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The development of cryptofinance regulation – National focus

The Digital Regulator

Redefining Finance for the New Economy

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Executive summary

Regulation met cryptofinance five years ago, when regulators in many countries warned investors about the risks posed by a new form of financing – the ICOs – and issued supporting guidance. Since then, an increasing number of countries have developed relatively sophisticated and stable frameworks – on balance favouring the development of cryptofinance while focusing on investors protection and prevention of money laundering.

Early adopters of a regulation supporting cryptofinance in different ways include Switzerland, Liechtenstein, Singapore, UK, Japan, Hong Kong, Germany, and France. Early banners of all or parts of cryptofinance comprise China, India, South Korea, Laos, Burundi, Venezuela, Israel, and Qatar. Over time, the countries banning cryptofinance in different degrees have lost importance in relative terms.

More recent adopters cover important regions and capital markets such as the USA and the EU, while late movers encompass a growing number of African, Central and South American jurisdictions.

Key drivers for this development are the compelling cryptofinance business propositions, a demand for alternative investments and business cases, and, not least, the fundamental support to innovation in finance provided by international regulators and regulatory policy bodies, as well as their own endorsement of the distributed ledgers as a possible technological solution for Central Bank Digital Currencies.

The integration of DLT in finance and the trust of regulators and market participants is increasing over time and the direction seems irreversible. Yet, tensions persist in areas, such as DeFi, where extending the regulatory principles of traditional finance is not straightforward or even possible. An open and constructive dialogue between regulators and the industry is key to harvest the benefits of Distributed Ledgers Technologies.

The last five years have witnessed a rapid development of cryptofinance regulation. Initially, it reacted to, and framed, innovative practices. Then, it has broadly supported the development of cryptofinance, opening it up to traditional investors. An open and constructive dialogue between regulators and the industry is key to harvest the benefits of Distributed Ledgers Technologies.

The evolution of national cryptofinance regulation

Tracking the development of cryptofinance regulation across the countries is not an easy task. Each attempt seems to rely on specific, proprietary, definitions and scopes. Hence, comparisons and aggregations are difficult.

- The Law Library of (the US) Congress updated the report Regulation of Cryptocurrency Around the World in November 2021. The report focuses on the legal status of cryptocurrencies, and applicable tax and AML/CFT laws. It records 103 jurisdictions (including EU member states) that have provided a legal status to cryptocurrencies and largely applied such laws
- Thompson Reuters 2022's Cryptocurrency regulation by country covers 70 jurisdictions, taking a broader scope than the US Congress Law Library report
- Complyadvantage looks at the most active countries – a couple of dozens of jurisdictions – focusing on cryptocurrencies and crypto exchanges
- The Atlantic Council tracks CBDCs initiatives in 105 countries
- METI Advisory AG has been tracing developments in cryptofinance regulation for 5 years, with a scope encompassing most of the dimension mentioned above, and currently covers 120 jurisdictions

Considering these sources, it emerges that until five years ago, the regulation of DLT-based finance was reactive and minimal. Few regulators reacted to entrepreneurial developments in their jurisdictions and focused on basic conduct violations and tax issues. They tackled fundamental definitional issues, legal in nature, raised by these innovations. The involvement of financial regulators in cryptofinance has become more intense and increasingly pro-active/anticipatory from mid-2017 onwards as a direct consequence of the developments in the ICO space. Some nations have developed early on supportive frameworks or banned cryptofinance in different ways. Several other countries representing important capital markets took more time to develop supportive frameworks. More recently, we have witnessed the adoption of cryptofinance regulations in Africa and Central & South America.

The early adopters

Regulatory pronouncements mushroomed from mid-2017 onwards and were initially concerned with informing consumers and retail investors about the speculative and risky nature of ICO and more broadly cryptocurrency investments. On balance, the desire to promote ICOs in a risk-controlled environment prevailed. Several jurisdictions went further and issued guidance providing the market with regulatory certainty around the ICO process and/or embarked on developing stepwise a broader regulatory framework for cryptofinance. These jurisdictions include:

