHF 10 million.

5.7. TT Verifying Authority

TT Verifying Authority checks the legal prerequisite for disposal (for e.g., age verification for the acquisition of alcoholic drinks). This is usually done by a software.

5.8. TT Price Service Provider

These are persons who provide TT system users with aggregated price information on the basis of purchase and sale offers or completed transactions.

5.9. Token Generators

Tokens are programmed before their "generation". They are generated by providing their code in the relevant TT system for further use (deployment). This is undertaken by the Token Generator. If however, the issuer generates the Tokens for its own issuance and not as a service to third parties, then a registration under TVTG is not required.

5.10. TT Identity Service Providers:

These are persons who identify the person in possession of the right of disposal related to a Token and who record it in a directory as a professional service. If the AML / KYC checks are performed to comply with their own requirements (i.e., no service for third parties) under the Due Diligence Act, then no registration is required.

5.11. TT Agent

A person who professionally distributes or provides TT Services in Liechtenstein on behalf of and for the account of a foreign TT Service Provider. This takes the setup and the operation of, for e.g., BTC ATMs into account.

6. LIECHTENSTEIN'S TVTG AND THE EUROPEAN MICA

As Liechtenstein has been innovation friendly, the working group of the first comprehensive regulatory framework of digital assets in the EEA began their cooperation in the year 2016. This proactive and future oriented approach enabled Liechtenstein to deal with various regulatory necessities during the initial developmental stages of the blockchain ecosystem. The TVTG has been in force since January 01, 2020, and was used as a blueprint for several other jurisdictions, including the European Union's 'Market in Crypto Assets Regulation' ("**MiCA**"). Overall, Liechtenstein remains a crypto-friendly jurisdiction while providing the possibility for VASPs to switch to a 'passportable' MiCA licence when it is in force, therefore enabling VASPs to provide their products and services throughout the European Union and EEA.

UNITED KINGDOM

Authored by Jonathan Geen, Solicitor, England and Wales

The UK is generally supportive of the development of crypto assets in a controlled way that protects consumers. UK issued the 'Guidance on Cryptoassets' in July, 2019 ("**Guidance**"). Since issuance of the Guidance, the regulatory framework has gradually expanded and in some cases tightened. The digital assets market is being closely scrutinized, particularly in light of the recent speculative behaviour, market falls, emergence of NFTs as an asset class, and the wider ramifications of blockchain based products for retail investors.

While regulations are being scrutinised and are likely to be updated in the near future, the current regime follows an approach which has been in place since 2019. Broadly, this can be described as follows.[25]

REGULATORY FRAMEWORK

The UK has a well-established regulatory regime for dealing with financial assets.[26] This system is well regarded and perceived as effective at protecting investors and is compatible with MiFID II. Rather than following the approach of many other jurisdictions in setting up an entirely new digital business licensing regime for crypto assets, UK chose to classify crypto assets according to their functions in relation to investment activity (rather than focusing on the underlying technology).

Following an extensive sandbox testing regime, the FCA, who regulates crypto assets and other investment activities, decided[27] to separate crypto assets into three broad categories. Note that these are distinct from electronic money which has its own regulatory regime.[28] These categories are as follows:

a. **Exchange Tokens:** Essentially cryptocurrencies and coins issued in order to be exchanged for other assets (think Bitcoin and Litecoin);

a. **Utility Tokens:** Digital tokens which can be redeemed for certain benefits which are restricted to the particular platform of the issuer (and therefore not widely tradeable outside of that platform); and

a. **Security Tokens:** Tokens which represent digital securities such as stocks or bonds or units in collective investment schemes (funds) and have ownership characteristics such as voting and control or rights to participate in profits of a fund which is a pooled investment and separately managed.

