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Cryptoasset regulatory and risk developments: the global picture

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The regulatory landscape for cryptocurrencies and digital assets has varied significantly across different jurisdictions worldwide, sparking a debate on the most appropriate approach. Some countries have opted for a detailed regulatory framework, while others have favoured a lighter-touch approach, targeting specific harms for regulation. However, in the aftermath of the failure of the cryptocurrency exchange FTX and the subsequent prosecution of its founder, Sam Bankman-Fried (***SBF***), there is a growing consensus on the necessity of a regulatory framework to ensure the sustainable growth of crypto businesses.

In this newsletter, we provide a comparative analysis of the cryptoasset regulatory frameworks in the UK, the EU, the US and Asia. For more information, as well as insights into the SBF trial, see our webinar from February 2024.

European Union

Currently, in the EU, cryptoassets are principally regulated by the fifth AML

Directive (***AMLD5***), which requires custodian wallet providers and providers of exchange services between virtual currencies and fiat currencies to register in the Member State where they provide services. Member States have the autonomy to introduce supplementary regulations, which has resulted in 27 distinct national regimes. These regimes vary in their structures and approaches, with some closely aligning with AMLD5, while others cover additional types of cryptoassets and/or service providers and in some cases establish comprehensive regulatory frameworks. Furthermore, there is no EU-wide passport that enables firms authorised in one jurisdiction to do business in other Member States. Consequently, cryptoasset businesses encounter significant challenges navigating the diverse regulatory landscapes across the EU, which has impeded business expansion efforts.

However, this will change with the introduction of the Markets in Crypto-Assets Regulation (***MiCA***), which will become applicable later this year. MiCA will introduce a harmonised regime covering all cryptoassets, broadly defined as a "digital representation of a value or of a right that is able to be transferred and stored electronically using distributed ledger technology (***DLT***) or similar technology". This encompasses all forms of existing cryptoassets regardless of their use as a virtual currency, means of investment or similar, with the exception of most unique and non-fungible tokens (often called ***NFTs***), which fall outside of MiCA's scope.

On 30 June 2024, the issuance and redemption of stablecoins, referred to in MiCA as asset-referenced tokens (***ARTs***) and e-money tokens (***EMTs***), will become subject to MiCA rules. The issuance of stablecoins will require a licence, and issuers of ARTs will have to comply with comprehensive ongoing requirements, including a duty to maintain a reserve of assets. For EMTs, the MiCA rules expand on the existing rules governing the issuance of e-money, which has been regulated in the EU since 2009. The remainder of MiCA will apply in EU Member States from the end of this year.

In terms of the primary market, public offerings of cryptoassets and admission for trading will require a "white paper" similar to a prospectus. These white papers will need to be notified to the relevant competent authority and will be subject to prospectus-style liability.

With regard to the secondary market, the provision of certain services in relation to cryptoassets will become a licensable activity under MiCA. These services include custody services, exchange services, the operation of a trading platform, placing services, the execution, reception and transmission of orders, investment advice, portfolio management and transfer services. Licensed institutions may rely on their existing licences in some cases, depending on the type of licence and service. The provision of these services will be subject to conduct rules, some of which are quite similar to those under existing financial services regulation, such as the obligation to act honestly, fairly and professionally and in the best interest of clients, as well as rules on governance arrangements, complaints handling and outsourcing. Other rules are tailored to the specific characteristics of cryptoasset services, such as rules

on custody, on the exchange of cryptoassets for funds, and on operating a trading platform for cryptoassets. The trading of cryptoassets will also be subject to the prohibition on insider trading and market manipulation, mirroring rules for securities trading.

In terms of geographical scope, MiCA will apply to offerings to the public in the EU and services provided to clients in the EU. This means that service providers based outside the EU will be captured if they are offering services within the EU. MiCA requires that the entity and its operations are actually established in the EU, which could result in an onshoring of foreign service providers. Only under very limited circumstances will no licence be required where a client requests, on their own initiative, a service from a provider outside the EU.

