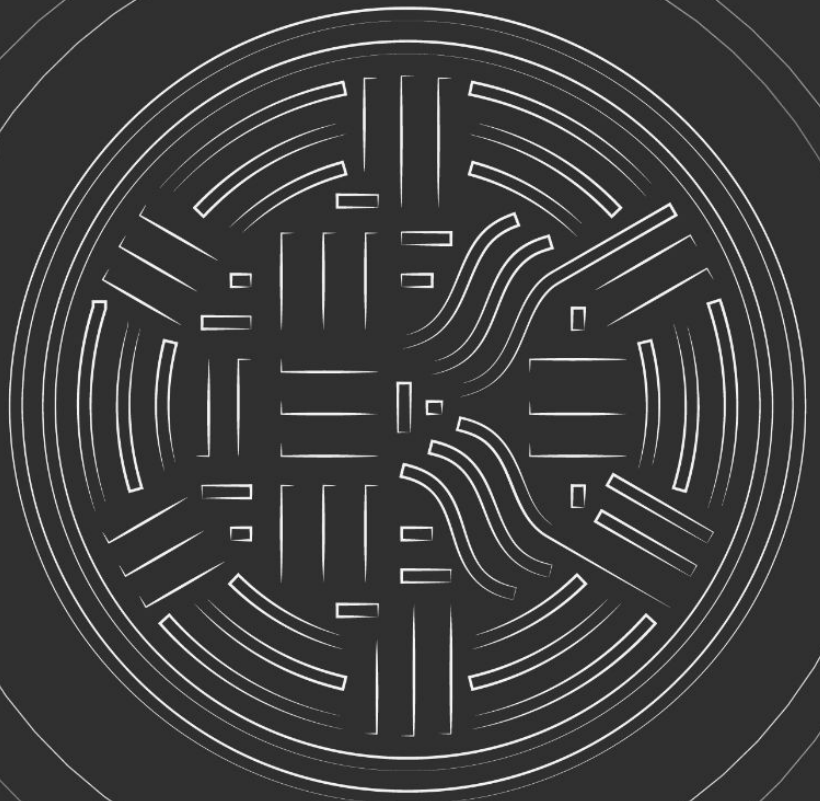


The UAE Virtual Assets Market

A report on the regulatory landscape,
with special focus on financial crime compliance



Introduction

In a statement released on 3 May 2022, Dubai's Virtual Assets Regulatory Authority (VARA) announced its MetavHQ hub in 'The Sandbox' (SAND), a diverse metaverse built on the Ethereum blockchain ¹. This makes VARA the world's first regulator to make its metaverse debut. The Dubai Government media office stated that expanding VARA's resources to a borderless audience is part of Dubai's strategy to create a prototype decentralised regulator model ².

Founded less than six months ago, on 28 February 2022, under the aegis of the Law No. (4) of 2022, "Regulating Virtual Assets in the Emirate of Dubai"³ also referred to as the Virtual Assets Law, VARA is an independent regulator, tasked with the regulation, governance, and licensing of cryptocurrencies, Non Fungible Tokens (NFTs) and other virtual assets in Dubai.

VARA seeks to facilitate collaborative engagement between global Virtual Asset Service Providers (VASPs), industry thought leaders, and international regulatory authorities.

The excitement on ground is mirrored by international interest in the UAE's developing crypto market, as evidenced by the entry of global players Binance, Kraken, Bybit, FTX and most recently, Web3 Holdings FZE, Ex-Singapore Parliamentarian, Calvin Cheng's NFT investment holding company ⁴.

Given these interesting developments, several questions arise:

- What is driving the growth in virtual assets in the UAE?
- How does the UAE market and regulatory landscape compare with the global market?
- What are the regulatory implications especially in terms of financial crime risks?
- What should be the key considerations for the UAE regulators?

This report seeks to answer these questions by setting the backdrop, clear linkages, comparative analysis, and expertise driven regulatory recommendations. The intended audiences are VASPs, banks, and regulators in the UAE.

The market related data included in this report is as of the time of writing and is intended to provide a contextual reference rather than actively promote investments in virtual assets.

The terms virtual assets, digital assets, crypto assets and crypto are used interchangeably in this report, and follow the definition from the Virtual Assets Law, "a digital representation of value that may be digitally traded, transferred, or used as an exchange or payment tool, or for investment purposes." Digital representation of fiat currencies is excluded from the sphere of virtual assets.

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The global crypto market



On 15 May 2022, the Financial Times reported that Goldman Sachs and Barclays had valued British hedge fund billionaire Alan Howard's cryptocurrency trading platform, Elwood Technologies, at US\$ 500 million and invested US\$ 70 million in it ⁵. This type of institutional investment is a clear indication of the mainstream adoption of crypto.

Twelve years ago, in May 2010, Laszlo Hanyecz paid 10,000 Bitcoins to buy two Papa John's pizzas ⁶. Worth US\$41 back then, the equivalent price paid for those pizzas today is US\$223 million, given that the price of Bitcoin, as of 23 July is US\$22,300 ⁷. Ever since, 22 May is celebrated as Bitcoin Pizza Day!

According to Statista, an independent market data aggregator, the crypto market capitalisation, calculated as the price of crypto currencies times the number of coins in the market, stands at ~US\$1 trillion, as of 23 July 2022 ⁸.

While both, the price of Bitcoin and market capitalisation of crypto are impressive figures in absolute terms, it is worth noting the price volatility of crypto. Statista also pinpointed how the the market capitalisation has dropped 67% from the 10 November '21 high of US\$3 trillion, a time when Bitcoin was trading at US\$ ~68,000 ⁹.

There are several explanations offered for this contraction.

- The Wall Street Journal, in a detailed report published on 27 May 2022, attributes this drop to the collapse of the stablecoin, TerraUSD (UST), triggering a sell-off in May from an all-time high of US\$18 billion, while UST's sister coin, Luna, lost almost all of its value at the same time, wiping out investors ¹⁰.
- As per The Washington Post, the crypto market plunge is reflective of a wider trend to dump risky tech stocks, with even heavyweights like Netflix and Meta dropping 74% and 45% in the past six months ¹¹.