The UK approach was to leave the first two categories (Exchange and Utility Tokens) as largely unregulated (save for wider legal remedies such as the law of misrepresentation (for e.g., for excessive promises in whitepapers), AML regulations and general consumer regulations[29]) and to throw its regulatory perimeter around the last category, i.e., Security Tokens. The result was that Security Tokens fall within the FCA's regulatory gaze (as "specified investments") and any activity relating to Security Tokens is subjected to the same treatment as an activity for any other securities.

Note that the net is cast wide for the definition of Security Tokens. A digital token representing shares, bonds, government securities, fund units, pension rights, environmental emissions, derivatives, insurance rights, home mortgage contracts, hire purchase agreements or rights to any of the above, falls within the definition.

This means that activities such as custody (for e.g., wallet providers), dealing (for e.g., crypto exchanges) and advising would all be regulated activities which must be carried out with the appropriate licences if they relate to Security Tokens, but not if they are related to Exchange or Utility Tokens. Their reasoning was that Exchange Tokens were relatively functional and were not seen as an investment activity (though recent speculative investment by retail investors and their 2022 losses is changing that perception and will undoubtedly result in increased regulation soon). With Utility Tokens, they were not seen as harmful to investors due to their limited tradability.

[25] This note is a high-level summary only and is not to be treated as legal advice and no liability is accepted to readers.

[26] Financial Services and Markets Act 2000 as supplemented by the Regulated Activities Order 2001, SI 2001/544

[27] Financial Conduct Authority's Guidance on Cryptoassets (PS 19/22)

[28] Electronic Money Regulations 2011

[29] UK Consumer Rights Act 2015

As the distinction between Utility Tokens and Security Tokens has become crucial, further guidance was issued so that industry actors could determine with reasonable certainty whether or not their activity would fall into the lightly regulated Utility Token world or the more heavily regulated Security Token environment.[30]

One interesting consequence of the above approach is the actual technology or business involved does not require regulation per se. It is the activity or function carried out in relation to crypto assets (dealing, exchanging, advising, etc.) which attracts the regulation, provided the crypto asset falls into the category of Security Token.

It also has an effect on the marketing of Security Tokens. The UK has strict prohibitions on 'financial promotion', i.e., anyone marketing securities (and hence Security Tokens) to UK citizens unless they are properly licenced by the FCA.[31] The penalties for breach are severe and involve criminal liabilities as well as fines.

1. IMPLICATIONS FOR CRYPTO ACTIVITY

The effect of the above rules was to slow the creation and issuance of Security Tokens until the relevant platforms could be properly vetted. It no doubt deterred entry to the market as those intent upon issuing anything resembling Security Tokens opted to pursue other jurisdictions where regulatory regimes were not as precise. Only those with significant resources would have the patience, expertise and capital to go through a full licensing regime.

Nevertheless, much of the crypto market could continue without fear of falling into this regulatory perimeter. For example, those issuing cryptocurrencies, NFTs and stabelcoins, and Utility Token platforms felt reasonably secure that as long as they stayed away from giving rights or benefits akin to Security Tokens, they could safely transact their business in the UK or with UK citizens.

2. CLARIFICATIONS AROUND STABLECOINS

As stabelcoins gained increased prominence and use as a means of payment by 2020, FCA chose to offer further guidance concerning their treatment.[32] Broadly speaking, the UK intends to bring the issuance and use of stablecoins into the regulatory perimeter by amending electronic money regulations. This reflects the previous view that as stablecoins were pegged to fiat currencies or stabilisation mechanisms, they should be treated as electronic money and regulated under that regime.

Once again, this reflects the UK approach of bringing novel technologies within existing tried and tested regulatory systems rather than developing bespoke new rules to govern them.

3. E-MONEY

To distinguish crypto assets from 'electronic money' (separately regulated), FCA has determined that electronic money is monetary value stored electronically and represented by a claim on the issuer which (a) is issued on receipt of funds to make payment transactions; (b) is accepted by another person; and (c) is not otherwise carved out of the definition of e-money. E-money is regulated separately.[33]

4. NFTS

NFTs represent a grey area in terms of regulation. The current view of many practitioners is that if a digital token represents an asset then it should not fall within regulation but if the asset could be considered as a fund unit (for e.g., a share of artist royalties or profits) then it could fall into the Security Token classification and hence, UK regulation.