Certain cryptoasset service providers that have provided their services in accordance with national law before MiCA comes into force may continue to do so until 1 July 2026 or until they are granted or refused authorisation. However, Member States are free to shorten this transition period, and the European Securities Markets Authority (***ESMA***) has encouraged them to limit the transition period to the end of 2025 in order to foster supervisory convergence. Member States may apply a simplified authorisation process for these entities. For more information, see our blog post.

For a guide to MiCA and what cryptoasset issuers and service providers must do to comply with the new EU framework, please see our navigator.

United Kingdom

In the UK, even more so than the EU, the regulatory regime for cryptoassets has been implemented in a fragmented manner. Although the details of a more comprehensive future regime have been published, there are currently two regulatory regimes in force that impose requirements on cryptoasset businesses in the UK.

First, in-scope firms must be registered under the Money Laundering Regulations 2017 (***MLRs***). In 2019, the UK implemented AMLD5 by extending the scope of the MLRs to cover some activities involving cryptoassets. Cryptoasset exchange providers and custodian wallet providers are now required to register under the MLRs. The MLRs were subsequently amended further to introduce, for example, new requirements on changes in control of cryptoasset businesses. The definition of cryptoassets in the MLRs refers specifically to the use of DLT. This restrictive definition means the MLRs may fail to capture cryptoassets relying on other technology.

Second, the Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2023 (the ***Financial Promotions Order*** or ***FPO***) brought “qualifying cryptoassets” within scope of the UK’s financial promotions regime. This amendment was intended to address the specific harm caused by promotions of cryptoasset-related financial services, including promotions of

such services by social media influencers. It is now a criminal offence in the UK to make a financial promotion in respect of a qualifying cryptoasset unless that financial promotion is exempt or approved by an authorised firm. The FPO adopted a wider definition of “cryptoasset” relative to the MLRs, as the FPO’s definition could be satisfied by a token that does not use DLT. The definition of cryptoasset in the FPO also carves out fiat currencies that are issued digitally. As such, central bank digital currencies (or other fiat currencies that are issued digitally) would not be within scope of the UK’s FPO regime. For more information, see our blog posts on the expanded FPO regime and the FCA’s rules and guidance on financial promotions for cryptoassets.

The UK is now in the process of implementing a more comprehensive cryptoassets regime. Unlike the EU, however, the UK is not going to introduce a fully bespoke, holistic cryptoassets regime. Instead, the UK is adopting a phased approach whereby existing regulatory frameworks will be modified to capture in-scope cryptoassets. The stated rationale for this approach is that cryptoassets which are most likely to be used widely by retail customers should be regulated first. This approach is also intended to be “technologically neutral”. The UK’s future regime has been divided into two phases. Both phases have adopted the same broad definition of “cryptoasset”, which was initially laid down in the Financial Services and Markets Bill 2022 (now the Financial Services and Markets Act 2023). In comparison to the equivalent definitions under the MLRs and FPO, this definition (i) references a wide range of underlying technology (rather than exclusively DLT-based technology like the MLRs definition) and (ii) does not require cryptoassets to be fungible (in contrast to the FPO definition). For more information, see our blog post on the new regime.

The first phase of the new regime (***Phase 1***) relates to fiat-backed stablecoins, since it is believed that these have the greatest potential to become a widespread means of payment, particularly by retail customers. How fiat-backed stablecoins will be regulated depends on their use. The use of fiat-backed stablecoins in payment chains with at least one leg in the UK will be regulated through amendments to the Payment Services Regulations 2017. For issuance and custody activities, on the other hand, fiat-backed stablecoins will become regulated under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (***RAO***). Firms will need to be authorised and will be subject to a fairly extensive suite of FCA rules covering all of the areas common to regulated entities. The UK government’s current plan is to introduce Phase 1 legislation at some point this summer.