- The Financial Times, also attributes crypto's fall in value is part of a larger market correction. Referring to the Celsius's June '22 block on withdrawals, the FT surmised it as, "the broad repricing of risk assets in the wake of accelerating inflation, higher interest rates and a possible recession" ¹².
- In January this year, the International Monetary Fund (IMF) released data showing a correlation between Bitcoin and the S&P 500, raising concerns that crypto is no longer the investment diversification tool it was initially presumed ¹³. Indeed, investor sentiment has been spilling between the stock market and crypto, over the last few months.

Similar to the aftermath of the dot-com bubble, it is expected that the surviving virtual assets stocks are going to emerge stronger once the market eventually consolidates and recovers. 'Cryptocrash survivors could become tomorrow's Amazons and eBays', Bloomberg quoted Bank of England Deputy Governor Jon Cunliffe, on 22 June 2022 ¹⁴.

In contrast to price volatility, the volume growth of crypto has been phenomenal. Across all cryptocurrencies tracked by Chainalysis, the blockchain-based data platform, total transaction volume grew to US\$15.8 trillion in 2021, a staggering increase of 567% from 2020 ¹⁵.

International crypto regulations

Given that crypto is still an emerging market, global regulation is also at an evolving stage. The level of oversight on crypto today varies greatly from one country to another, with some regulators like the EU, taking the lead, and others still grappling the regulatory challenges of this new financial instrument.

What is also interesting to note is that the state of development of the financial industry/ economy is not correlated to the regulatory approaches to crypto. In-between the extreme stances of China's outright ban on crypto ¹⁶, and El Salvador's adoption of Bitcoin as legal tender in September 2021 ¹⁷, are the more cautious approaches of countries like the U.S. and the UK which have announced moves to bring regulatory oversight to the industry, while encouraging market development. Japan currently has the world's most progressive regulatory climate for cryptocurrencies, recognising them as legal property, under its Payment Services Act (PSA). ¹⁸

Nigeria, with one of the highest numbers of crypto traders, has just announced new rules for crypto, which are aimed at investor protection and transparency ¹⁹.

Earlier in March this year, US President Biden signed off on the long-awaited Executive Order on Ensuring Responsible Development of Digital Assets (the "EO") ²⁰. The executive order urges government wide coordination on digital assets, to consolidate the regulatory landscape in the US. This is much needed, as the current fragmented approach to virtual assets regulations in the US not only exposes investors to risks but also makes the market uncompetitive.

On 30 June 2022, an agreement was reached on the European Commission's **Markets in Crypto-Assets Regulation (MiCA)**, first proposed in September 2020 ²¹.

MiCA, the first EU wide virtual assets regulation, is a framework that calls for consumer protection, establishes clear crypto industry conduct, and introduces new licensing requirements for its 27 member states. MiCA, undoubtedly sets a benchmark for other regional regulators to emulate. The biggest advantage of a MiCA style regulation is to avoid a fragmented approach which leads to unfair scaling effects.

Regulatory trend watch

The growth of the crypto market and its movement correlation with stock markets, as presented in the previous section, coupled with the varied and fragmented regulations across the globe, implies a serious risk to the stability of the overall financial markets. Hence, the need for a strong international framework to regulate the crypto industry and prevent regulatory arbitrage.

Furthermore, isolated regulations and inconsistent compliance measures/ enforcement of virtual assets regulations present a potential risk for money laundering (ML), terrorism financing (TF) and other financial crimes, such as fraud, malware and ransomware attacks. According to the **Financial Action Task Force (FATF)**, 'gaps in the global regulatory system have created significant loopholes for criminals and terrorists to abuse'²³.

In early March 2022, Forbes reported an indictment against two siblings, John and Jonatina Barksdale, for violating securities laws, and misleading 12,000 retail investors into buying an unregistered security called Ormeus Coin in a scam of USD 124 million²⁴. Hence, the future regulatory focus will be predominantly on financial crime compliance, a topic which is discussed in detail later in this report.

Another emerging focus, as the industry matures and integrates increasingly with the traditional financial system, will be on consumer protection, setting standards to protect consumers from fraud and manipulation²⁵.

In the UK, the Advertising Standards Authority (ASA) has already banned a number of campaigns for being irresponsible and ads for crypto are now subject to rules governed by the Financial Conduct Authority (FCA)²⁶.

Similarly, in Spain, advertising by crypto service providers and any person advertising on their own or on behalf, such as influencers, are required to inform the Spanish National Securities Market Commission (CNMV) at least 10 days in advance on content, for campaigns targeting over 100,000 people²⁷.

Singapore has gone a step further and prohibited all public advertising of crypto products, stating that "Crypto is highly risky and not suitable for the general public"²⁸. The ban includes crypto ATMs which are considered a form of promotion.

It is expected that 2022 will see greater regulation in this industry with a focus on consolidation, international coordination, financial crime compliance and consumer protection. MiCA will serve as a guide other regulators to seek control and curtail market instability through greater reserve requirements, transactions limits and stricter licensing requirements.

According to the World Economic Forum, '**piecemeal approaches to cryptocurrency regulation must be replaced by a globally coordinated framework**'.²²

The UAE crypto market

The UAE's share in the global crypto market has **increased 500%** between July 2020 and June 2021 and is now over

US\$25 billion
in transactions value.

400+
crypto
businesses

Regionally
ranked
3rd
by volume

The Middle East is one of the fastest growing cryptocurrency markets in the world, making up 7% of global trading volumes, according to Chainalysis ²⁹, and as quoted by CNBC ³⁰, the UAE's share in the global market is around US\$25 billion transactions, and it has increased 500% between July 2020 and June 2021.

Regionally, the UAE ranks third by volume, behind Turkey which had US\$132 billion in transactions volumes and close to Lebanon at US\$26 billion. While the key reason for the high rate for crypto adoption in Turkey and Lebanon is value preservation, for the UAE, the increase in transaction volume is multifactorial, as explained next through the growth factors.

While official figures are unavailable, The National News, a local daily, reported that there are more than 400 crypto businesses currently in the UAE. Ahmed bin Sulayem, Executive Chairman and CEO of the Dubai Blockchain Centre (DMCC), cited during GITEX Global in Dubai, is confident that there will be "well over" 1,000 crypto businesses in the UAE by the end of 2022 ³¹.