- Switzerland (ICO guidance's in 2017, 2018 and further work culminating in the entry into force in 2021 of a comprehensive DLT Framework)
- Liechtenstein (ICO Factsheet in 2017 and further work leading to the entry into force of a comprehensive blockchain Act in 2020)
- Malta (passing a bill in 2018, introducing a comprehensive regulatory framework for crypto assets)
- France (which ruled crypto assets in the context of the PACTE Law in 2019)
- Germany (with legislation on crypto assets enacted in 2020)
- Gibraltar (which implemented a DLT framework in 2018)
- Singapore (which regulated DLT-based finance in 2017 and step-wise since then)
- UK (which issued a crypto assets regulatory guidance in 2019, followed by continuous ongoing adaptations)
- Hong Kong (which issued several cryptofinance legislations from 2019 on)
- Japan (which enacted incremental cryptofinance legislation from 2017 onward)
- Australia (which defined a national blockchain roadmap in 2019 and has implemented it step-wise, with adaptations, since then)

The late adopters

By contrast to the early adopters mentioned above, the large capital markets of the USA and the EU were late adopters.

The **USA** have long suffered from their intricated federal and state-based regulatory system and by a directionally unsettled economic policy stance. The issuance of the White House Executive Order on Ensuring Responsible Development of Digital Assets on 9 March 2022 was a watershed event, as it marked an official endorsement of cryptofinance by the US and set out its intention to become a global leader in the field.

From a policy point of view, the executive order takes a supportive and sustainable approach, recognising the need to align the governmental approach to digital assets, the national interest in responsible innovation – one capable of expanding access to safe and affordable financial services and to reduce the cost of domestic and international fund transfers and payments – and the need to protect consumers and investors, as well as combating illicit finance and mitigating systemic risk.

The Order makes clear the objective to reinforce the leadership of the US in the global financial system, while preserving the economic and national security benefits derived from the central role played by the USD and US financial institutions globally.

The **EU** did not legislate DLT-based finance at the single market level until September 2020, leaving member countries to take the initiative, and limited its policy action to recommendations supportive of DLT, while addressing AML aspects of cryptofinance through the EU-wide AML directive.

In September 2020, the EU issued a Digital Finance Package (DFP) that includes a proposal for an EU regulatory framework on crypto assets aimed at seizing related opportunities in a risk-controlled environment. The DFP also includes a proposal for a pilot regime for market infrastructures based on the DLT. The proposal complements existing EU-wide regulations that already apply to crypto assets, such as AML/Combating the Financing of Terrorism (CFT) provisions and the Markets in Financial Instruments Directive (MiFID), and it is based on the principle of 'same activity, same risk, same rule'.

The implementation deadline for member states is set for 2024, but is may be brought forward because of work carried out following the adoption of economic sanctions against Russia in early 2022.

The recent movers

The last 18-24 months have witnessed an exponential number of initiatives to provide a regulatory framework to cryptofinance in regions including Africa, Central and South America, and the Middle East. Some of these countries took an earlier interest in cryptofinance but have only more recently developed a regulatory framework.

The desire of the BIS to see an increasing number of countries analysing and implementing CBDCs has helped this development, as well as the broader and well-recognised private sector use cases for crypto assets and cryptofinance.

In **Africa**, Ghana, Namibia, Nigeria, Rwanda, South Africa, Zambia, Cameroon, and the members of the East Africa Community (Burundi, Kenya, South Sudan, Tanzania and Uganda) took recently an active interest in CBDCs.

- Nigeria stands currently out as the most advanced country in the CBDC space: It rolled out the Digital Naira in October 2021, recording a higher-than-expected adoption rate
- Uganda and Botswana have focused on developing a comprehensive cryptocurrencies regulatory framework
- South Africa got involved in cryptofinance earlier on, studying and publishing crypto asset regulation since 2018

During 2020, South Africa officially declared its intention to align its crypto regulation to FATF standards, and in May 2021 commenced a feasibility study for a retail CBDC. The country is expected to introduce comprehensive crypto regulation during 2022. In April 2022, the Central African Republic made bitcoin legal tender, becoming the second country after El Salvador (see below).

In the **Central and South American region**, Brazil has been the most active and crypto supportive state in the region. It has developed its crypto regulatory framework since 2019. In 2020, the central bank began assessing how a CBDC could fit with the payment system and committed to implement a CBDC by 2024. In early 2022 the government initiated legal steps to acknowledge and regulate crypto markets in the country.

El Salvador wrote history in 2021 by passing the “bitcoin law” on 9 June, making bitcoin legal tender as of 7 September 2021.

