GLI GLOBAL LEGAL INSIGHTS

Fintech

2021

Third Edition

Contributing Editors:
Todd W. Beauchamp, Stephen P. Wink & Yvette D. Valdez

glg global legal group

CONTENTS

Crypto-Asset Trading Platforms: Another Regulatory Trip Around the World

Todd W. Beauchamp, Stephen P. Wink & Yvette D. Valdez
Latham & Watkins LLP

Crypto-asset trading is a fast-growing part of the financial sector.[1] Some countries have wholeheartedly embraced crypto-assets, some have been reticent to permit widespread adoption, others have actively clamped down on crypto-assets and the platforms they trade on. Generally, countries have interpreted existing laws and regulations to apply to crypto-assets or adopted new laws or regulations to specifically address crypto-assets – or embarked on some combination of the two. Due to their use of blockchain and other distributed ledger technology, crypto-assets are, in most cases, inherently cross-border and cross-jurisdictional. Thus, most issuers of crypto-assets and operators of trading platforms must address multiple legal and regulatory frameworks when attempting to enter the market.

While this chapter will explore the regulation of crypto-assets and trading platforms in the European Union, the United States, Hong Kong, Singapore, Thailand, and Japan, it is important to note that there are, generally speaking, two types of crypto-asset trading platforms: centralised; and decentralised. Centralised crypto-asset trading platforms usually act as custodian for the crypto-assets and are responsible for legal and regulatory compliance (in this way, traditional exchanges provide a relatively straightforward analogue). Decentralised trading platforms are different. Instead of taking custody of a user's crypto-assets, and facilitating and executing trades itself, a decentralised trading platform may simply provide the trade-matching technology, with users retaining control/custody of their crypto-assets and automatically transferring crypto-assets between wallets pursuant to triggered smart contracts and without the involvement of a clearly identifiable intermediary.

Centralised trading platforms have been targets of hackings (both informational and monetary) because, as the name suggests, they act as central repositories of funds (i.e., crypto-assets and/or fiat currency) and information (e.g., personal information provided by users to satisfy know-your-customer ("KYC") requirements). Given they generally operate in a non-custodial fashion, decentralised trading platforms, on the other hand, have not been an immediately attractive target for these sorts of attacks since they hold no funds and limited, if any, personal information. With that said, decentralised platforms are certainly not immune from other forms of hacks and exploits. Indeed, decentralised applications ("DApps") have recently been subject to: sophisticated hacks that exploit bugs in the underlying blockchain protocol code; exploit bugs in the smart contracts governing how the DApp operates; or by execution of a 51% attack, whereby hackers gain control of more than half of a crypto-asset's mining process, and therefore gain control of the network for malicious ends.

Due to the generally hands-off, non-custodial approach of decentralised finance and DApps, whether and to what extent certain legal and regulatory regimes may be applicable is often unclear. In manycases, if the decentralised trading platform does not hold or transfer funds, and transactions happen peer-to-peer, then it may not be captured by existing regulatory

regimes that were devised with centralised entities and agents in mind. Hence, as the market for decentralised trading platforms continue to grow and evolve, regulators continue to grapple with the increasingly complex questions of whether and how these platforms *should* or *can* be regulated. It is increasingly clear, however, that regulators are no longer taking a wait-and-see approach and are now focused on measuring compliance by decentralised finance markets and platforms with the existing regulatory mandates applicable to centralised finance, including those intended to address consumer protection risks, financial crime risks, and financial system risks.

European Union

The EU has an overarching financial regulatory framework principally made up of regulations (which are directly applicable in EU Member States) and directives (which must be adopted into national law by each EU Member State). While this framework ensures a degree of harmonisation across EU Member States, it does not guarantee uniform regulation.

Crypto-asset regulation provides a good illustration of this issue. When considering whether EU financial regulation applies to crypto-assets, a threshold question to ask is: do the crypto-assets constitute a "financial instrument" or "electronic money"? A platform that facilitates trading in crypto-assets that are financial instruments or electronic money will typically be subject to licensing and other regulatory requirements. The definitions of financial instrument and electronic money are set out in Directive 2014/65/EU ("MiFID II") and Directive 2009/110/EC ("2EMD"), respectively. EU Member States have interpreted and implemented these directives differently; thus, it is possible that the same crypto-asset could be a financial instrument in one jurisdiction and not in another.[2] In addition, national laws, such as long-standing domestic securities laws, financial promotion and public offer laws, and newly introduced laws or regulations specifically addressing crypto-assets, may impose additional regulation on crypto-assets (whether or not they fall within the scope of MiFID II or 2EMD).[3] In addition to the variance in national laws, Member State-specific guidance increases the risk of regulatory divergence throughout the EU. Given this fragmentation, it is necessary to classify a given crypto-asset in accordance with the national laws of each EU Member State in which it is to be marketed, distributed, traded, or otherwise used.

The European Securities and Markets Authority ("ESMA"), which is the European Supervisory Authority ("ESA") with jurisdiction over financial markets and investor protection in the EU, and the European Banking Authority ("EBA"), the ESA with jurisdiction over banking activity in the EU, both noted the fragmented state of affairs in their respective advice to the European Commission ("Commission") and European Parliament on regulating crypto-assets ("ESMA Advice"[4] and "EBA Report",[5] respectively).

The ESMA Advice highlighted areas of the EU regulatory framework (e.g., the requirements relating to settlement under the European Central Securities Depositories Regulation, which are critical to trading activities in financial instruments in the EU) that may be difficult to apply to crypto-assets that are classified as transferable securities (a type of MiFID II financial instrument). The ESMA Advice also cautioned that the introduction of Member State-specific regulatory regimes addressing crypto-assets will create an unequal playing field for crypto-assets across the EU. Considering the inherently cross-border nature of most crypto-assets, the ESMA Advice encouraged an "EU-wide approach" to the regulation of crypto-assets not otherwise captured by MiFID II and 2EMD.