Drivers of growth

1. Friendly regulatory regime

According to Reuters ³², a friendly regulatory regime is catalysing growth, with over 30 licences issued for crypto exchanges to operate in Dubai and Abu Dhabi in recent months. As quoted by Reuters, VARA has given approval in March this year to Binance, the world's largest cryptocurrency exchange, and FTX, which will set up a regional headquarters in Dubai, in a statement released on 15 March 2022.

Global exchanges Bybit and Crypto.com are also planning similar moves. Kraken, which has been granted a licence to operate in Abu Dhabi's free trade zone ³³, seeks to become the first cryptocurrency exchange to offer direct funding and trading in UAE Dirhams against Bitcoin, Ethereum and a range of other virtual assets after receiving a full licence to operate in the country, Curtis Ting, Kraken's managing director for Europe, the Middle East and Africa, told CNBC. Binance, with licences for the free trade zones of both Dubai and Abu Dhabi, plans to recruit 100 employees, and its CEO Changpeng Zhao, has relocated from Singapore to Dubai ³⁴.

BitOasis, a UAE based crypto asset exchange, which raised US\$30 million in a Series B funding round in October 2021, has also received provisional approval under VARA, as reported by Reuters ³⁵.

2. Government support

In order to expand the use of crypto assets, the Dubai Multi Commodities Centre (DMCC) opened a new Crypto Centre to companies developing various crypto and blockchain technologies ³⁶.

The DMCC houses companies offering, issuing, listing, and trading crypto assets, as well as those developing blockchain trading platforms, fully supported by the national government.

3. Increase in private wealth

Private wealth has risen by US\$46 billion between 2019 and 2021 with 5,600 millionaires moving into the UAE, as quoted in Henley's 'Global Citizen's Report Q1 2022' ³⁷. Increase in private wealth has a cascading effect on investments, particularly of the 'wild west' kind. About 15 percent of family offices worldwide already have some form of exposure to crypto, according to a survey by Goldman Sachs. And just over half of the families Goldman surveyed this year said they were considering investing in crypto.

A Financial Times article published in late 2021 ³⁸ highlights how wealth managers are under increasing pressure from their high networth clients for crypto investments. The fear of missing out on an expanding market are high.

Secondly, as many of these wealthy individuals have already made their wealth in crypto on apps, they are now looking to shift to VIP services offered by major crypto exchanges, creating additional demand pressure on wealth managers. This stimulates the institutionalising of virtual assets. Moreover, according to the Financial Times, crypto investment by the rich attracts less regulator concern than retail consumers, as "wealthy clients tend to have professional advisers, can safely take on more risk and can afford to lose money".

4. Consumer trust

UAE consumers appear to have a healthy appetite and trust in crypto. A YouGov survey showed that 'two-thirds of UAE residents (67%) say they are interested in investing into cryptocurrencies within the next five years, ... and, that UAE is one of the top markets globally where consumers say they trust cryptocurrencies (40%)'. ³⁹

The burgeoning interest in crypto by UAE consumers was underlined at the recently held Crypto Expo Dubai. The two day expo, from 16-17 March 2022, marked a 50% increase in exhibitors and a 40% increase in visitors from last year's edition. ⁴⁰

4. Partnerships with local banks

On 18 July 2022, as reported in the Arabian Business ⁴¹, Rakbank has announced a partnership with Kraken that will allow UAE residents to fund crypto accounts through local transfers from any bank in the country. Such integration with mainstream financial services offered by local banks will drive user adoption and market growth.

Use cases for crypto

The UAE is considered one of the most progressive use cases for crypto. Mass use cases for crypto in the UAE are airlines and real estate firms, some of which are now accepting payments in crypto.

Airlines

From the announcement by Adel Ahmed Al Redha, COO of Emirates Airlines, the national flagship carrier, at the Arabian Travel Market on 10 May 2022 ⁴², it is clear that this is only the first step, as the airline intends to 'embrace advanced digital solutions such as Blockchain, metaverse and cryptocurrency as part of its strategy to connect with customers in a faster and more flexible way'.

Etihad Airways, the national airline of the United Arab Emirates, on 6 July 2022, announced the airline's first non-fungible token (NFT) collection, 'EY-ZERO1' ⁴³. NFT will owners get Etihad Guest Silver tier membership for one year, and a chance to enter a draw for free tickets. Etihad has future metaverse products planned as part of its Web3 strategy.

Real estate

DAMAC, an international real estate developer, announced on 27 April 2022 that it will start accepting payments in Bitcoin and Ethereum ⁴⁴.

Earlier in 2019, Ellington Properties ⁴⁵ made a similar announcement and the Knox Group ⁴⁶ has offered the option of paying with Bitcoin (via the U.S. company BitPay).

Since the UAE still prohibits the use of cryptocurrencies as a method of payment, real estate buyers must work with a third-party broker to convert their crypto to fiat currency before sending it to the seller.

SMEs

Local businesses like grocery delivery company Yalla Market ⁴⁷ and café Bake 'N' More ⁴⁸ have said that they are now accepting cryptocurrencies as a form of payment.

Remittances

Finally, remittances, another prevalent use case for cryptocurrency in many Middle Eastern countries, are also expected to impact the expansion of the UAE crypto market given that the UAE is the second biggest source country of remittances in the world with US\$43 billion remitted in 2020

⁴⁹

The UAE crypto regulatory landscape

Background

As outlined in the previous section, lawmakers across the world are navigating cryptocurrency regulations. The UAE, with its light-touch approach, is aiming to attract crypto firms and boost the domestic industry.

The UAE's regulation appears to be more about overseeing the crypto sector rather than curbing it. It is recognised that regulation is not always a deterrent and some risks associated with cryptocurrency, such as financial crime, can be mitigated by thoughtful regulation and thereby facilitate user adoption.

Governance

The UAE follows a civil law system influenced by Shariah (Islamic) law. While each of its seven member states have instituted their own regulations in areas where there is no federal law, the financial and capital markets, are by and large, governed by the Central Bank of the UAE (CBUAE) and the Securities and Commodities Authority (SCA).

