Regulatory Aspects of Trading Digital Assets

Deliberations at the Digital Asset Legal & Regulatory Asia update Lunch, London, February 2023

Regulatory Aspects of Trading Digital Assets

Few parts of the world have embraced virtual assets like Asia. Indeed, the region has some of the highest adoption and growth rates for cryptocurrency, which has left regional regulators scrambling to create new rules and guidance to help propel growth and drive innovation, while protecting consumers and their respective financial systems.

Virtual asset products, otherwise known as cryptocurrency products, are investment products that enable investors to invest in virtual assets that are underpinned by Distributed Ledger Technology.[1] As such, these products are authenticated and recorded in public ledgers without the need for central authorities or government interference.

In the light of the high-profile collapse of FTX – a cryptocurrency exchange and cryptocurrency hedge fund – in 2022, financial regulators in Asia have been pro-active in establishing rules to protect retail investors in virtual assets. Many of those involved in the virtual asset space see distributed ledger technology as the solution to key traditional market risks, such as inefficiencies in settlement/clearing, liquidity issues and inconsistencies of cross-border payments (particularly where multiple currencies are involved). The decentralised nature of the blockchain[2] – a form of distributed ledger technology – limits these risks by ensuring that every transaction is publicly viewable and accountable, and inherent programming protocols ensure lower value of collateral is needed to reduce credit risk. Detractors, however, highlight recent cryptocurrency controversies as a compelling reason to retain regulatory oversight to ensure investors in virtual assets are protected from malpractice and market-failures. These different perspectives characterise the wider debate within the industry, wherein some see regulation as a threat to innovation, while others see it as an opportunity to regain and maintain the confidence of investors – retail and institutional, alike.

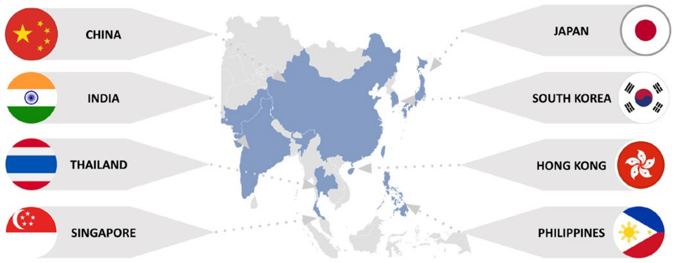
This article examines the current cryptocurrency landscape in Asia, based on some of the discussion points raised at the Digital Asset Legal & Regulatory Lunch that brought together key players within the virtual asset space. The article also draws in insights presented by ComplianceAsia at the event.

Protecting Versus Stifling Investments

The markets in Asia shown in **Figure 1** are all highly active in the trading of virtual assets and this article will be limited to the discussion of markets in these countries.

Figure 1: Asian Countries with Highly Active Virtual Asset Markets

Source: GreySpark analysis



Across the Asia-Pacific region, there appears to be a consensus by regulators that the trading of virtual assets must be regulated to ensure adequate protections for retail investors, in particular.

The approach taken by Japan Financial Services Agency (JFSA) has become significantly more cautious following the collapse of Mt. Gox[3], introducing strict regulations around the custodial holding of digital assets, which includes the separation of business and consumer wallets, but also requires 95% of assets in cold storage. The Monetary Authority of Singapore (MAS) passed the Payment Services Act in 2019 that tightened rules for payment institutions (known as 'Payment Service Providers') and made specific amendments to the Securities and Futures Act for dealers in virtual assets. Hong Kong's Securities and Futures Commission (SFC) has issued requirements for virtual asset service providers (VASPs) and cryptocurrency firms.

[1] Distributed ledger technology (DLT) is a form of technological infrastructure and protocols that allow simultaneous access, validation and record keeping / updating. They are essentially a database that does not need a third party to ensure recorded entries are valid and honest.
[2] Blockchains are created using distributed ledger technology and are a system in which a record of transactions is maintained across computers that are linked in a peer-to-peer network.
[3] Mt. Gox was a bitcoin exchange based in Tokyo, Japan. At its peak, it was handling 70% of global bitcoin (BTC) transactions worldwide. In 2014, it went bankrupt and ceased operations amid its involving in the loss / theft of hundreds of millions worth of bitcoin in USD.