While definitive classification remains subject to EU Member States' laws, some high-level principles for classification of crypto-assets can be extracted from ESMA's survey of Member States:

- ESMA did not include "pure payment-type" crypto-assets (including Bitcoin) in the survey on the basis that they "are unlikely to qualify as financial instruments".
- For a majority of the regulators surveyed, the existence of attached profit rights (whether or not alongside ownership or governance rights) was sufficient for a crypto-asset to constitute a transferable security, provided the crypto-asset was freely tradable and not a payment instrument.
- None of the regulators surveyed characterised "pure utility-type" crypto-assets as financial instruments on the basis that the "rights that they convey seem to be too far away from the financial and monetary structure of … a financial instrument".

Similarly, while the EBA Report recognised that crypto-assets must be classified on a case-by-case basis, it stated that crypto-assets are not considered "funds"[6] or equivalent to fiat currency in any EU Member State for the purposes of EU financial regulation,[7] and indicated that crypto-assets are most likely to satisfy the definition of electronic money in circumstances where the value of the crypto-asset is pegged to the value of fiat currency (e.g., stablecoins) and the crypto-asset is redeemable for fiat currency.

Indeed, what the ESMA Advice and the EBA Report suggest is that for the purposes of regulation, the characterisation of crypto-assets proceeds predominantly on the basis of an intrinsic assessment of a given crypto-asset, focused on the rights or entitlements granted to holders,rather than on the basis of extrinsic factors, such as the intended or actual use of the crypto-asset or other contextual factors relating to the crypto-asset (such as whether a platform to which the crypto-asset relates is currently operational or whether the network underlying the crypto-asset is decentralised).

On December 19, 2019, the Commission launched a public consultation to review the suitability and effectiveness of the current EU regulatory framework applicable to crypto-assets.[8] The purpose of the consultation was to examine crypto- assets that are within the scope of the existing regulatory framework and determine whether a separate EU regulatory framework should be adopted for crypto-assets that do not fall within scope, either by introducing an EU directive or an EU regulation. The Commission recognised that different interpretations and applications of existing requirements can lead to divergent approaches by national competent authorities, resulting in uncertainty, difficulties with the cross-border provision of crypto-asset services, and a fragmentation of the existing EU regulatory approach toward crypto-assets. The public consultation closed in March 2020, and the Commission's proposals were published on 24 September 2020 as (among other things) the draft Markets in Crypto-Assets Regulation ("MiCA"). The proposal is part of the EU Digital Finance package, a set of measures designed to make the EU fit for the digital age and to further enable and support the potential of digital finance in terms of innovation and competition while mitigating the risks involved.

As an EU regulation, MiCA would create a new, uniform EU-wide licensing regime for crypto-asset issuers and service providers along with substantive conduct of business and consumer protection requirements. Broadly, MiCA would apply in relation to crypto-assets that are not otherwise regulated at an EU level (for example, as financial instruments under MiFID II) to persons that are either: (i) engaged in the issuance of such crypto-assets; or (ii) provide services related to such crypto-assets in the EU. The proposals would impose regulatory requirements on issuers of crypto-assets, and also subject crypto-asset service providers to authorisation requirements and a broad range of general prudential, conduct of business, and governance requirements, as well as additional requirements that apply depending on the types of crypto-asset services being provided. A market abuse regime for

in-scope crypto-assets in line with that applicable to traditional financial instruments under the EU Market Abuse Regulation is also included in the draft. MiCA would also introduce a new EU-wide passport that is available to market participants who become licensed under the MiCA regime in their home Member State.

MiCA has been designed to interplay with existing EU financial services legislation and authorisation requirements. Many of the requirements it imposes on crypto-asset issuers and service providers will be familiar to legal and compliance professionals in traditional financial services, although adapted to meet the idiosyncracies of the crypto-asset market. MiCA is currently making its way through the EU legislative process and whilst the precise timetable for its implementation is currently unclear, the Commission's ambition is for MiCA to be in force by 2024. Under the proposals, crypto-asset service providers that began providing their services before the date MiCA comes into force would have 18 months from the date that MiCA comes into force to become authorised and would only be required to comply with the requirements of MiCA once granted an authorisation within that period. However, until authorised, crypto-asset service providers would need to continue to comply with the existing national laws of Member States. The proposals also contain a grandfathering provision meaning that certain crypto-assets issued before the date on which MiCA comes into force will not be subject to it, but this will not apply to "asset-referenced tokens" or "e-money tokens" (each as defined in MiCA) in respect of which MiCA will apply even if such tokens were issued prior to it coming into force.

Separately, EU Directive 2018/843 ("5MLD") extended EU anti-money laundering ("AML") and counter-terrorism financing ("CFT") regimes to capture certain crypto-asset service providers (broadly, persons engaged in cryptocurrency exchange and custodial wallet providers). Notably, the definition of a crypto-asset for these purposes is very broad (and not related to the definition of financial instruments under MiFID II or electronic money under 2EMD) and so the EU AML regime may nevertheless apply to crypto-asset market participants that otherwise fall outside the scope of EU financial services regulation. While 5MLD was required to be implemented by EU Member States on or before January 10, 2020, a number of EU Member States have not yet fully done so. And the Member States that have implemented 5MLD have taken divergent approaches (e.g., some Member States have gold-plated the requirements of 5MLD and imposed licensing regimes on in-scope entities), which again raises the question of fragmentation of the EU regulatory approach toward crypto-assets and may amplify the calls for a directly applicable EU regulatory regime implemented through EU regulations rather than directives.

United States

In the US, crypto-asset markets and related activities are regulated under several federal and state regulatory regimes. At the federal level, the Securities and Exchange Commission ("SEC") is concerned with whether a crypto-asset is a "security", the Commodity Futures Trading Commission ("CFTC") asks whether a crypto-asset is a "commodity", and the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") regulates certain activities involving "convertible virtual currency". A crypto-asset can be one or more of these things simultaneously, and may also be subject to any number of state-level money transmitter, securities, and tax regimes. The applicability of these laws and regulations to a decentralised trading platform will depend on how the platform operates and is marketed; its decentralised nature is not the determining factor in analysing whether it is subject to regulation.