The exceptions are the two financial free zones: the Dubai International Financial Centre (DIFC), where the regulator is the Dubai Financial Services Authority (DFSA), and the Abu Dhabi Global Market (ADGM), where the regulator is the Financial Services Regulatory Authority (FSRA).

The UAE federal criminal laws such as the federal anti-money laundering laws do, however, apply in the DIFC and the ADGM.

In the following sections, current regulations around crypto are presented for onshore, and DIFC and ADGM.



Onshore UAE

After a wait and see approach for several years, the SCA issued a long awaited regulation on crypto assets on 1 November 2020.

SCA's Decision No. 23 of 2020 concerning Crypto Assets Activities Regulation (CAAR) ⁵⁰, regulates the offering, issuing, listing, and trading of crypto assets in onshore UAE including initial coin offering (ICO), exchanges, marketplaces, crowdfunding platforms, custodian services, and related financial services based upon or leveraging crypto assets .

Crypto assets under CAAR are defined as: “a record within an electronic network or distribution database functioning as a medium for exchange, storage of value, unit of account, representation of ownership, economic rights, or right of access or utility of any kind, when capable of being transferred electronically from one holder to another through the operation of computer software or an algorithm governing its use”.

The CAAR lays down standards and requirements for wide range of market participants like issuers of securities, investors including Qualified Investors, Custodians, Crypto trading platforms, brokers and promoters engaged in Crypto Asset industry, anyone who promotes, offers or issues crypto assets in the UAE; provides crypto asset custody services, operates an exchange for crypto assets or operates a crypto fundraising platform in the UAE; and carries on any other financial activities in the UAE.

The framework initially covers security and derivative tokens it refers to as investment tokens; digital representations of rights and obligations, equivalent to those conferred by assets such as shares or futures contracts, issued, transferred, and stored using distributed ledger technology such as blockchain.

Hence, items regulated by the CBUAE such as currencies, virtual currencies, digital currencies, stored-value units, payment tokens and payment units are not within the scope of CAAR. The issuance of the SCA virtual assets regulation came after the CBUAE issued an updated Stored Value Facilities (SVF) Regulation, which also apparently considered crypto assets. However, CBUAE issued a clarification on 6 December 2020 in which it stated that crypto assets or virtual assets are not legal tender, and that the SVF Regulation aims to license the entities who issue or provide SVFs in the UAE ⁵¹.

An important aspect of CAAR is the definition of qualified investors as: Institutional investors who hold more than AED 75 million in assets, or have a net turnover of AED 150m, or state governments, foreign governments and international bodies, and individuals with AED 4m in funds or an annual income of AED 1m, and with whom a licensee can verify that they possess sufficient knowledge and understanding about the risks of investing in crypto assets.

The SCA is expected to issue another consultation this year for tokens not yet covered by the regulation, including exchange tokens, also known as cryptocurrencies, utility tokens and some asset-backed tokens such as stablecoins.

Virtual Assets Law and VARA

The Virtual Assets Law No. 4 of 2022 on the Regulation of Virtual Assets in the Emirate of Dubai entered into force on 11 March 2022, on the date of its publication in the official gazette. Approved on 28 February 2022, by Sheikh Mohammed bin Rashid Al Maktoum, Vice President and Ruler of Dubai, it is applicable to virtual asset services in Dubai, except in the DIFC.

The Virtual Assets Law also establishes the Dubai Virtual Assets Regulatory Authority (VARA), affiliated with the Dubai World Trade Centre Authority (DWTCA), as the primary virtual assets regulator in Dubai. VARA aims to promote Dubai's position as a regional and international destination in the virtual assets sector. It will provide a full range of services in coordination with CBUAE and SCA and is mandated with organising and setting the rules and controls for conducting activities related to virtual assets. This includes cryptocurrencies, tokens, non-fungible tokens, and any other virtual asset determined by VARA.

Activities subject to authorisation from VARA include operating and managing VA platform services; exchange services between virtual assets and currencies, whether national or foreign; exchange services between one or more forms of virtual assets; virtual asset transfer services; custody and management services; and services related to the offering and trading of virtual tokens.

Entities operating in Dubai which fall within the scope of the Virtual Assets Law shall be prohibited from engaging in certain regulated activities in Dubai unless authorised to do so by VARA and within the limits of the authorisation granted. Prerequisites include establishing Dubai as the business headquarters and obtaining a commercial business licence from the relevant licensing authority in Dubai.

VARA is expected to establish rules and conditions for the practice of the regulated activities as well as expand the list of activities under its ambit. The specific licensing process and additional ongoing requirements with respect to anti-money laundering, disclosure, transparency, and KYC procedures are expected to be set out as supplementary to the Virtual Assets Law, including acts that constitute a violation of the provisions of the Virtual Assets Law and corresponding penalties.

VARA is permitted to take various actions and measures, including suspending the issuance of authorisations/ activities of any VASP and suspending dealings in any virtual assets in certain circumstances.

With its metaverse presence, as mentioned in the introduction, VARA is undoubtedly a forward looking regulator paving the way to pioneering crypto regulations not just regionally, but also globally.

The DFSA and DIFC

The DFSA, which is the regulator for the DIFC, currently does not regulate crypto assets. The DFSA website “reiterates that it does not regulate any other types of cryptocurrencies, crypto assets, virtual assets, or digital assets (called Crypto Assets for the purposes of this statement) and that no firms are licensed or supervised by DFSA to provide financial services relating to Crypto Assets in or from the Dubai International Financial Centre (DIFC)”⁵².

The website cites fraud, volatility, liquidity, information, and money laundering risks, urging investors to exercise caution.

The lack of a specific regulatory framework, however, has not stopped crypto and blockchain projects from setting up in the DIFC. In November 2020, Ripple set up its regional headquarters in the DIFC, though it appears to only conduct marketing activities there⁵³.

However, in 2021, the DFSA conducted a public consultation for security tokens on a proposed framework, indicating future regulation prospects⁵⁴. The framework covered security and derivative tokens which it refers to as investment tokens - digital representations of rights and obligations equivalent to those conferred by assets such as shares or futures contracts, issued, transferred, and stored using Distributed Ledger Technology (DLT) such as blockchain⁵⁵.