The second phase (***Phase 2***) will bring broader changes, extending the current regulatory framework under the Financial Services and Markets Act 2000. This will capture various specified activities in respect of cryptoassets including issuance, exchange, investment and lending activities (unlike MiCA, which will not regulate cryptoasset lending). Notably, portfolio management services in respect of cryptoassets will not be considered a regulated activity under Phase 2. A wide range of cryptoassets will be covered, including algorithmic stablecoins and commodity-linked tokens, neither of which fall within the scope

of Phase 1. Significantly, the geographical ambit of Phase 2 is more extensive than other UK financial services legislation. The proposed regulations will target the provision of services “in or to” the UK, and the exemption for overseas entities under the RAO will not be available. However, the UK government intends to collaborate with international partners on equivalence or deference arrangements. Legislation for Phase 2 is currently expected to be laid before Parliament at some point later in 2024.

The UK prime minister has called a general election that will take place on 4 July 2024 and which could result in a new government. It is unclear what effect, if any, this could have on the legislative initiatives that are currently in place. The Labour Party has indicated that, if elected, it would largely continue with the existing government’s policy approach to financial services; in a document published in January 2024 on its plan for financial services, it promised to embrace new technology, though it did not mention cryptoassets specifically. An incoming Labour government may decide to make changes to the timing and substance of the cryptoassets regime that is in the process of being rolled out; for example, it could choose to introduce more consumer protections or bring in more defences against financial crime.

The Bank of England (the ***Bank***) has separately been considering the regulation of systemic payment systems using stablecoins, publishing a discussion paper in November 2023 which focused on the regulation of sterling-denominated stablecoins. In line with its “same risk, same regulatory outcome” approach, the Bank proposes to rely on its existing framework to regulate systemic payment systems using stablecoins to the extent that the risks are similar to those of other systemic payment systems. At the same time, however, the Bank recognises that regulations will need to account for the innovative features of these payment systems, such as the use of external and distributed ledgers. The Bank also recently made clear that, for systemic payment systems, stablecoins must be 100% backed by central bank deposits. In addition, no interest can be received on these deposits and paid to coinholders. Instead, such issuers must generate revenue from the fees they charge customers to use their payment rails, as is currently the case for interbank payment systems.

United States

In the US, while there has been an uptick of enforcement actions and some criminal cases in the crypto space, the regulatory framework is not in the same place as the UK and EU. Regulators are trying to figure out how they can use existing tools to try and bring effective order to a market that has outstripped the pace of regulatory development. There appears to be limited initiative in establishing a set of comprehensive federal rules that could either complement existing legal frameworks or supersede them. Despite years of efforts to pass various crypto-specific legislation through Congress, progress has been consistently hindered and, particularly with the upcoming presidential election, it is unlikely that there will be any advancements in the near future.

In the absence of a federal framework, regulatory oversight is left to the discretion of individual regulators and states, resulting in an ad hoc and somewhat patchwork approach. New York has what is probably the most comprehensive set of rules, the BitLicense, and in 2023, the New York Attorney General introduced proposed legislation that would implement a comprehensive new regulatory regime for cryptoassets in the state, including registration requirements for market participants and restrictions on financial promotions by influencers. California has also implemented a specific regime quite similar to New York's BitLicense model. In addition, Wyoming has introduced a special purpose depository institution charter, which has become popular for crypto companies. The multitude of distinct regulatory regimes across the US presents a challenge for crypto businesses, as these frameworks often lack synergy and compatibility.

There were hopes in the US for a comprehensive federal framework for the regulation of fiat-backed stablecoins. However, this has not materialised, leaving the regulatory landscape fragmented, with fiat-backed stablecoins being offered under various licences.

Hong Kong

The Hong Kong regulatory framework has taken shape with the Securities and Futures Commission (***SFC***) applying the same risk, same regulation approach to digital assets. The SFC was an early mover, with an opt-in regime for the regulation of cryptoasset platforms being made available in 2019, although only two platforms managed to obtain approval under that structure. Since 1 June 2023, the SFC's formal regulatory framework for cryptoasset platforms commenced, with the grandfathering period for existing platforms to apply for a licence expiring on 31 May 2024. Clear guidance was also provided to the market, to the effect that only those currently approved or in the course of being approved for a licence would be able to provide cryptoasset platform services in Hong Kong. There are plans to establish a licensing and registration regime for fiat-backed stablecoins, with a consultation paper being released in December of last year, and also for over-the-counter cryptoasset trading, as set out in a consultation paper released this February.