It is likely that the FCA will clarify its treatment of NFTs in the near future.

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[30] Financial Conduct Authority's Perimeter Guidance manual
[31] Financial Services and Markets Act 2000, ss 19 and 21 and Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, SI 2005/1529
[32] HM Treasury Consultation: UK Regulatory Approach to Cryptoassets and Stablecoins
[33] Electronic Money Regulations 2011, SI 2011/99 and Payment Services Regulations 2017, SI 2017/752

5. ADDITIONAL BARRIERS TO ENTRY

The UK implemented the final sections of the EU Fifth Directive in relation to AML.[34]

These AML Regulations largely concerned routine matters relating to identification of market participants and were being tightened and extended in ways which were widely understood. However, in relation to cryptocurrencies they incorporate a new licensing regime in which anyone undertaking one of two activities in the UK would need to be licenced:

a. A crypto asset exchange provider, i.e., a firm / person who provides services as a creator or issuer of crypto assets and when providing those services, exchanges crypto assets for money (or the reverse), exchanges one crypto asset for another or operates exchange software to facilitate exchanges.

b. Custodian wallet provider, i.e., a firm / person who offers services to safeguard and administer crypto assets on behalf of its customers or private keys to hold, store and transfer crypto assets.

The net effect of this was that anyone wishing to issue any form of crypto asset in return for fiat money would be regarded as needing a licence. This would not be such a concern for the industry except that FCA licences are (i) difficult to acquire (with a high rejection rate) and (ii) take many months (possibly over one year) to obtain. Any applicant would have to demonstrate to the FCA that it has very robust protocols for dealing with AML and handling client assets.

Additionally, the FCA has banned the sale of derivatives and exchange traded notes that reference unregulated transferable crypto assets to retail customers.[35]

As a result, many clients in the crypto space (even those who are very keen to create brand value by being UK regulated) are now looking overseas for incorporation with a medium-term plan to return to the UK once they can devote the time and resources to obtaining an FCA licence.

6. FUTURE CHANGES

Following the dramatic losses sustained by retail investors in the 2022 'crypto bear market', the FCA has intimated that it is not satisfied that such investors are properly protected by the current regime. It is therefore trying to play catch up with the pace of innovation and breadth of new offerings.

It is widely anticipated that the UK will update (and tighten) its regulations to introduce measures such as limits on retail customers investing large proportions of their portfolios into crypto assets, disclosure requirements and personalised risk pop-ups, cooling off periods for first time investors, and a ban on inducements to invest. These changes are likely to focus on fungible crypto assets aimed at the retail market. This will increase the need for issuers of crypto assets to obtain declarations that the investors are sophisticated, as is the case in other areas of financial regulation for collective investment schemes.[36]

7. CONCLUSION

Having scrutinised DLT very closely in 2017 and 2018, the UK authorities (led by HM Treasury and the FCA) have chosen not to create specific new rules for digital business. Instead, they have selected elements of various tokens (notably Security Tokens) and activities and chosen to designate these as falling under its existing regulatory rules, which have been in place since 2000.

As the sector has experienced increasing innovation, and as acceptance of the technology has broadened and penetrated deeper into the retail investor space, the regulators have progressively tightened the rules. In particular, more and more activities around crypto assets are falling into the remit of requiring a licence to operate. The time and cost of obtaining such licences remains a concern for the industry and has prompted many players to seek regulation overseas, either permanently or during a transition phase. However, UK has always considered itself a leader in financial regulation and it is likely that its updated regulations will be mirrored in other major financial centres.