Under the consultation, any person carrying on certain activities relating to investment tokens, in or from the DIFC, will require DFSA authorisation. The activities include, without limitation, carrying on a financial service which relates to an investment token, including promotions, public offers, or applying for a security token to be admitted to the official list of securities. An investment token, depending on the nature of the rights and obligations it confers, falls into one or more existing categories of a security or derivative. As to security tokens, it is expected that they will be regulated in accordance with existing regulation with additional requirements to tackle technological risks specific to DLT and Blockchain.

The DFSA is also formulating proposals for other tokens not covered by the investment tokens framework, which is expected to include, amongst others, cryptocurrencies, and utility tokens. It recently launched a Consultation Paper (CP) on 8 March 2022 for a regulatory regime for financial services activities in respect of Crypto Tokens, which it defines as a token that is used, or is intended to be used, as a “medium of exchange or for payment or investment purposes but excludes an Investment Token, or any other type of Investment, or an Excluded Token. A Crypto Token includes a right or interest in the relevant Crypto Token”⁵⁶.



The FSRA and ADGM

A pioneer in crypto regulations, ADGM states that it's the 'first regulator globally to regulate platforms that enable the trading of Virtual Assets as Multilateral Trading Facilities' ⁵⁷. In 2018, the FSRA issued a regulatory framework, incorporated within the Financial Services and Markets Regulations (FSMRs), for 'crypto asset' businesses. This framework is regularly updated in line with global trends. The last update was issued in February 2020, along with detailed guidance notes ⁵⁸.

The FSMRs divide virtual coins and tokens into two classes, the first class comprises of currently regulated digital assets, which includes virtual currencies, digital securities, fiat tokens (fully backed by fiat), and derivatives and funds, and the second class which includes digital securities, offerings or for other capital raising purposes, and which are not regulated currently. Virtual assets are defined as: 'a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status in any jurisdiction'.

From a regulatory policy perspective, the FSRA treats virtual assets as commodities and therefore not as specified investments under the FSMRs. Derivatives of virtual assets are treated as commodity derivatives and therefore as specified investments under the FSMRs.

Even though not all virtual assets are specified investments, any market operator, intermediary or custodian dealing in virtual assets is required to be approved by the FSRA as a financial service permission holder in relation to the applicable regulated activity.

Where the FSRA classifies digital assets as digital securities or derivatives, or collective investment funds of virtual assets, dealing in them and their issuance must fully comply with the provisions applying to securities, derivatives and funds as set out in the FSMRs and ancillary rules issued by the FSRA.

On 21 March '22, the FSRA released a consultation to seek views on 'significant proposed enhancements to its capital markets regulatory framework' and virtual assets, especially proposed approaches for NFTs in the ADGM ⁵⁹.

Financial crime risks

Virtual asset activities may create illicit finance vulnerabilities due to their borderless nature, decentralised structure, limited transaction transparency, hidden/undisclosed UBOs, and speed of operations. Anonymised cryptos or privacy coins further reduce transparency and obscure the source through cryptographic enhancements, thus circumventing typical Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) controls.

Fiat currencies are created and issued by sovereign governments and stored and transferred by banks and other regulated financial institutions on behalf of users. In contrast, the virtual asset ecosystem can enable users to create, store and transfer virtual assets without the need for any third party. This creates a set of unique challenges for regulators worldwide. Without regulated entities centrally controlling the creation and use of VA, the system is open to significant financial crime risks.

While crypto based crime surged in absolute number to US\$14 billion in 2021, up from US\$7.8 billion in 2020, reported illegal activity accounted for less than 0.2% of digital currency transactions, as per Chainalysis. Secondly, Chainalysis claims that the increase in criminal activity is much lower in proportion to the overall increase in crypto activity- 79% versus 567% from 2020 to 2021 ⁶⁰.

Furthermore, the ability of lawmakers to clamp down on crypto related illicit activity has also strengthened, given recent filings against several crypto scams; FBI's takedown of the prolific REvil ransomware; OFAC's sanctioning of Russian exchanges Suex and Chatex because of money laundering, and similar convictions.

While this analysis is encouraging, the absolute figure of US\$14 billion of crypto related crime is still a major concern for regulators, as reflected in an IMF report quoted by Bloomberg in April 2022, in which it was indicated that crypto assets "may be used to transfer corruption proceeds or circumvent capital controls" ⁶¹.

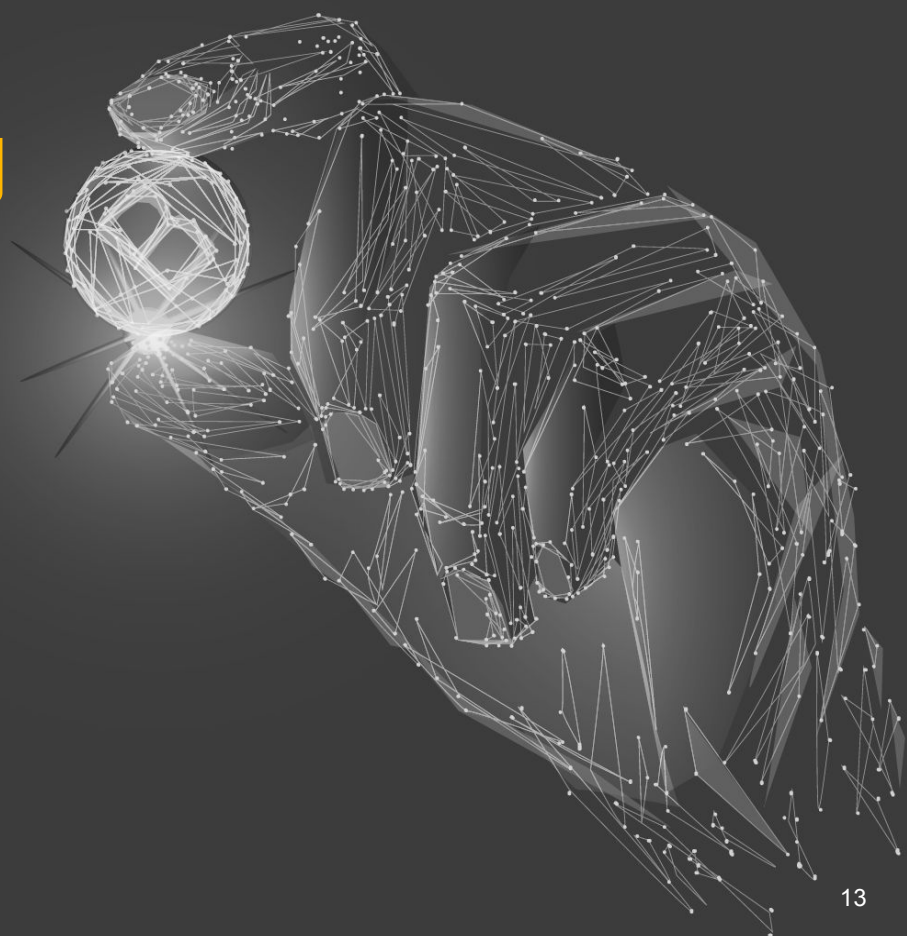
The IMF said it drew its baseline data on cryptocurrency usage from information collected in a survey conducted by the German company Statista.