Acting as a Security. If a crypto-asset fits within the definition of a security, it is regulated by the SEC and subject to existing laws and regulations.[9] If so, the issuer of the crypto-

asset needs to either register the offering and sales of the crypto-asset under section 5 of the Securities Act of 1933 or find an applicable exemption.[10]

Further, the Securities Exchange Act of 1934 regulates intermediaries that engage in securities transactions. Thus, those crypto-asset exchanges that engage with securities are required to register as a securities exchange or, depending on their business model, a broker-dealer.[11] For centralised exchanges and broker-dealers acting as custodians of digital asset securities, the SEC issued a joint staff statement with the Financial Industry Regulatory Authority ("FINRA") on July 8, 2019, highlighting the importance of compliance with Rule 15c3-3 of the Securities Exchange Act of 1934 (the "Customer Protection Rule"). It also issued a related statement on December 23, 2020 ("Custody of Digital Asset Securities by Special Purpose Broker-Dealers"), clarifying its position on how broker-dealers can establish possession or control of digital assets in compliance with the Customer Protection Rule to mitigate the risk of the loss or theft.

Any investment funds that invest in crypto-assets that are securities are subject to the same laws applicable to pooled vehicles that invest in securities generally, such as the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Notably, while the SEC regulates crypto-assets that are securities, the SEC staff has indicated that they do not consider the two most well-known crypto-assets – Bitcoin and Ether – to be securities. If, however, these non-security crypto-assets were bundled into investment vehicles (such as exchange-traded funds), they would become securities and subject to SEC regulation.

Acting as a Commodity. The CFTC considers crypto-assets (including Bitcoin and Ether) that are not securities to be commodities for purposes of the Commodity Exchange Act. The CFTC regulates futures, options on futures, and swaps (i.e., derivatives) on commodities (including crypto-assets) (collectively, "Commodity Interests"), subjecting market participants and transactions in such Commodity Interests to certain regulatory oversight and registration requirements. While the CFTC does not have general regulatory jurisdiction and oversight with respect to spot crypto-assets markets, the CFTC does retain general enforcement authority to police against manipulation and fraud in the spot commodities markets (including spot crypto-asset markets). Thus, the CFTC regulates the crypto-asset spot markets by enforcement, and has done so aggressively over the past few years.[12]

In addition to transactions in Commodity Interests, the CFTC also regulates commodity transactions with retail customers that are entered into or offered on a leveraged, margined or financed basis as if they were futures contracts (the "Retail Leveraged Rules"). However, if a transaction results in "actual delivery" of the relevant commodity within 28 days, such leveraged transaction will not be subject to regulation as a futures contract. Crypto-asset markets have exhibited increasing use of leverage and margin for the trading of crypto-assets, and the application of the Retail Leveraged Rules to transactions in crypto-assets has been an area of CFTC regulatory and enforcement emphasis. The CFTC has finalised interpretive guidance ("Guidance") on what constitutes "actual delivery" in the context of crypto-assets which serve as a medium of exchange (i.e., virtual currency),[13] providing two primary factors for what would constitute "actual delivery" for purposes of the Retail Leveraged Rules: first, the purchaser must have possession and control over the virtual currency; and second, the purchaser must be able to use the virtual currency in commerce.

Under the CFTC's regulatory framework, certain intermediaries are subject to regulation and registration. Thus, in general, futures or options on crypto-assets (and crypto-asset transactions regulated as if they were futures contracts under the Retail Leveraged Rules)

may only be offered to retail customers by designated contract markets ("DCMs") subject to CFTC regulation and oversight. Other intermediaries involved in soliciting or accepting orders for such transactions may be required to register, absent an applicable exemption, as a futures commission merchant ("FCM") or introducing broker. The CFTC has issued a primer with respect to the heightened scrutiny of futures contracts on crypto-assets, and CFTC Commissioners have publicly stated that the agency will be paying strict attention to this market.[14] On the other hand, bilateral swaps on crypto-assets may only be entered into between sophisticated counterparties that qualify as "eligible contract participants" under the Commodity Exchange Act and markets and facilities for the trading of swaps must generally register with the CFTC as a swap execution facility ("SEF").

On October 21, 2020, the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") issued CFTC Staff Letter No. 20-34, clarifying its views on the acceptance, holding, and reporting of virtual currency (e.g., Bitcoin or Ether) in segregated accounts by FCMs and the development of appropriate risk management programmes in relation thereto. Specifically, the advisory related to virtual currencies deposited by customers with FCMs in connection with physically delivered futures contracts or swaps. Due to the "custodian risk" associated with holding virtual currency as segregated funds, the Advisory lays out specific guidance for FCMs on virtual asset acceptance and custody, and their responsibility to implement appropriate policies, procedures, and oversight programmes.

Although not a binding rule or regulation, a recent speech by CFTC Commissioner Dan M. Berkovitz on June 8, 2021 provides a stern reminder that the existing regulatory requirements under the Commodity Exchange Act, including the DCM and SEF registration requirements, extend to decentralised finance markets and platforms. In this regard, Commissioner Berkovitz emphasised that the Commodity Exchange Act does not contain any registration exceptions for smart contracts and decentralised finance applications, and decentralised trading markets and platforms would be in violation of the law absent appropriate registration.

Acting as a Currency. If the crypto-asset is intended to act as a medium of exchange, it may be treated similarly to fiat currency for purposes of the Bank Secrecy Act of 1970 and its implementing regulations (collectively, the "BSA"), which serves as the principal AML regulatory regime in the US.[15]

The BSA applies to "financial institutions", which includes banks and other entities, such as money services businesses ("MSBs").[16] MSBs include multiple categories of entities, the most relevant to crypto-asset exchanges being a "money transmitter".[17] A money transmitter is "[a] person that provides money transmission services",[18] which, in turn, is defined as "the acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means".[19] Generally, any person falling within the definition of money transmitter must register with FinCEN and comply with the attendant requirements under the BSA. However, if an entity is functionally regulated by the SEC or the CFTC, it does not need to register as an MSB even if it otherwise meets the criteria.