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[34] Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, SI 2017/692
[35] Financial Conduct Authority's Conduct of Business Sourcebook (COBS), COBS 22.6
[36] Financial Conduct Authority's Discussion Paper "Strengthening our financial promotion rules for high-risk investments and firms approving financial promotions" (DP 21/1)

KARM

UNITED STATES OF AMERICA

Authored by Eric Hess, Founder and Managing Counsel at Hess Legal

Digital assets market participants in the United States must engage with many regulatory regimes. The primary regulators market participants need to consider include the SEC, CFTC, and the FinCEN. However, other agencies also have regulatory power over digital assets. Multiple federal regulators can exercise jurisdiction over a single market participant at the same time, and there are also state-level regulations and fraud laws to consider. While federal and state regulators have the power to mandate registration and to enforce violations of federal laws and regulations in civil court, only the U.S. Department of Justice has the power to bring criminal charges. Currently, United States digital assets regulation can be quite complex, but there is hope for further legislative clarifications in subsequent years.

REGULATORY FRAMEWORK

1. DIGITAL ASSET CLASSIFICATION

Generally, digital assets in the United States can be classified as financial commodities or securities. The classifications are not mutually exclusive, and overlap could cause regulatory oversight by multiple agencies.

A digital asset can be considered a security if it is an 'investment contract'. An 'investment contract', as defined in SEC v. W.J. Howey Co. and its progeny, is:

a. An investment of money;

b. In a common enterprise;

c. With an expectation of profit; and

d. To be derived from the efforts of others.

If a digital asset is deemed a security by the SEC (which currently adopts a broad definition of what constitutes a security), marketing or offering the digital asset to a U.S. resident will be deemed a violation of federal securities laws, absent securities registration or an exemption from registration. The primary issue with both securities registration or an exemption from registration is that they are incompatible with token issuance on the public blockchain.

A financial commodity is defined under the U.S. Commodity Exchange Act ("**CEA**") as, "Any futures or option contract that is not based on an agricultural commodity, a natural resource such as energy or metals, or other physical or tangible commodity. It includes currencies, equity securities, fixed income securities, and indexes of various kinds." As of September 2022, Bitcoin and other virtual currencies ("**VC**") have been determined to be commodities under the CEA. VCs are "digital assets that encompass any digital representation of value or unit of account that is or can be used as a form of currency". In other words, they are a medium of exchange. Clearly, under current regulatory guidance, some digital assets can fit both the definition of an 'investment contract' and a VC.

These digital asset classifications inform registration requirements, burdens, and enforcement risk.

2. SECURITIES REGULATION

The SEC regulates securities issuance and exchange. The Securities Act of 1933 ("**Securities Act**") and the Securities Exchange Act of 1934 ("**Exchange Act**") are the primary laws that confer the SEC its authority. All offers and sales of securities must either be registered with the SEC under the Securities Act or benefit from an exemption like Regulation Crowdfunding, Regulation D, or Regulation A. Regulation D is the most popular exemption for U.S. based security issuance related to token projects, but as noted, not the digital asset itself as it permits an unlimited amount of capital to be raised from a limited number of accredited investors.

The Exchange Act also requires registration of certain securities intermediaries. Those entity types include broker-dealers, exchanges and ATS, clearing agencies, and transfer agents. Broker-dealers engage in effecting transactions in securities for the accounts of others, as well as buying and selling securities for their own account. Exchanges are any organizations or persons that constitute, maintain, or provide a marketplace that brings together buyers and sellers of securities.

Under the recent proposal of Regulation ATS by the SEC, an ATS is defined as any system that "(1) would constitute, maintain, or provide a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange under proposed Rule 3b-12 of the Exchange Act; and (2) would not regulate its members or surveil its own market." The proposal would require ATS to register as broker-dealers or as a national securities exchange unless they have limited volume or were operated by NFA. The proposal could be interpreted as requiring digital asset trading systems that do not engage in traditional broker-dealer activities to register as such anyways. Clearing agencies are intermediaries that are engaged in making payments, deliveries or both in connection with transactions in securities or that provide facilities for comparison of data respecting the terms of settlement of securities transactions. Lastly, transfer agents are entities that work for the security issuer to record changes of ownership, maintain the issuer's security holder records, cancel and issue certificates, and distribute dividends.