The IMF report talks about instituting know-your-customer (KYC) measures to prevent fraud, money laundering and terrorism financing which countries, like the U.S., have already implemented.

Typologies

According to the 'Virtual Assets Red Flag Indicators' report ⁶² by the Paris based, Financial Action Task Force (FATF), the majority of crypto offences relate to predicate or Money Laundering (ML) offences- the sale of controlled substances and other illegal items (including firearms), fraud and scams, extortion, tax evasion, cyberthefts/ ransomware, child exploitation, human trafficking, sanctions evasion, and Terrorism Financing (TF).

More recently, the FATF has observed that professional ML networks are also exploiting VAs as a ML layering technique, and not just for an initial placement into the financial system.





International guidance

In 2013, the US Department of the Treasury Financial Crimes Enforcement Network (FinCEN) first published guidance on crypto assets, establishing grouped persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies as “users,” “administrators,” or “exchangers,” and concluded that “administrators” or “exchangers” are Money Services Business (MSB), with exceptional limitations/ exemptions, and therefore subject to FinCen regulations under the Bank Secrecy Act (BSA) of 1970 ⁶³. The BSA and the regulations promulgated thereunder by FinCEN require that MSBs establish an effective anti-money laundering (AML) programme and comply with certain recordkeeping and reporting requirements.

Ever since, AML/CFT and transaction monitoring requirements have come into place across the world to combat the exploitation of crypto assets by illicit actors. Indeed, FinCen, on 9 May 2019, issued an “Interpretive Guidance” on how FinCEN’s (MSB) regulations apply to a variety of business models that use Convertible Virtual Currency (CVC) ⁶⁴. The 2019 FinCEN Guidance clarifies that a person may be a money transmitter when operating either on a transactional basis or on an account basis.

Concurrent with the issuance of the CVC interpretive guidance, FinCEN published an ‘Advisory on Illicit Activity Involving Convertible Virtual Currency’ in 2019 ⁶⁵, to assist financial institutions in identifying and reporting suspicious activity concerning how criminals exploit convertible CVCs for money laundering, sanctions evasion, and other illicit financing purposes, particularly involving darknet marketplaces, peer-to-peer (P2P) exchangers, foreign-located MSBs, and CVC kiosks/ ATMs, and typologies and red flags associated with such activity.



FATF

Several iterations of guidance on digital assets from the FATF have underscored the focus on AML/CFT regulation. Although FATF’s recommendations and guidance do not carry a legal status, nevertheless they provide important direction to financial institutions and regulators. In 2021, FATF issued an ‘Updated guidance for a risk-based approach- virtual assets and virtual asset providers’ ⁶⁶.

This guidance is intended to help regulators to develop regulatory and supervisory directives for virtual asset activities, and to help VASPs to understand and execute their AML/CFT obligations. For regulators, FATF recommends a risk-based approach (RBA); technological neutrality; future proofing and a level playing field, while recognizing the internet-based, borderless nature of VAs.

For VASPs, the guidance clarifies the five listed activities which are covered under FATF Recommendations under which all jurisdictions are obligated to impose specified AML/CFT requirements on Financial Institutions (FIs), Designated Non-Financial Businesses and Professions (DNFBPs) and VASPs, and in particular the ‘Travel Rule’.



The travel rule

FATF’s Recommendation#16 or the ‘Travel Rule’, adapted from the BSA, requires financial institutions to share data on transactions beyond a threshold. The Travel Rule was expanded to crypto and VASPs by FATF on 21 June 2019. The new Travel Rule guidance ⁶⁷ recommends VASPs, including exchanges, banks, OTC desks, hosted wallets, and other financial institutions, to share certain Personally Identifying Information (PII) about the recipient and sender for cryptocurrency transactions over USD/EUR 1000 globally. The rule applies for inter-VASP transfers but not for VASP-to-private wallet transfers at present. Further updates regarding private wallets, DeFi, NFTs, and stablecoins are expected in 2022.

The Travel Rule is intended to block terrorist financing; deter payments to sanctioned individuals, entities, and countries; enable law enforcement to subpoena transaction details; support reporting of suspicious activities and prevent money laundering.

While the Travel Rule is applicable to all 37 FATF member countries, there have been a number of challenges arising from non-uniformity, lack of interoperability and technological limitation, that have affected implementation.

The UAE financial crime compliance regulatory landscape

In the UAE, the Federal Law No. 20 of 2018 on Anti-Money Laundering and Combating the Financing of Terrorism and Financing of Illegal Organisations (the AML Law) ⁶⁸ and Law No. 7 of 2014 on Combating Terrorism Offences (the CTO Law) ⁶⁹ are the key legislations on ML/ TF, supported by accompanying, executive regulations.

The AML Law, which defines the crimes of money laundering and terrorist financing and details the sanctions for these activities is a federal law applicable across all the 7 emirates, including the DIFC and ADGM. The definitions are wide enough in scope to presumably cover virtual assets and VASPs.