While the BSA does not expressly reference or contemplate crypto-assets or crypto-asset-related activities, in 2013 FinCEN published initial guidance, and subsequently issued a series of administrative rulings, regarding the application of the BSA to certain crypto-asset-related activities. In an effort to further clarify its previously articulated positions, FinCEN issued consolidated guidance on the topic in May 2019 ("2019 Guidance"), which included additional discussion regarding what constitutes "convertible virtual currency"[20] ("CVC"),

which is the central focus of FinCEN's regulatory efforts. The 2019 Guidance also included further discussion regarding the application of the BSA to the different types of participants in certain CVC arrangements, which FinCEN has defined as follows:

- A "user" is "a person that obtains virtual currency to purchase goods or services".
- An "exchanger" is "a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency".
- An "administrator" is "a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency".[21]

FinCEN has stated that a user of CVC is not an MSB, but that an administrator or exchanger of CVC[22] that "(1) accepts and transmits CVC or (2) buys or sells CVC for any reason *is* a money transmitter under FinCEN's regulations".[23]

Finally, on December 23, 2020, FinCEN issued a proposed rule that would impose significant new obligations on market participants in the cryptocurrency and digital asset market ("Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets"). The proposal would require banks and MSBs to submit reports, keep records, and verify the identity of customers (and counterparties) in relation to transactions involving CVC or digital assets with legal tender status held in unhosted wallets, or held in wallets hosted in a jurisdiction identified by FinCEN, if the transaction is greater than US$10,000. The proposal, controversial in the crypto-asset for the significant compliance burdens it would impose, has not yet been finalised.

Broadly speaking, based on FinCEN's guidance, if a trading platform engages in the purchase or sale of crypto-assets as a customer business, provides services involving the receipt and transmission of crypto-assets, or provides customers with a hosted wallet (or similar custodial solution), then it is a money transmitter under the BSA and must register with FinCEN and comply with the applicable rules. On the other hand, if the trading platform simply provides information and the opportunity for customers to match and execute their own trades, like most decentralised trading platforms, then it likely is not a money transmitter. However, as reflected in FinCEN's prior guidance and rulings, analysing whether certain activities are subject to the BSA is often very fact-specific, and given the rapidly evolving landscape drawing lasting bright lines of distinction is increasingly difficult. Therefore, any person involved in the space should stay abreast of all regulatory developments and continually evaluate the potential impact of any updated guidance or new rulings on their prior analysis.

Finally, US states and territories regulate the provision of money transmission services to residents of their respective jurisdiction.[24] Although the requirements and related definitions vary slightly from state to state, money transmission services typically include: (i) traditional money remittance; (ii) issuing or selling open-loop stored value or prepaid access; or (iii) issuing or selling payment instruments. Generally, if an entity is engaged in any one of those activities, it must be: (i) licensed as a money transmitter under the relevant state law; (ii) appointed and serve as the authorised agent of a money transmitter licensed in the relevant state; or (iii) an entity or activity that is exempt under the relevant money transmitter statute.

The states have not taken a uniform approach with respect to regulating the transmission of crypto-assets. Some states have expressly amended their existing money transmission statutes to contemplate crypto-assets, some have issued guidance and/or interpretations that incorporate crypto-assets into their current money transmission statutes, and others have issued guidance finding that crypto-asset-related activities do not constitute money transmission under their statutes. The State of New York is unique in that its financial services regulator issued

a stand-alone regulation specific to crypto-asset-related activities.[25] As a general rule, though, if a trading platform accepts money or crypto-assets from one person or place and stores it and/or sends it to another person or place, in most instances, that activity constitutes money transmission.[26] Also unique among the 50 states is Wyoming. On July 1, 2021, a law came into effect making Wyoming the first state in the nation to allow decentralised autonomous organisations ("DAOs") to obtain legal company status. A DAO is a form of DApp, and the legislation would allow DAO protocol creators to pursue development and growth post-token launch by registering in Wyoming as a limited liability company ("LLC") (a popular business structure first established by Wyoming in 1977). DAOs would benefit immensely from the ability to incorporate, register, transact, hire employees, and scale like any other LLC can. The legislation would therefore provide legal structure, regulatory clarity, and operational legitimacy for many fledgling digital asset projects and decentralised trading platforms.

Hong Kong

'Opt-in' licensing regime for security virtual assets trading platforms

In November 2019, the Securities and Futures Commission ("SFC") published a position paper ("Position Paper")[27] setting out its approach on the regulation of virtual asset trading platforms ("VATPs"),[28] whereby VATPs can opt-in to be regulated by the SFC in a manner similar to licensed securities brokers and automated trading venues.

VATPs that operate in Hong Kong and trade at least one virtual asset considered to be a "security" under the Securities and Futures Ordinance ("SFO") must apply for a licence from the SFC for Type 1 (dealing in securities) and Type 7 (providing automated trading services) regulated activities. Upon becoming licensed, a VATP will operate in the SFC's regulatory sandbox under close supervision (i.e., subject to frequent reporting, monitoring, and reviews).

The SFC will impose certain conditions for licensure, along with terms and conditions on licensed VATP operators, including that the VATP must:

- Only offer services to "professional investors"[29] (meaning the general public/retail investors will not be able to trade on SFC-licensed VATPs), and such clients must have sufficient knowledge of virtual assets.
- Adhere to stringent criteria for the inclusion of virtual assets to be traded on the VATP.
- Submit to the SFC written legal advice in the form of a legal opinion or memorandumon the legal and regulatory status of every virtual asset that will be made available in Hong Kong.
- Not conduct any offering, trading, or dealing activities of virtual asset futures contracts or related derivatives.
- Not provide any financial accommodation (e.g., loans) for its clients to acquire virtual assets.
- Adopt a reputable external market surveillance system to supplement its own market surveillance polices and controls.
- Ensure that an insurance policy covering the risks associated with custody of virtual assets is in effect at all times.
- In relation to virtual assets that are "securities", only include virtual assets that: (i) are asset-backed; (ii) are approved or qualified by, or registered with, regulators in comparable jurisdictions; and (iii) have a post-issuance track record of 12 months.