3. COMMODITIES REGULATION

The CFTC empowered by the Commodity Exchange Act ("**CEA**"), regulates VC markets and has four coverage areas:

a. VC derivatives transactions,

b. fraud and manipulation in VC spot transactions,

c. VC 'retail commodity transactions', and

d. swaps.

'Retail commodity transactions' are defined as margined, leveraged, or financed transactions. Typically, the CFTC does not regulate VC spot markets unless it finds fraud or manipulation, but if a spot trading platform offers its customers margin or leverage, then the CFTC does have authority over that spot market. Notably, the CFTC does not regulate VC issuance, but if the VC in question fits the definition of a security, then the SEC regulates its issuance.

The NFA handles the registration and examination of intermediaries on behalf of the CFTC. Those intermediaries whose registration is mandated includes associated persons, commodity pool operators, commodity trading advisors, floor brokers, floor traders, futures commission merchants, introducing brokers, principals, retail foreign exchange dealers, and swap dealers. Depending on the nature of their activities, a certain intermediary may be subject to various financial, disclosure, reporting and recordkeeping requirements.

4. FINCEN REGULATION

Entities not regulated by federal agencies, but that meet FinCEN's definition of 'exchanger' or 'administrator' may be required to register as a money services business with FinCEN and any state where participants to a transmission are located. An 'exchanger' is a person engaged as a business in the exchange of VC for real currency, funds, or other VC. An 'administrator' is a person engaged as a business in issuing (putting into circulation) a VC, and who has the authority to redeem (to withdraw from circulation) such VC. An administrator or exchanger that (i) accepts and transmits a convertible VC, or (ii) buys or sells convertible VC for any reason is a money transmitter under FinCEN's regulations. The most common exemption as it relates to VC, if applicable, is the exemption for an entity that provides the delivery, communication, or network access services used by a money transmitter to support money transmission services. Other exemptions are also available but generally not applicable to VC.

FinCEN released 2019 Guidance which explicitly outlined whether the Bank Secrecy Act's AML obligations apply to certain crypto-native business models and further clarified the relevant definitions.

5. INVESTMENT FUNDS

Under the Investment Company Act, funds who invest substantially into securities and wish to issue their shares to the public are subject to regulation and registration by the SEC as investment companies. However, generally, private funds do not need to register with the SEC if they are traditional funds or venture capital funds with no more than USD 10 million filing under section 3(c)(1), or funds limited to qualified purchasers filing under section 3 (c)(7). Section 3(c)(1) funds are pooled investment vehicles that do not meet the definition of an investment company because there are less than 100 beneficial owners (or less than 250 beneficial owners in the case of qualified venture capital funds). Section 3(c)(7) funds, on the other hand, are excluded from the definition of an investment company because they are limited to investors who are qualified purchasers only. Under the Securities Act, investment funds seeking to issue their shares publicly can use Regulation D in order to raise capital without the registration of their offering as a security with the SEC.

In the case of CFTC regulation, investment funds who engage in derivatives trading must register as a Commodity Pool Operator ("**CPO**") or as Commodity Trading Advisors ("**CTA**") and must subsequently register as members of the NFA. CPOs are classified as funds that oversee investments in commodity securities, while CTAs provide personalized advice on the trading of commodities and financial commodities such as futures contracts, option contracts, and off-exchange currency contracts and swaps.

In order for an investment fund to qualify for a registration exemption, they must meet the de minimis rule, which requires that commodity derivatives are not a material component of the investment fund's portfolio and that the fund's securities are sold in transactions exempt from registration under the Securities Act and are offered and sold without marketing to the public in the United States. Although, if the de minimis rule is unmet, most registered CPOs are exempt from disclosure requirements if they transact exclusively with qualified purchasers.