Current Challenges

1 An all-encompassing financial crime regulation

The Dubai World Trade Centre (DWTC)'s association with VARA, as mentioned previously, and Virtual Assets Law, while offering the first, indeed landmark regulation in the UAE, do not yet offer comprehensive AML/ CFT guidance. In December 2021, when it was announced that the DWTC will become a crypto zone and regulator for cryptocurrencies and other virtual assets, the Dubai Media Office had stated that: "Rigorous standards for investor protection, anti-money laundering, combating the financing of terrorism, compliance and cross border deal flow tracing," will be developed ⁷⁰.

Furthermore, in parallel to the Virtual Assets Law, the SCA released a Statement on 8 March 2022, that it has concluded a consultation on the regulatory and supervisory framework to assure AML/CFT Compliance for virtual assets in the UAE ⁷¹.

Also, the current UAE regulation, onshore and offshore, doesn't yet provide clarity for permissionless peer-to-peer systems, although VARA covers Decentralised Finance (DeFi). The 2021 DIFC consultation indicated a lack of risk appetite to support DeFi, at least not in areas relating to security tokens. Similarly, for NFTs, with the issuance of the ADGM consultation on NFTs, regulations for status NFTs and the application of intellectual property laws are evolving.

In the coming months, as the expected comprehensive regulatory and supervisory framework including AML/CFT requirements is issued by the SCA, it will offer greater clarity as well as the interplay between the Virtual Assets Law and SCA regulations, given that the SCA has federal authority.

Given that a comprehensive AML/CFT law for virtual assets is yet to be enacted, while the number of crypto companies setting up in the UAE is growing amidst increasing interest by institutional investors ⁷² and wealth managers to increase their exposure to virtual assets, it is crucial that UAE regulators keep up with their pace of regulations and guidance in this area.

2 FATF Grey listing

While the UAE has been acclaimed for its crypto friendly approach and its forward-looking legislation, it has also come under increasing international scrutiny for not doing enough to crack down on overall ML/ TF vulnerabilities, and was placed on the FATF Grey List, on 4 March 2022 ⁷³. In its 2020 mutual evaluation report, while FATF accepts that the UAE identifies and investigates TF activities to a large extent, it cited ML risks in certain industries, including real estate and precious metals, and the 'low number of ML prosecutions in Dubai is particularly concerning considering its recognized risk profile' ⁷⁴.

The UAE is strongly committed to address the FATF points by implementing a National Action Plan to strengthen the effectiveness of its AML/CTF regime. As quoted by Reuters ⁷⁵, FATF said the UAE has made "significant progress" since the 2020 report on issues around terrorism financing, money laundering, confiscating criminal proceeds and engaging in international cooperation and "Additionally, the UAE addressed or largely addressed more than half of the key recommended actions from the mutual evaluation report".

3 Inherent vulnerabilities of the real estate sector

In its 2020 mutual evaluation report, FATF had stated that Dubai's high-end luxury real estate market has been exposed to transactions in cash, has a highly internationalised client base, and is therefore attractive to ML risks. The real estate sector was rated by FATF as a medium-high risk, regardless of whether real estate transactions took place on the mainland or in a free zone.

On 8 August 2022, new reporting requirements, announced by the Ministry of Economy (MoE) and the Ministry of Justice (MoJ) in partnership with FIU, requiring reporting of: cash payments equal to or above AED 55,000 and payments with virtual assets/ funds derived from a virtual assets have been very well received as string regulatory measures to tackle the inherent ML vulnerability of this sector ⁷⁶.

4 Licensing related issues

As reported by the Financial Times ⁷⁷ on 11 May 2022, in its featured article, "The sun starts to set on the Wild West days of crypto", calling for greater and more cohesive regulation in the industry, an issue on licensing was also highlighted.

Case in point- Anchorage Digital Bank, whose licence was revoked by the Comptroller of the Currency, just eighteen months after authorisation, bringing to light the importance of thorough due diligence required by the regulator when awarding licences. VARA and other regulators would do well to heed this example to avoid appearance of flip flopping like the Comptroller of the Currency. Proper licensing protocol is a must-have requirement to increase trust and eliminate the possibility of exploitation, when granting or renewing licences.

5 The 'Sunrise' and borderlessness issues

This last challenge is not a UAE specific issue, but rather a global one. One of the biggest issues for crypto regulation is its borderless nature in that it is difficult to accurately ascertain the location of a crypto deal, which may sit across different jurisdictions and therefore be subject to different and possibly conflicting legal frameworks. This issue is further compounded in case of disputes.

Added to this is the 'Sunrise' issue, which refers to the difficulties in complying with international standards for crypto regulation such as the FATF Travel Rule, because of a difference in compliance level/ regulatory maturity in different countries. For VASPs to exchange transaction details, there must be an interoperable communication system for VASPs to receive and send Personally Identifiable Information (PII) data. This requires the crypto industry to collaborate on an approach with the ideal data and communication protocols, which are also cognisant of security and data privacy breach risks.

Future direction for UAE Regulators

Governments want to foster innovation and market growth- but they're also cautious about the potential misuse of crypto for sanctions evasion, fraud, terror financing and money laundering. Facilitative crypto regulation should have appropriate space for innovation and healthy competition while clamping down on illicit conduct.

The UAE has been harbouring an encouraging environment for the growth of its crypto industry, especially with Dubai's enactment of the Virtual Assets Law and establishment of VARA, and while the industry was largely unregulated a few years ago, recent legislative measures have shown the government's keenness to reduce the potential financial crime risk in the nascent industry.

This section covers our Point of View (PoV) and recommendations to the UAE regulators, banks and VASPs.



The way forward

The crucial policy and strategic question for the UAE is how to maintain the fine balance between inviting innovation, technology and wealth generation and owning the future of crypto and blockchain- being the 'Wall Street of Crypto' ⁷⁸, as recently termed by Bloomberg, versus having robust regulations in place to control the potential risks related to financial crime that such new, technology frontiers may unwittingly bring.