The SFC's regulatory framework applies to VATPs on a holistic basis, even though the trading of non-security virtual assets technically is not a "regulated activity" under the SFO. In other words, licensed VATPs must comply with all the relevant regulatory requirements when conducting their virtual asset trading business, whether it involves security tokens or non-security tokens (e.g., Bitcoin) and whether it occurs on or off the trading platform.

The regulatory framework is only available for operators of centralised VATPs. In the Position Paper, the SFC states that it is focusing its efforts on the regulation of VATPs that provide trading, clearing, and settlement services for virtual assets and have control over investors' assets (i.e., centralised VATPs), and will not be accepting licensing applications for VATPs that only provide a direct peer-to-peer marketplace for transactions by investors who typically retain control over their own assets (i.e., decentralised trading platforms).

Mandatory licensing regime for non-security virtual assets exchanges

Having licensed the first VATP in November 2020, the SFC and the Financial Services and the Treasury Bureau of the Hong Kong government ("FSTB") immediately turned their attention towards regulating exchanges that only facilitate trading in non-security virtual assets (e.g., Bitcoin) by issuing a consultation paper outlining a new regulatory framework to bring operators of non-security virtual asset exchanges within a formal regulatory regime under the supervision of the SFC.

The conclusions to the consultation were issued in May 2021 and the FSTB intends to introduce a Bill to Hong Kong's law making body, the Legislative Council, to give effect to the new regime during the 2021–2022 legislative session. Upon commencement of the new regulatory regime, market participants are expected to have a transitional period of 180 days to comply with the new requirements.

The new regulatory regime will mark a significant change to the way in which virtual assets are regulated in Hong Kong. It will also implement the latest requirements of the Financial Action Task Force in relation to virtual asset service providers ("VASPs"). Under the new regulatory regime, the operation of a non-security virtual assets exchange ("VA Exchange") will be a regulated virtual asset activity under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance ("AMLO"), and persons operating a VA Exchange will need to apply for a VASP licence from the SFC. Licensed VA Exchange operators will be subject to AML and CFT requirements stipulated under the AMLO and other regulatory requirements.

VATPs that are already regulated by the SFC under the opt-in regime described above will be exempt from the new regime. Decentralised VA Exchanges and other peer-to-peer trading platforms would also not be covered by the definition of a VA Exchange, provided that virtual asset transactions are conducted outside the platform and the platform is not involved in the underlying transaction by coming into possession of any money or any virtual asset at any point in time.

Controversially, the new regime will initially only permit licensed VA Exchanges to deal with "professional investors", thus excluding the general public/retail investors from dealing with regulated VA Exchanges. It appears that retail customers could continue to trade in virtual assets through: (i) peer-to-peer trading platforms, which are excluded from the new regulatory regime; (ii) overseas exchanges, if the retail customers have sought out these exchanges on their own initiative without any active marketing by the exchanges (i.e., on a reverse solicited basis); and/or (iii) over-the-counter virtual asset brokerage firms that do not meet the definition of an VA Exchange.

Singapore

In Singapore, the regulatory regime applicable to any crypto-asset exchange depends on what type of crypto-asset is being traded. A crypto-asset exchange that offers any "digital payment token service" is regulated under the Payment Services Act ("PSA"), which came into effect on January 28, 2020. Under the PSA, a crypto-asset exchange that deals (i.e., buys and sells)

digital payment tokens or facilitates the exchange of digital payment tokens on a regular, centralised basis will require a licence from the Monetary Authority of Singapore ("MAS").

A crypto-asset exchange that facilitates trading in security tokens must apply to the MAS to become an approved exchange or a recognised market operator ("RMO"), unless otherwise exempted. In May 2018, the MAS proposed expanding the existing RMO regime from a single tier to three tiers to accurately reflect the risks posed by different market operators ("MOs").[30] Under the current regime, RMOs are only permitted to deal with "accredited investors" and cannot deal with retail investors.[31] Under the proposed multi-tiered RMO regime, the permissible activities and customer base would vary depending on the tier. For example:

- Tier 1 would be the most heavily regulated. A Tier 1 RMO would have limited access to Singapore-based retail investors and would thus be subject to more stringent regulatory requirements than other RMOs. A Tier 1 RMO would be required to comply with all the requirements imposed on Tier 2 RMOs, along with additional requirements designed to protect retail investors (e.g., prospectus requirements, continuing obligations, and change-of-control transactions).
- Tier 2 would capture those MOs that qualify under the existing RMO regime. MOs thatare authorised under the existing RMO regime would be re-classified as Tier 2 RMOs.
- Tier 3 is aimed at smaller MOs that target the non-retail market segment (e.g., banks). Tier 3 RMO applicants would need to fulfil a reduced set of capital requirements under Singapore's Securities and Futures Act and a simplified set of technology risk management and outsourcing compliance requirements. The application process for Tier 3 RMO applicants would also be simplified: such applicants would be able to self-certify their compliance with a checklist of requirements prepared by the MAS. However, Tier 3 RMO applicants would continue to be subject to the "fit and proper requirements" that are imposed on existing RMOs.[32]

In July 2020, the MAS published a consultation paper on a new Omnibus Act, setting out its approach on the regulation of VASPs which are incorporated in Singapore, but may not be captured under existing legislation as they offer such services outside of Singapore.[33]

Under the MAS' proposal, the activities that would bring a Singapore-incorporated entity within scope of this regulatory regime include: (a) dealing in, or facilitating the exchange of, digital tokens ("DTs"); (b) inducing or attempting to induce persons to enter into agreements with a view to buying or selling DTs in exchange for money or other DTs; (c) accepting DTs for the purposes of transferring, or arranging for the transfer of, the DTs; (d) safeguarding or administration of a DT or DT instrument; and (e) advisory services relating to the offer or sale of DTs.

If within scope, the MAS proposed requiring such entities to fulfil certain criteria in order to ensure that they have a meaningful presence in Singapore such that the MAS has sufficient supervisory oversight over them. These criteria include: (i) having at least one executive director who is resident in Singapore; (ii) having a permanent place of business in Singapore where books of all transactions in relation to DT services are kept; (iii) appointing at least one person to be available for the MAS to contact regarding AML/CFT queries or complaints; (iv) fulfilling the MAS' financial requirements as may be prescribed by notice; and (v) fulfilling the MAS' fit and proper requirements for directors and CEOs.

