

FSR OUTLOOK 2022: GLOBAL UPDATE - REGULATING CRYPTOCURRENCY MARKETS

07 December 2021

Legal Briefings - By **Alex Cravero, Clive Cunningham, Natalie Curtis, Vincent Danton, Charlotte Henry, Steven Jacobs, Dana Kim, John O'Donnell, Steven Pettigrove, Jenny Seong**

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After a breakthrough year, will we see regulatory arbitrage in the cryptocurrency markets in 2022?

In a nutshell:

- **2021 saw a continued cryptocurrency bull run, the growth of decentralised finance (DeFi), and the rise of cryptocurrency derivatives and stablecoins**
- **Lawmakers and regulators around the globe are scrutinising systemic and consumer risks in cryptocurrency markets and grappling with a wide range of issues including market conduct and AML/CTF concerns**
- **While most jurisdictions have taken a cautious approach, some early movers have implemented or proposed bespoke legislative regimes to regulate cryptocurrency markets. Further such developments are expected in 2022**

2021 was a turbulent year in cryptocurrency markets as prices soared, declined and soared again. Regulators scrambled to assess systemic and consumer risks and calibrate an appropriate response, often with no 'fit-for purpose' regulation. On 20 October, the Bitcoin price hit a new all-time high of above US\$66,000 on the back of continued institutional interest in cryptocurrencies and news that the **US** Securities and Exchange Commission (SEC) had approved the first exchange traded fund (ETF) referencing Bitcoin. Another new high of above US\$67,000 was reached on 8 November.

Interest also burgeoned in decentralised finance or DeFi in 2021. DeFi comprises a range of software applications to date mostly built on the Ethereum blockchain which facilitate spot and derivatives trading, lending, insurance and other services, ostensibly without any central intermediary. The total value locked in DeFi applications has risen from US\$10 billion to US\$110 billion since July 2020.

Meanwhile, lawmakers and regulators have been grappling with whether, and how best, to regulate cryptocurrency exchanges, which cryptocurrencies should be treated as regulated securities, market manipulation, scams, the rise of cryptocurrency derivatives and stablecoins; as well as continuing concerns around cryptocurrencies facilitating money laundering and terrorist financing.

Most jurisdictions have so far taken a cautious approach, regulating cryptocurrencies to the extent that they fall within existing laws or extending anti-money laundering and counter-terrorist financing (AML and CTF) regulations to cover cryptocurrency exchanges and crypto-custodians. For example, in the **EU** and the **UK** the revised money laundering standards originating from the 5th Money Laundering Directive now require cryptocurrency exchanges and crypto-custodians to register and be supervised for AML compliance. The **UK** FCA considered a large number of crypto firms' registration applications to be deficient, which led to application withdrawals. In some business models, this might be the only regulatory regime which bites at the moment.

A small number of jurisdictions have established or proposed bespoke regimes to regulate cryptocurrency markets. This regulatory flux has encouraged major exchanges, including Coinbase and FTX, to put forward their own proposals for regulation of cryptocurrency markets.

2022 will bring further regulatory developments in a number of jurisdictions. The regulation of DeFi and AML/CTF concerns will be continuing areas of focus. DeFi and decentralised trading protocols pose a challenge for traditional regulatory approaches centred on regulation of financial intermediaries. DeFi projects commonly involve development of software which automates transactions. Thereafter, the developers purport to step away, allowing the trading protocol to operate without a manager or central authority. The SEC Chair, Gary Gensler, considers that DeFi projects are not immune from regulation: he questions whether they are truly decentralised where a core group of individuals write the software and retain an interest in ongoing governance and fees generated. These projects also raise difficulties with respect to the application and implementation of AML/CTF measures such as the intergovernmental Financial Action Task Force's (FATF) 'travel rule' - this requires virtual asset service providers (VASPs) to obtain, hold and transmit required originator and beneficiary information when conducting virtual asset transfers.

ASIA

In Asia, **Japan** and **Singapore** were early movers in regulating cryptocurrencies. **Japan** requires exchanges and custodians of digital assets to register and restricts the tokens which can be traded on these platforms. In 2016 the Payment Services Act was amended to incorporate new regulations relating to cryptocurrency exchange businesses. Further amendments were made in 2020 to regulate, for the first time, crypto-asset related derivatives businesses to bolster protections for investors. Crypto-asset operators are also regulated by the Financial Instruments and Exchange Act and must be registered to engage in derivatives businesses.

The **Singapore** Payment Services Act 2019 (the PSA) which came into force in 2020, regulates both traditional payments businesses and digital payment token services. Amendments introduced in January 2021, but yet to come into force, will extend the licence requirements under the PSA to the provision of transfer (remittance) services and custodial services in relation to digital payment tokens. The first licences under the PSA to digital payment token services were granted in October 2021.

Other Asian jurisdictions have adopted a more cautious approach or sought to ban cryptocurrency trading entirely. In **Korea**, the Financial Services Commission formed in September 2021, an independent bureau to supervise virtual asset transactions. Further, enhanced anti-money laundering measures which came into force on 24 September resulted in the closure of a number of Korean exchanges. A partial amendment to the Income Tax Act will tax gains on cryptocurrency trading starting in 2023.

On 24 September 2021, ten government bodies, including the People's Bank of China, jointly published a notice reiterating a ban on the use of cryptocurrencies in **Mainland China** and deeming cryptocurrency business activities illegal. The notice explicitly extends to overseas platforms servicing Chinese customers. Meanwhile, the Hong Kong government has announced plans to license VASPs and limit the sale of cryptocurrencies to professional investors. Draft legislation is expected to be introduced in the next Legislative Council session.