CPOs may be exempt from registration if operating a 'family, club, or small' pool, if operators do not receive compensation for operating the pool, or if participation in the pool is restricted to sophisticated investors. Additionally, a CPO may claim an exemption from registration if they do not commit more than 10% of the fair market value of their assets to establish commodity interest trading positions and they trade commodity interests in a manner solely incidental to their securities trading activities.

CTAs may claim an exemption from registration with the CFTC:

a. if they are registered with the SEC as an investment adviser;

b. if their business does not consist primarily of acting as a commodity trading advisor; and

c. if they do not act as a CTA to any investment trust, syndicate, or similar form of enterprise that is engaged primarily in trading in any commodity for future delivery on or subject to the rules of any contract market or registered derivatives transaction execution facility.

6. CONCLUSION

Legislators are seeking to simplify digital asset regulation and minimize overlapping jurisdiction. The 2021-2022 legislative session has seen a slew of new bills focused on updating cryptocurrency regulation. While most legislation has stalled before making significant progress to passing, it is helpful to understand the issues receiving the most attention.

One bill would protect non-custodial blockchain services and software developers from being treated as money transmitters or financial institutions. Another bill would clarify that digital tokens are separate and distinct from the securities offering they may have been a part of. Yet another bill would encode SEC Commissioner Hester Pierce's Token Safe Harbor Proposal 2.0, which would allow blockchain developers to raise money for blockchain development, release semi-annual reports showing progress on reaching decentralization, and then allow the digital tokens to escape being classified as securities if the network reaches sufficient decentralization.

The most talked about piece of legislation in the digital asset space is the Lummis-Gillibrand Responsible Financial Innovation Act ("**RFIA**"). The RFIA encompasses everything from taxation, clearing up cross-jurisdictional overlap between the SEC and the CFTC, consumer protection efforts and banking regulations. The RFIA rewards the most decentralized protocols with the least burdensome regulations.

CONCLUSION

The digital assets sector has witnessed rapid growth in the recent years. Chainalysis' DeFi Adoption index states that "the total digital assets sector has grown over 2300% since Q3 2019 through to end Q2 2021".

In the last few years, we have witnessed several positive regulatory developments for the digital assets sector, with UAE, Bahrain, Switzerland and Liechtenstein emerging as forward-looking and digital assets friendly jurisdictions. The regulatory framework of these jurisdictions for digital assets, the openness of regulators to actively engage with VASPs and overall progressive ecosystem have cemented their position as global hubs for VASPs. Although each of these jurisdictions have varied regulatory approaches to regulation of digital assets (for instance, nomenclature and definition, licensing requirements, categories of tokens recognised), we note similarities in their approaches. For example, under the licensing and compliance requirements, AML/CFT controls, consumer protection measures, technology governance and a risk-based approach remain key priorities for all the regulators. Overall, these jurisdictions are actively working towards offering a clear and transparent regulatory regime for VASPs.

It must be highlighted that governments and regulators across the globe are no longer overlooking this sector and we could expect further developments in the near future. For instance, the President of USA issued an Executive Order 14067 on March 9, 2022, titled 'Ensuring Responsible Development of Digital Assets' which outlines the government's approach towards addressing the risks and harnessing the potential benefits of digital assets and their underlying technology. On the other hand, as of November, 2022, the European Parliament was due to vote on adopting the regulation on markets in crypto-assets ("**MiCA**") which, if enacted, would establish harmonised rules for crypto-assets at the European Union level. Having regard to the overall growth in the sector and the parallel technological improvisations (like NFTs and DeFi platforms), the regulators are further engaging in consultations with market participants to amend their existing frameworks to address the latest developments.

Globally, authorities around the world are proactively engaging in policy discussions surrounding digital assets and going into 2023, we could expect to see significant movement in the regulatory landscape for the digital assets sector.

On that note, we hope that you enjoyed reading this report. We would like to express our sincere thanks to MME, Nagele Attorneys, Hess Legal Counsel and Mr. Jonathan Geen for their contribution in drafting this report.


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