Thailand

Digital asset business operators are required to obtain a licence from the Minister of Finance upon the recommendation of the Thailand Securities and Exchange Commission ("Thai SEC").[34] To obtain a crypto-asset exchange licence, the company must, among other things:

(i) be established under Thai law; (ii) meet certain financial thresholds (as determined by the Thai SEC); and (iii) maintain policies, systems, and measures (including KYC and AML programmes, IT systems, and internal control measures) that comply with the Thai SEC's standards.

Japan

On May 1, 2020, Japan implemented certain amendments to the Payment Services Act ("Japan PSA") and the Financial Instruments and Exchange Act ("Japan FIEA") to address crypto-assets. Under the Japan PSA, crypto-asset exchange service providers[35] are required to be registered with the Financial Services Agency ("FSA").[36] Further, crypto-asset-related derivatives businesses are now subject to the Japan FIEA.[37] Thus, if the FSA-registered crypto-asset exchange service provider trades crypto-assets that are securities that entitle investors to a distribution of profits or assets, both the crypto-asset exchange and the crypto-assets could be subject to regulations promulgated under the Japan FIEA.

Japan has also established a self-regulatory body for crypto-asset exchanges, the Japanese Virtual Currency Exchange Association, which provides additional regulation and guidance, as well as the imposition of disciplinary sanctions for non-compliance, applicable to licensed crypto-asset exchange service providers.

Conclusion

As the various regulatory approaches outlined here indicate, most jurisdictions are still determining how to regulate crypto-assets without stifling innovation. In the EU, despite the existence of a centralised regulatory system, Member States have not been uniform in their interpretation of directives, leaving a crypto-asset exchange that hopes to operate EU-wide with the unenviable task of attempting to understand and comply with more than 20 regulatory regimes. In the US, the key takeaway is that all crypto-assets and crypto-asset exchanges are likely to be captured under *some* regulatory regime, but it can be difficult, at both the state and federal levels, to determine which one best applies. In Hong Kong, regulators created a licensing regime for certain crypto-asset exchanges. In Singapore, the MAS implemented a more tailored regulatory regime to address the disparate needs of crypto-asset exchanges. In Thailand and Japan, crypto-asset exchanges are required to be registered (or licensed) with their respective regulator and to meet ongoing compliance requirements.

Although the vision of a global financial system where crypto-assets facilitate instantaneous execution and borderless trades may still be remote, the growing popularity of crypto-assets and the trading of these instruments is forcing countries to re-examine their existing legal and regulatory frameworks and their application to crypto-assets and the platforms that trade them. The coming years will be critical for the development of regulatory regimes that address crypto-assets and crypto-asset trading platforms. Striking the right balance between consumer protection and market integrity and resilience without stifling innovation is the challenge all regulators face.

* * *

Endnotes

1. For ease of reading, we use the term "crypto-asset" as a catch-all for the variety of financial instruments that a cryptocurrency, token, or coin can represent, including currency, securities, and commodities. Some jurisdictions' regulatory regimes differentiate between the type of instrument that is being traded, while others simply address the trading of crypto-assets, generally. If a governmental agency has defined a different

term to capture the same concept, we have used that term in the discussion of that agency's regulation of crypto-asset-related activities.

2. The same is true for electronic money, although the definition has been implemented with a greater degree of uniformity across EU Member States than the definition of financial instruments.
3. Examples of such additional regulation notably exist in France, Germany, Gibraltar, Italy, and Malta.
4. ESMA, *Advice – Initial Coin Offerings and Crypto-Assets* (Jan. 9, 2019) (https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf).
5. EBA, *Report with advice for the European Commission on crypto-assets* (Jan. 9, 2019) (https://eba.europa.eu/documents/10180/2545547/EBA+Report+on+crypto+assets.pdf).
6. Unless they otherwise fall within the definition of electronic money.
7. A position with which both the Bank of England and the European Central Bank (as well as other Member State central banks and monetary authorities) have publicly concurred on many occasions.
8. Commission, *Consultation Document on an EU Framework for Markets in Crypto-assets* (December 2019) (https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-crypto-assets-consultation-document_en.pdf).
9. Whether the crypto-asset is a security is decided pursuant to regulation but also to the threshold test imposed by the Supreme Court in *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946) (often referred to as the *Howey* test). Under the Securities Act of 1933, an instrument is an investment contract (or a security) if it is a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party".
10. For example, SEC Regulation D and Regulation A both offer issuers potential exemptions.
11. *See*, *e.g.*, SEC Order Release No. 84553, Administrative Proceeding File No. 3-18888, *In the Matter of Zachary Coburn, Respondent* (Nov. 8, 2018), where the SEC settled with the owner of a decentralised trading platform, EtherDelta, on charges that the platform operated as an unregistered national securities exchange (https://www.sec.gov/litigation/admin/2018/34-84553.pdf).
12. *See*, *e.g.*, *CFTC v. Patrick McDonnell and CabbageTech Corp. d/b/a Coin Drop Markets*, 18-CV-361, E.D.N.Y. (Mar. 6, 2018).
13. Retail Commodity Transactions Involving Certain Digital Assets, 85 Fed. Reg. 37,734 (June 24, 2020) (https://www.govinfo.gov/content/pkg/FR-2020-06-24/pdf/2020-11827.pdf).
14. CFTC, *A CFTC Primer on Virtual Currencies*, Oct. 17, 2017 (https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf).
15. FinCEN is responsible for administering the BSA.16.
16. 31 C.F.R. § 1010.100(ff).
17. *Id*. § 1010.100(ff)(5).
18. *Id*. § 1010.100(ff)(5)(i)(A).
19. *Id*.
20. FinCEN distinguishes "convertible virtual currency" from "virtual currency", neither of which are specifically referenced in the BSA. FinCEN defines "virtual currency" as "a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency". "Convertible virtual currency" is more narrow and includes "virtual currency [that] either has an equivalent value in real currency, or acts as a substitute for real currency". FinCEN's rulings address CVC.