- Panama passed a law on 29 April 2022 supporting the blockchain and cryptofinance
- Argentina ruled in May 2021 that all cryptocurrency exchanges operating within the country must file comprehensive transaction data on their customers every month, and that it may consider a national crypto regulatory framework
- Ecuador announced digital currency regulation in February 2022
- Mexico declared that cryptocurrencies are not legal tender in the country, but that it may issue a CBDC by 2023
- Paraguay introduced new crypto regulation on 29 April 2022
- Peru eyed blockchain technology in 2019 with the aim to counter political corruption
- Venezuela established a legal framework for cryptocurrencies in early 2019

In the **Middle East**, the blockchain strategy launched in 2018 by the UAE around the pillars of government efficiency, industry creation, and international leadership, and the early move by Abu Dhabi (guidance on ICO and crypto assets in October 2017) were followed by plans to introduce a regulatory framework for tokenised securities and cryptocurrencies by Dubai in 2021.

- Bahrain issued comprehensive cryptofinance regulation in 2019 and announced plan to develop a CBDC. In the early months of 2022, the central bank announced the completion of the DLT-based digital currency test, and the successful performance of a CBDC cross border transaction
- Qatar announced an initiative to study CBDCs in March 2022 it, while in April 2022
- Oman said it would include real estate tokenisation into its virtual asset regulatory framework
- Israel disclosed cryptoregulatory plans in March 2019. The securities regulator approved a DLT-based digital securities exchange on 19 February 2021, while the central bank defined CBDC plans on 13 May 2021
- Cyprus went its own way on cryptoregulation, along many other EU member states, in 2019 when it drafted a blockchain legislation able to attract many projects into the regulatory sandbox. On 21 May 2022, it announced the possibility to introduce own crypto regulation before the EU finalises an EU-wide approach.

The banners

Some jurisdictions banned cryptofinance at the outset. Examples include South Korea, Venezuela, Vietnam, India, and China. It should be noted that in most cases the ban was driven by the need to understand better the developments before taking a permissive action. As the number of nations that have issued supportive legislation around crypto-finance has grown exponentially during the last five years, the number of countries that took a restrictive stance on crypto assets has been dwindling consequently, in relative and absolute terms. South Korea lifted the ICO ban enacted in 2017, in May 2022.

China stated in September 2017 that Bitcoin shall not serve as a fiat currency and all ICOs should be regarded as illegal financing activities. The regulations have explicitly provided that no crypto assets may be used as investment assets for trusts and investment funds, and no financial institutions or payment-processors may accept Bitcoin as payment. The government has focused heavily on CBDC in the course of 2020, releasing its e-yuan and committing to making its official digital yuan to be the only yuan-pegged stablecoin in China. During the second quarter of 2021, China reiterated and reinforced the prohibition for banks and payment firms to provide services related to cryptocurrency transactions and resolved to crack down on crypto mining and improper trading behaviour as part of the effort to control financial risks. The authorities have otherwise been highly supportive of DLT, announcing plans to make Beijing a blockchain innovation hub by 2022.

India recognised the potential of DLT as early as 2013. However, the authorities emphasised the risks for consumers associated with DLT-based financial products and services and in May 2018 announced a ban for all financial firms operating in the country from dealing with or providing services to crypto asset operators. In January 2021, the Indian government introduced, for consideration and passing, the Cryptocurrency and Regulation of Official Digital Currency Bill, supporting the creation of a CBDC, however not crypto/blockchain-based. In November and December 2021, multiple parties from the official sector consistently affirmed that cryptocurrencies should be regulated instead of banned. India communicated its readiness to consult on a global framework for digital assets in June 2022.

Conclusion

Without the generally proactive involvement of financial regulators, crypto finance would not have witnessed the development it has over the last five years, both in terms of diversity of products and services, and in terms of global adoption. Fundamentally driven by a technological innovation – blockchain/distributed ledgers – the refinement of existing, and the development of new, products and services, the growth of crypto financial markets and related intermediaries and service providers, are ineluctable.

Crypto finance regulation has been a major driver for this development, despite tensions in areas – such as DeFi - where the extension of traditional financial regulatory principles is not straightforward and perhaps possible without paradigmatic changes. An open and constructive dialogue between regulators and the industry is key to harvest the benefits of Distributed Ledgers Technologies.

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