Beyond financial crime regulatory considerations, locally and internationally, the UAE will have to consider consumer protection and benefits, ensuring financial access and economic inclusion, and a level playing field, if it wants to establish itself as a pioneering virtual assets regulator.

Leading regional and international coordination to eliminate regulatory arbitrage and making cross border compliance easier, is another aspect that can distinguish the UAE as a reputable player in the global crypto industry.



Our recommendations for UAE regulators

We recommend a three-stage facilitative model for UAE regulators, which is based on Jonathon W. Lim's model "A Facilitative Model for Cryptocurrency Regulation in Singapore", published in the book "A Handbook of Digital Currency, Bitcoin, Financial Instruments and Big Data"⁷⁹.

Step 1

Clear regulations

The crucial building block is clear and unambiguous legislation, backed by law enforcement. The UAE requires a comprehensive, all-encompassing framework that covers all AML/CFT and financial crime aspects. Niche regulation on areas like DeFi and NFTs is also essential given the luxury real estate and arts market in the UAE, as this will not only help eliminate ML and TF risks but also help to expand the market.

Institutional investors, who seek clarity and protection through regulations, invest in regulated markets. Also, regulatory certainty makes it easier for small firms to seek financing and establish banking relationships and retail investors are more confident when there is government endorsement.

Step 2

Industry self-regulation

In addition to clear legislation, self-regulating approaches can also be extremely beneficial, especially in high tech and rapidly advancing industries such as crypto where industry players have much greater expertise than external regulators.

The UK's Financial Conduct Authority (FCA) recently concluded a two-day 'Crypto Sprint', in May, to 'explore how the evolving world of crypto assets could be regulated in the UK'⁸⁰. With 100 diverse participants this was the first of such planned industry engagements, before the FCA developed its overarching crypto regulation. This is an excellent example of regulators reaching out to the industry to gather expert opinions and diverse thoughts before drafting a regulation.

There are many benefits to this approach. By collaborating with industry experts, fintechs, crypto firms, academics, consumer interest bodies and subject matter experts, regulators can reduce their monitoring and enforcement costs and encourage greater cooperation and compliance to mutually agreed and set standards. Added benefits can include advanced training programmes and sharing of insights and research.

A case in point is the Japanese Virtual Currency Exchange Association (JVCEA)⁸¹, the official Self-regulating Organisation (SRO) that was formed after the 2018 hacks to Coincheck and Zaif exchanges of US\$500 million and US\$60 million, respectively. The Japanese government is relying on the JVCEA, which is currently drafting proposals for Japan's crypto travel ban. In April 2020, the Japanese Financial Services Authority (JFSA) recognized another SRO, the Japan STO Association, to target crypto securities, specifically security token offerings (STOs).

Another example is the Crypto Market Integrity Coalition (CMIC)⁸², formed by Solidus Labs and a number of other familiar names in the crypto world, which has pledged a commitment to safe markets and working with regulators. The launch of the CMIC, as stated by the group, is "an industry defining pledge focused on cultivating a fair digital asset marketplace to combat market abuse and manipulation and promote public and regulatory confidence in the new asset class."

Self-regulation, is proposed as a complement to legislation, and not as a replacement, and requires the involvement and support of legislators for success.

Step 3

International coordination and cooperation

As brought out earlier, with reference to the IMF report calling for greater international coordination, the Sunrise issue and borderless nature of crypto can not only cause friction and misalignment but also make compliance difficult for firms, especially where extraterritorial treaties exist.

Greater international harmonisation, communication and cooperation is required with other jurisdictions for the UAE to succeed in this last stage of our proposed model.

How can PwC help?

Undoubtedly, where the apparent endorsement of digital assets in the UAE comes as welcome news to virtual assets firms, especially given the mixed signals from other jurisdictions, there are several challenges on how to ensure that transparency and trust form the foundation for the long-term growth in this sector.

Added to this is the expectation of greater regulatory oversight within the UAE and internationally, and challenges around compliance, and the risks of unwittingly committing a breach.

If you are a regulator

As highlighted in our proposed 'three-stage facilitative model for UAE regulators', we believe that regulators can benefit immensely in establishing clear and comprehensive regulations, collaboration with industry experts, and international cooperation.

Given our global standing and expertise in financial crime regulations and our work in virtual assets space, we can assist in collating and analysing industry feedback through consultations; assessment, integration, and enhancement of existing regulations in light of international guidance, and co-creating new regulatory standards, as well as regional/internationally applicable guidance in conjunction with regulators in other jurisdictions in the areas of licensing requirements, KYC, 'fit and proper' test, compliance officer requirements, UBO disclosures, KYT, threshold based reporting requirements, Travel Rule, etc.

On an ongoing basis, we can assist in formulating supervisory procedures, update typologies, and to perform an advisory role as new products/ services and technologies come up in this innovative industry.

If you are a bank

Together with our global network of PwC firms, we strive to deliver solutions that provide trust, transparency, and security. Traditionally banks aren't equipped to perform due diligence for VASPs. We can offer due diligence of VASPs as a managed service to your bank, thereby allowing you to onboard this upcoming customer segment with the confidence of compliance checks that assess risks considering the cross-border nature of virtual assets and their pseudonymous transactions and validate the VASPs' own financial crime compliance programmes.

These type of managed services, including custodial services in Wealth Management, will become even more relevant and beneficial to you in future, given the merging of crypto in mainstream finance and given that more and more institutional investors are now investing in virtual assets.

If you are a VASP

We, at PwC can help you smoothly navigate the domain of current and future regulatory requirements applicable to your virtual asset business. We provide a turnkey solution to all your regulatory and financial crime compliance requirements, right from assistance in your licensing application, developing compliant frameworks and to defining your compliance roadmap, catering to existing and expected regulations in the UAE.

While we take care of carrying out your risk assessment, developing control frameworks, creating Compliance Manuals and AML/CFT and Sanctions policies, in line with local and international guidance such as the FATF Standards, we can also assist with your KYC and due diligence processes, compliance monitoring, training and regulatory reporting obligations in the UAE.

With your compliance needs catered for, you can focus on expanding your client base, developing your market, and harnessing new technologies for innovative products and services. Our strategic partnership can propel your business towards secure, compliant, and future proofed growth.

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