Singapore

Singapore's regulatory framework for cryptoassets recently underwent some changes. Providers of services for cryptoassets, or digital payment tokens (***DPTs***), are regulated under the Payment Services Act 2019. Under this legislation, a licence is required in order to provide certain payment services, which includes dealing in and facilitating the exchange of DPTs. DPT service providers must also have various AML/CFT procedures in place and are subject to certain promotion restrictions.

In April this year, the Monetary Authority of Singapore (***MAS***) introduced amendments to the existing framework, bringing additional activities within scope of the regulatory framework, including custodial services for DPTs and

the facilitation of cross-border money transfers. The amendments also empower the MAS to impose user protection and financial stability-related requirements on DPT service providers. In addition, there are new requirements for DPT service providers to deposit customers' assets, including DPTs, into a custody account held on trust for the customers. Importantly, although assets belonging to a customer can be commingled with those of other customers, they must be segregated from the DPT service provider's own assets.

Cryptoasset exchange-traded products

Meanwhile, regulators in several jurisdictions have this year given the green light to exchange-traded products with exposures to cryptoassets. In January 2024, following a federal court ruling, the Securities and Exchange Commission (***SEC***) approved a number of Bitcoin exchange-traded funds (***ETFs***), having turned down more than 20 similar requests over the previous five years. In a statement, the SEC chair, Gary Gensler, explained that the decision was limited to ETFs holding one non-security commodity, Bitcoin, and in no way signalled the SEC's decision to approve listing standards for cryptoasset securities, nor did the SEC approve or endorse Bitcoin.

Following the SEC's announcement, which led to a dramatic increase in the price of Bitcoin, the FCA announced in March 2024 that it would not object to requests from recognised investment exchanges (***RIEs***) to create a UK listed market segment for cryptoasset-backed exchange traded notes (***ETNs***). The FCA will consider applications on a case-by-case basis. Unlike in the US, however, these products will not be available to retail investors. A ban on the sale of cryptoasset-backed ETNs (and crypto derivatives) to retail consumers, which was first introduced in 2020, remains in place.

More recently, in Hong Kong the SFC approved several ETFs with spot-Bitcoin and spot-Ether exposure.

In Europe, Bitcoin is currently available as an ETN, but the diversification rules of the UCITS regime do not allow ETFs with Bitcoin as the sole constituent. In May 2024, ESMA launched a call for evidence in which it is seeking views on expanding the range of eligible assets under UCITS to include cryptoassets, among other things, as either direct or indirect exposures. The deadline for responses is 7 August 2024.

Despite these developments, the European Central Bank (***ECB***) remains unconvinced about the promises of Bitcoin. In a February 2024 blog post entitled "ETF approval for bitcoin – the naked emperor's new clothes," the ECB's Director General for Market Infrastructure & Payments, Ulrich Bindseil, questioned how an ETF backed solely by Bitcoin meets the "financial logic" of diversification. He declared that the SEC's decision to approve Bitcoin "doesn't change the fact that Bitcoin is not suitable as means of payment or as an investment." In his view, the fair value of Bitcoin was "still zero," and he also warned of environmental impact of Bitcoin mining.

Conclusion

The diversity of regulatory approaches outlined above presents opportunities as well as challenges for the cryptoassets industry. The global trend is towards more regulation, whether through a bespoke regime such as in the EU or by regulating through existing frameworks such as in the US. What shape that regulation ultimately takes, and what impact that will have on the cryptoassets industry, remains uncertain in many jurisdictions, especially with elections looming not only in the UK but also in the US and elsewhere. Participants in the cryptoassets industry need to monitor developments across borders, adapt where necessary, and be aware of risks as regulators seek to prevent another FTX from failing, and prosecutors seek justice where it does.

For insights on other financial services topics, you can review our earlier editions here.

If you would like to provide feedback on this or other editions, please contact Chris Bernard.

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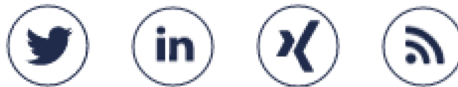

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