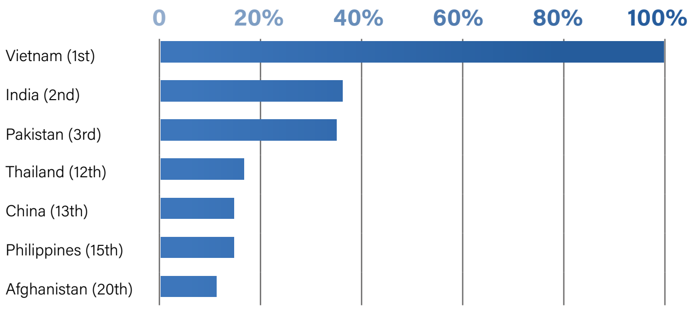
The well-established markets in Singapore and Hong Kong have shown an appetite to regulate cryptocurrency in an effective way. The SFC and the MAS have been active in tightening regulation in the digital asset space around anti money laundering (AML) and counter terrorism financing. Since 2019, MAS introduced strict guidelines in the Payment Services Act and in 2021, the Regulatory Notice PSNO2, both of which illustrate how payment service providers (PSP's) are now subject to MAS' regulatory control. In December 2022, the SFC implemented a new licensing regime for cryptocurrency exchanges that will subject providers to the same AML legislation that traditional financial institutions follow. Once implemented, cryptocurrency exchanges based in Hong Kong will have to demonstrate the ability to perform due diligence on their customers.

MAS and the SFC also placed regulatory limitations on VASPs in an attempt to reduce the risk of investor harm. For instance, in 2022, MAS banned advertisements for cryptocurrency retail investment, while foreign-based cryptocurrency exchanges are not allowed to actively market their services in Hong Kong unless they are licensed by the SFC. Furthermore, MAS has been considering barring retail investors from trading cryptocurrencies and, in 2023, is signalling imminent restrictions on payment using cryptocurrencies, citing their lack of intrinsic value and their price volatilities. Additionally, the primary bank regulator in Hong Kong - the Hong Kong Monetary Authority (HKMA) - appears to view stablecoins as acceptable for retail investors but nevertheless is looking to restrict retail investors' access to cryptocurrencies.

Regulators in established financial centres such as Hong Kong and Singapore, certainly view virtual assets as more speculative than other investment types and that retail investors require more protection when investing in virtual assets. However, this perspective is not shared across the region. In some Asian markets with the highest cryptocurrency penetration, (see **Figure 2**), cryptocurrency is becoming the preferred tool for cash remittance transfers. In less developed countries, which lack state-owned fast payment systems, the adoption of cryptocurrencies as a cheap, efficient method to send remittances to large, unbanked populations – particularly as smartphone adoption and internet access is almost universal.[4] Unlike the major financial markets, regulation in the developing and frontier financial markets of Asia often focuses on the point of conversion to fiat money. In Pakistan – where there is high cryptocurrency use – regulation does not allow the use of cryptocurrency for the purpose of transferring value outside of the country, while India, which currently has no specific rules on virtual assets, is rumoured to be examining the implementation of higher taxes on cryptocurrency payments and transfers.

Figure 2: Asian Countries with the Highest Levels of Cryptocurrency Penetration

Source: Chainanalysis



*The index is prepared with the metrics of On-chain cryptocurrency value received, Retail value tranferred, and Peer-to-peer (P2P) exchange trade volume, weighted by purchasing power parity.

[4] World Economic Forum. 20202. *Why Decentralised Finance is a Leapfrog Technology for the 1.1 Billion People Who Are Unbanked.* [online] Sustainable Development Impact Meetings. Available at: <https://www.weforum.org/agenda/2022/09/decentralized-finance-a-leapfrog-technology-for-the-unbanked/>.

Singapore and Hong Kong: Locating a Virtual Asset Firm Headquarters

The 'title' of top Asian financial centre has always been fought over by Hong Kong and Singapore. Both Singapore and Hong Kong are key centres of financial activity regionally as well as globally, and is the case for virtual assets as well as fiat currencies. According to a recent report, Singapore's virtual assets market is estimated to be 25% greater than Hong Kong.[5] There is a perception in Singapore that the issuance of PSP licences has been easier for domestic firms, particularly the established banks compared to non-banking, non-Singapore market entrants. This is at odds with the country's stated ambition to establish itself as a fintech hub.

According to the Worldwide Crypto Readiness Report, published in 2022, Hong Kong is the most 'crypto-ready' location.[6] Julia Leung (CEO, SFC) Hong Kong is recognised as being open and pro-digital assets. The SFC is creating a regulatory framework that allows retail investors to trade exchange-traded funds (ETFs) with exposure to cryptocurrency futures. Indeed, in December 2022, the city's first cryptocurrency futures ETFs were launched, allowing Hong Kong investors to access to cryptocurrency traded on the Chicago Mercantile Exchange.[7]

In recent years, Hong Kong's relationship with mainland China has created uncertainty for new entrants, particularly with western financial institutions investors. Some foreign firms are wary of conducting business in Hong Kong in light of the 2020 National Security Law and the perceived expanding influence of the Peoples Republic of China on Hong Kong's domestic affairs. However, experience on the ground in Hong Kong within the financial sector is that business continues as usual and the HKMA, the SFC and the Hong Kong Exchanges operate efficiently and independently and will continue to do so.[8]

China's ban on cryptocurrency mining in 2021 has meant that many new cryptocurrency firms have had to take decisions on whether to have entities in Hong Kong – and, if they do, what is their role and what they do there. The banning of cryptocurrency mining and exchanges in China removes competition for the proposed roll-out of the Digital Currency Electronic Payment (Digital Yuan) – a fully convertible cryptocurrency, based on China's legal fiat currency, the renminbi (RMB).