21. *Id*.
22. *Id*.
23. *Id*. (emphasis in original).
24. Only the State of Montana does not regulate money transmission.
25. The New York State Department of Financial Services adopted an entirely new regulatory regime specific to crypto-assets acting as currency: the Virtual Currency Business Activity licence ("Bitlicense") regime.
26. Some states have stated that their laws do not apply if there is no fiat currency involved in the transaction, *see*, *e.g.*: Pennsylvania Department of Banking and Securities, *Money Transmitter Act Guidance for Virtual Currency Businesses* (Jan. 23, 2019) and Texas Department of Banking, Supervisory Memo 1037, *Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act* (Apr. 1, 2019). Others have revised their statutes or issued interpretations to capture the activity, *see*, *e.g.*, Washington State, which defines "money transmission" in part as "receiving money or its equivalent value (*equivalent value includes virtual currency*) to transmit, deliver, or instruct to be delivered to another location … by any means". Wash. Rev. Code § 19.230.010(18) (emphasis added).
27. *See* the SFC's Position Paper: Regulation of Virtual Asset Trading Platforms (Nov. 6, 2019) (https://www.sfc.hk/web/EN/files/ER/PDF/20191106%20Position%20Paper%20and%20Appendix%201%20to%20Position%20Paper%20(Eng).pdf).
28. The SFC's term for crypto-asset trading platforms.
29. The term "professional investor" is defined in Part 1 of Schedule 1 to the SFO. The definition includes institutional investors (e.g., licensed banks, broker-dealers, insurance companies), corporates that satisfy minimum assets tests, and high-net-worth individual investors.
30. While public comments are no longer being accepted, the MAS has not yet published its response, and no bill has been introduced in Parliament to implement this proposal.
31. Accredited investors (both individuals and corporations) are defined in section 4A of the Securities and Futures Act and section 2 of the Securities and Futures (Classes of Investors) Regulations 2018.
32. The "fit and proper requirements" are the criteria that the MAS expects all persons carrying out regulated activities to meet. These include, but are not limited to, the: (i) honesty, integrity, and reputation; (ii) competence and capability; and (iii) financial soundness of the applicant. *See* MAS Guidelines on Fit and Proper Criteria (http:// www.mas.gov.sg/~/media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/Regulations%20Guidance%20and%20Licensing/Guidelines/Guidelines%20on%20Fit%20and%20Proper%20Criteria%20October%202018%20 Guideline%20No%20FSGG01.pdf).
33. *See* MAS Consultation Paper on the New Omnibus Act for the Financial Sector (https://www.mas.gov.sg/publications/consultations/2020/consultation-paper-on-the-new-omnibus-act-for-the-financial-sector).
34. Digital asset business operators include digital asset exchanges, brokers, dealers, and a catch-all for "other businesses relating to digital assets as prescribed by the Minister under the recommendation of the [Thai SEC]". Emergency Decree on Digital Asset Businesses B.E. 2561 (2018).
35. A crypto-asset exchange service provider is a person that engages in the sale, purchase, intermediation of a sale or purchase, or the custody of crypto-assets.
36. The Japan PSA only captures certain types of crypto-assets (those that satisfy all of the conditions in one of the two categories below), and only exchanges trading those types of crypto-assets need to be licensed.

Category No. 1: the token: (i) can be used as a means of payment for goods and/or services (to the extent that the merchants with whom the tokens can be used are not limited to certain persons designated by the issuer); (ii) is exchangeable for any fiat currency; and (iii) is electronically transferable. Category No. 2: the token is both: (i) exchangeable for Category No. 1 crypto-assets; and (ii) is electronically transferable.

37. The Japan FIEA has been amended to state that "crypto-assets" are included in the definition of "financial instruments", and investment interests that are transferrable through a blockchain are to be treated as "securities", both subject to the Japan FIEA. As such, fraudulent and deceptive acts with respect to regulated crypto-assets are now illegal and subject to criminal sanctions.

* * *

Acknowledgments

Stuart Davis

Tel: +44 20 7710 1821 / Email: stuart.davis@lw.com

Stuart Davis is a partner in the London office of Latham & Watkins and a member of the Financial Institutions and Financial Regulatory Practices and the FinTech Industry Group. Mr. Davis has a wide range of experience advising broker-dealers; investment, retail, and private banks; technology companies; market infrastructure providers; investment managers; hedge funds; and private equity funds on complex regulatory challenges. Mr. Davis counsels clients on the domestic and cross-border regulatory aspects of cutting-edge FinTech initiatives, including technology innovations in legislation, market infrastructure, tokenisation, trading, clearing and settlement, lending (including crowdfunding), payments, and regulatory surveillance. He also advises financial institutions on the impact of regulatory change on their businesses, including MAR and MiFID II, CASS, CSDR, PSD2, AIFMD, and Brexit, as well as strategically advising on their FX remediation projects, market conduct issues, best execution compliance, systems and controls, and governance.

Simon Hawkins

Tel: +852 2912 2733 / Email: simon.hawkins@lw.com

Simon Hawkins is a partner in the Hong Kong office of Latham & Watkins and a member of the Corporate Department and Financial Institutions Group. Mr. Hawkins serves a leading role in handling the firm's non-contentious financial regulatory work in Asia and is Co-Chair of the firm's Global Blockchain and Cryptocurrency Task Force. Mr. Hawkins advises clients on financial regulation, including licensing matters, prime brokerage arrangements, securities dealing, financial market regulations, intermediary and distribution arrangements, product development and structuring, and FinTech. Mr. Hawkins also advises on the regulatory aspects of capital markets and M&A deals involving financial institutions, and he has particular experience in structuring and negotiating bancassurance arrangements.