UNITED STATES

In the **United States**, an infrastructure bill signed into law in November includes onerous transaction reporting requirements for brokers facilitating digital asset transfers and other businesses which receive cryptocurrencies. Importantly, the legislation defines “broker” quite broadly, leading cryptocurrency advocates to be concerned that it will impose reporting requirements on individuals and entities (such as miners and hardware developers) that are not actually brokers, who will be unable to comply with the law. The legislation also expands a section of the US tax code by requiring businesses and exchanges to file a report with the Internal Revenue Service stating the name and social security number of any individual who pays or sends them more than US\$10,000 in cryptocurrency.

In 2021, the SEC and CFTC have also been active in targeting unlicensed or fraudulent activity relating to cryptocurrencies. SEC v. Ripple Labs Inc, No. 20-cv-10832 (S.D.N.Y. 2020) - a pending case that could create significant precedent regarding whether certain tokens constitute securities (and must be regulated as such) - is expected to continue into 2022. The SEC Chair has described cryptocurrency markets as the “Wild West” and we expect further action by US regulators in 2022. Nevertheless, cryptocurrencies continue to soar in popularity in the US, and the first SEC approved bitcoin futures-based ETFs began trading in October 2021.

EUROPE

In September 2020, the **European Commission** published a wide ranging proposal covering the regulation of utility and payment tokens and stablecoins (the Markets in Cryptoassets Regulation or MiCA). The regulation would impose new obligations on token issuers and subject some stablecoins to approval by regulators. The regulation would impose many of the compliance obligations which apply to regulated financial institutions on cryptocurrency exchanges. It also includes prohibitions on insider dealing and market abuse. MiCA continues to work its way through the European legislative process.

Within the EU, the French government introduced a comprehensive *ad hoc* regime for digital assets in France through law No. 2016-486 which entered into force on 24 May 2019 (the *Loi Pacte*). Under this regime, certain market players dealing with digital assets must register with the French Financial Markets Authority and comply with certain obligations (including in terms of AML/CFT). To some extent, the current French regime shares concepts and concerns found in MiCA and took inspiration from MiFID (although crypto-assets are clearly distinct from securities and financial services under French law). The French regime will be amended when MiCA is adopted.

Spain's recently enacted Law 11/2021 of 9 July on measures to prevent and combat tax fraud establishes a series of obligations for those who hold cryptocurrencies or other cryptoassets. These aim to make cryptocurrency transactions more transparent and include requiring: (i) individuals to inform the tax authorities of the virtual currencies they hold when they have their cryptocurrencies stored in international exchanges and (ii) companies that manage cryptocurrencies to report the amounts of cryptocurrencies managed as well as the identity of the holders of each amount. This new law also confirms cryptocurrencies as "virtual coin".

Spain has also transposed the EU's 5th Money Laundering Directive into Spanish law by Royal Decree Law 7/2021 of 27 April 2021. The Law creates a registry of Cryptocurrency Service Providers, supervised by the Bank of Spain, and regulates, for the first time in Spain, entities that provide exchange services between virtual currencies and wallet custodian service providers when the services are provided to residents in Spain, natural persons where the base, address or management of activities is in Spain, or to legal persons established in Spain providing those services. The Law imposes a broad set of obligations, subject to supervision and sanctions, including most notably: (i) the identification of transactions susceptible to money laundering, and (ii) the establishment of internal complaint channels and reporting procedures to SEPBLAC (Spanish Supervisory Authority in Money Laundering Prevention). Meanwhile, the **UK** conducted a public consultation on regulatory approaches to cryptoassets and stablecoins in 2021, the outcome of which is expected in the coming months. HM Treasury has said that it will look to ensure consistency, in the spirit of “same risk, same regulatory outcome” between regulation applied to stablecoins and comparable payments activities.

AUSTRALIA

To date, **Australia** has applied prevailing financial services and securities laws to token offerings and required cryptocurrency exchanges to register with AUSTRAC and comply with AML and CTF regulations. In October, following public consultation, a Senate Committee made a number of recommendations for regulating cryptocurrencies, including:

- i. a licensing regime for digital currency exchanges;
- ii. a custody or depository regime for digital assets;
- iii. a token mapping exercise to determine the best way to characterise different types of digital assets;
- iv. clarification of AML and CTF regulations to ensure they are fit for purpose and do not undermine innovation, and give due consideration to the purpose of FATF's 'travel rule';
- v. changes to the capital gains tax (CGT) regime such that a CGT event will only arise where there is a clearly definable capital gain or loss.

On 30 October 2021, the Australian Securities and Investments Commission (ASIC) issued updated guidance on crypto-assets and related investment products, such as ETFs. The guidance details ASIC's views on a range of regulatory issues including when a crypto-asset or token may constitute a regulated financial product and the circumstances in which a crypto-asset trading platform may be a financial market. The guidance on crypto-related investment products preceded the debut of Australia's first crypto-asset related ETFs on the Australian Securities Exchange (ASX), which set volume records in early trading demonstrating significant investor demand.

We expect more lawmakers and regulators to propose separate and bespoke regimes to regulate cryptocurrency markets in 2022. Many in the industry will welcome enhanced regulation to weed out bad actors, address market manipulation and encourage new investors into the market. Governments and regulatory authorities face a difficult challenge to protect investors without stifling innovation and competition. They will need to consider whether to apply existing regulatory models or establish new ones. This has the potential to create regulatory arbitrage between traditional finance and cryptocurrency markets and between cryptocurrency markets in different jurisdictions. These matters are likely to be subject to substantial debate in many jurisdictions as the legislative process moves forward.

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