Hong Kong's aspiration to become a global centre for digital assets is being tested, as it is struggling to attract and retain the necessary global talent although the Hong Kong government has recently launched a scheme to attract talent and has considerably simplified the process for obtaining work visas . The question of whether Hong Kong, in the light of the National Security Law and the extended response to the COVID-19 pandemic, will be able to rebuild its reputation and trust globally is still open.

Cross-market Enforcement: A Patchwork of Regulation

Each Asian market has its own distinct approach to and regulations for virtual assets. VASPs operating across the region need to be compliant, therefore, with a patchwork of legislation and regulation.

In some Asian markets including those of Hong Kong, Singapore, Japan and Korea, regulators have tended to focus on managing the risk of harm to retail investors. There are similarities in these markets' approaches to licensing restrictions, enhanced due-diligence and storage / custodianship requirements. Each market, however, retains its own nuanced regulation. South Korea and Hong Kong view most virtual assets as securities and, thus, they fall within the scope of existing regulation. Singapore and Japan clarified the legal status of virtual assets in new legislation. The commonality between all these key jurisdictions is that they all require virtual asset providers to apply to their respective regulatory authority for licenses.

[5] Financial Times, 2022. *Hong Kong Takes on Singapore for Asia's Crypto Crown.* [online] Available at: <https://www.ft.com/content/e90add6d-326e-4898-b8c1-78f98f2d6929>.
[6] ForexSuggest, 2022. *Worldwide Crypto Readiness Report.* [online] Available at: <https://forexsuggest.com/worldwide-crypto-readiness-report/>.
[7] CSOP Asset Management, 2023. *CSOP Bitcoin Futures ETF* [online] Available at: <https://www.csopasset.com/en/products/hk-btcfut>.
[8] ComplianceAsia, 2023. *Name of Event.* London, United Kingdom, 11 February.

There are limitations to regulators' enforcement capabilities when a VASP operates across the Asia region. For instance, if a firm is licensed in Jurisdiction A, but trading is carried out elsewhere and the investors are not located in Jurisdiction A, the regulator of Jurisdiction A has a limited ability to take enforcement action against that firm and may be limited to findings of fitness and properness. Additionally, although Memoranda of Understanding are in place amongst all the Asian regulators, there is no passporting in the European Union sense and that makes cross-market enforcement more difficult and time-consuming. This does not mean that regulators in each jurisdiction, however, will not push to take action and enforce penalties where they feel appropriate.

There is an argument that excessive regulation by any one nation state will push financial activities to offshore jurisdictions with fewer regulation of virtual currencies and less investor protection. This concern is epitomised by the FTX scandal, which saw the firm relocate to the Bahamas from Hong Kong in response to regulatory tightening and the tough COVID-19 restrictions before the firm collapsed. Hong Kong's SFC has aimed to combat the flight of firms to offshore locations by prohibiting VASPs that are located outside of its jurisdiction from engaging with retail investors under its jurisdiction.[9] In step with Hong Kong, Singapore has put measures in place to prevent foreign VASPS from soliciting Singapore users. Indeed, in 2021 MAS prevented Binance, a global leading cryptocurrency exchange, from listing its mobile app in local app stores and by geo-blocking local IP-addresses.[10]

A Positive Outlook for Virtual Assets

There will always be a difficulty regulating an asset which is explicitly designed to not be bound by centralised systems and authorities. With legislation across jurisdictions tightening, firms must optimise their operations to both ensure compliance and drive long-term growth. Overall, Asia's key financial hubs are undertaking a balancing act between encouraging growth and minimising risk to retail investors. While some governments are likely to rein in the adoption of virtual assets, opting instead for a central bank digital currency or stable coin; others, mainly the more established players, look to formalise the virtual asset sector in order to drive growth.

[9] Securities and Futures Commission of Hong Kong (SFC), 2019. *Regulation of Virtual Asset Trading Platforms.* [online] Available at: <https://www.sfc.hk/web/files/ER/PDF/20191106%20Position%20Paper%20and%20Appendix%201%20to%20Position%20Paper%20(Eng).pdf>.
[10] Monetary Authority of Singapore (MAS), 2022. *MAS Statement to Address Misconceptions in the Wake of Collapse of FTX.* [online] MAS Media Releases. Available at: <https://www.mas.gov.sg/news/media-releases/2022/mas-statement-to-address-misconceptions-in-the-wake-of-collapse-of-ftx>.