Sam Maxson

Tel: +44 20 7710 1823 / Email: sam.maxson@lw.com

Sam Maxson is an associate in the London office of Latham & Watkins. Mr. Maxson regularly advises a wide range of clients (including banks, insurers, investment firms, financial markets infrastructure providers, and technology companies) on all aspects of financial regulation. Mr. Maxson has a particular focus on FinTech and InsurTech, advising both established and emerging businesses on the application of global financial regulation to new and novel

uses of technology in finance and insurance. His expertise also extends to the increasingly widespread interest in crypto-assets and "tokenisation" of financial markets.

Adam Bruce Fovent

Tel: +1 212 906 1200 / Email: adam.fovent@lw.com

Adam Fovent is an associate in the New York office of Latham & Watkins and advises clients on regulatory, compliance, and transactional issues relating to commodities, securities, and derivatives products. Mr. Fovent also has experience advising clients on regulatory aspects of FinTech, cryptocurrency, and digital asset products and initiatives.

Gen Huong Tan

Tel: +65 6437 5349 / Email: genhuong.tan@lw.com

Gen Huong Tan is an associate in the Singapore office of Latham & Watkins and a member of the firm's Technology Transactions Practice. He has experience advising clients on data privacy matters, mergers and acquisitions, technology and commercial transactions.

Loyal T. Horsley

Tel: +1 202 637 2396 / Email: loyal.horsley@lw.com

Loyal Horsley is an associate in the Washington, D.C. office of Latham & Watkins and a member of the Payments & Emerging Financial Services Practice and Financial Institutions Industry Group. Ms. Horsley's practice focuses on a broad range of regulatory, transactional, and enforcement matters related to electronic and mobile payments, money services businesses, and other emerging payment technologies, including those related to money transmission, virtual currencies, payment instruments, and stored value offerings.

Charles Weinstein

Tel: +1 202 637 3343 / Email: charles.weinstein@lw.com

Charles Weinstein is an associate in the Washington, D.C. office of Latham & Watkins and a member of the Financial Institutions Industry Group, FinTech Industry Group, and Payments & Emerging Financial Services Practice. Mr. Weinstein focuses primarily on regulatory, transactional, and enforcement matters related to electronic and mobile payments, money services businesses ("MSBs"), and other emerging payment technologies, including those related to money transmission, virtual currencies, payment instruments, and stored value offerings. Mr. Weinstein also has experience advising clients on consumer credit issues.

Deric Behar

Tel: +1 212 906 4534 / Email: deric.behar@lw.com

Deric Behar is a knowledge management lawyer in the New York office of Latham & Watkins. He is a member of the Financial Regulatory Practice, and the Global Financial Institutions and Fintech Industry Groups. Mr. Behar brings experience in US and cross-border financial services regulation and regulatory enforcement affecting banking, securities, commodities, and derivatives markets. He focuses on the regulation of fintech, digital assets, and blockchain innovation, and is an active member of the firm's Blockchain and Cryptocurrency Task Force. He also regularly handles environmental, social, and governance ("ESG") issues and regulation as they relate to financial institutions and fintechs.

Todd W. Beauchamp
Tel: +1 202 637 2294 / Email: todd.beauchamp@lw.com

Todd W. Beauchamp is a partner in the Washington, D.C. office of Latham & Watkins and a member of the firm's Financial Institutions Industry Group. He serves as Global Co-Chair of the FinTech Industry Group and leads the Payments & Emerging Financial Services Practice. Mr. Beauchamp represents financial institutions, non-bank financial services companies, as well as technology companies, on a full spectrum of regulatory, transactional, and general corporate matters. He has comprehensive knowledge of emerging payment technologies, including those related to money transmission, virtual currencies, electronic payments, and stored value. Mr. Beauchamp counsels clients on a wide variety of federal, state, and international regulatory issues, as well as legislative developments. Additionally, he represents clients in matters before various state and federal bank regulatory agencies. Mr. Beauchamp advises clients in the structuring and negotiation of corporate transactions and commercial arrangements related to the offering of payments and credit products and services. In addition, he represents clients in the acquisition and sale of financial institutions and non-bank financial services companies, such as state-licensed money transmitters.

Stephen P. Wink
Tel: +1 212 906 1229 / Email: stephen.wink@lw.com

Stephen P. Wink is a partner in the New York office of Latham & Watkins, a member of the firm's Financial Institutions and FinTech Industry Groups, and Co-Chair of the firm's Blockchain & Cryptocurrency Task Force. Mr. Wink advises a diverse mix of clients, including broker-dealers, robo-advisors, crowdfunding platforms, cryptocurrency platforms, marketplace lenders, and payments providers on the financial regulatory considerations inherent in their proprietary FinTech transactions. He has in-depth knowledge and broad experience advising financial institutions on regulatory and related matters, gained in part from a decade as general counsel of a full-service investment bank.

Yvette D. Valdez
Tel: +1 212 906 1797 / Email: yvette.valdez@lw.com

Yvette D. Valdez is a partner in the New York office of Latham & Watkins and a member of the Derivatives Practice and Financial Institutions and FinTech Industry Groups. Ms. Valdez advises emerging companies, financial institutions, and investment managers on complex regulatory challenges in the development of bespoke financial crypto-asset and cryptocurrency technologies, including token sales, market infrastructure, trading, clearing, and settlement solutions on distributed ledger technology. She also advises clients on domestic and cross-border FinTech initiatives in the derivatives markets. In addition, Ms. Valdez has significant experience representing dealers, intermediaries, and end-users in connection with derivatives (swaps and futures) legal and regulatory matters under the Dodd-Frank Act, the Commodity Exchange Act, as well as related CFTC, SEC, and prudential regulation.

Latham & Watkins LLP

1271 Avenue of the Americas, New York, NY 10020, USA
Tel: +1 212 906 1200 / URL: www.lw.com

www.globallegalinsights.com

Other titles in the **Global Legal Insights** series include:

AI, Machine Learning & Big Data
Banking Regulation
Blockchain & Cryptocurrency
Bribery & Corruption
Cartels
Corporate Tax
Employment & Labour Law
Energy
Fund Finance
Initial Public Offerings
International Arbitration
Litigation & Dispute Resolution
Merger Control
Mergers & Acquisitions
Pricing & Reimbursement

GLI GLOBAL LEGAL INSIGHTS