

CONSULTATION PAPER NO.143



REGULATION OF CRYPTO TOKENS

8 MARCH 2022

PREFACE

Why are we issuing this Consultation Paper?

1. This Consultation Paper (CP) seeks public comment on our proposals for a regulatory regime for persons wishing to provide financial services activities in respect of Crypto Tokens.
2. The development of these proposals was prompted by the need to introduce appropriate investor protection requirements in this area, while also facilitating the development of this market in a responsible and prudent manner.

What is not covered under this Consultation Paper?

3. All the proposals in this paper relate only to Crypto Tokens. The regulation of Investment Tokens (previously referred to as Security Tokens), set out in [CP138](#), is not dealt with in this paper unless explicitly stated.

Who should read this CP?

4. The proposals in this paper will be of interest to:
 - a) Authorised Market Institutions (AMI) wishing to admit Crypto Tokens to trading, or clearing or settlement, on their facilities;
 - b) Operators of Alternative Trading Systems (ATS) wishing to trade Crypto Tokens on their facilities;
 - c) Digital Wallet Service Providers who safeguard and administer Crypto Tokens;
 - d) Authorised Firms wishing to undertake other Financial Services relating to Crypto Tokens, such as dealing in, advising on, or arranging transactions relating to Crypto Tokens, or managing discretionary portfolios or collective investment funds investing in Crypto Tokens;
 - e) persons who intend to apply to the DFSA for a licence to carry out the activities specified above;
 - f) issuers and creators of Crypto Tokens;
 - g) persons undertaking technology support or provision; and
 - h) persons providing legal, accounting, audit, or compliance services in the DIFC.

Terminology

5. Defined terms have the initial letter of the word capitalised, or of each word in a phrase. Definitions are set out in the Glossary Module ([GLO](#)). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

What are the next steps?

6. Please send any comments using the [online response form](#). You will need to identify the organisation you represent when providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide. However, if you wish

your comments to remain confidential, you must expressly request so at the time of making comments and give your reasons for so requesting. The deadline for providing comments on this consultation is **6 May 2022**.

7. Following the public consultation, we will decide which changes to the proposed regime are necessary and amend the proposed draft legislation as appropriate. The amended Regulatory Law and Markets Law will be submitted to His Highness the President of the DIFC for his consent and then for assent to His Highness the Ruler of Dubai. The final version of the Laws and Rulebook modules will be published on our website, and we will issue a notice on our website when this happens. You should not act on the proposals until the relevant changes are made.

Structure of this CP

Part I – Introduction;

Part II - Token Taxonomy;

Part III - Financial Promotions;

Part IV - Regulatory requirements in relation to Crypto Tokens;

Part V - Other regulatory requirements in relation to Crypto Tokens;

Part VI - Implementation and transitional arrangements;

Appendix 1 – Draft amendments to the Regulatory Law 2004;

Appendix 2 – Draft amendments to the Markets Law 2010;

Appendix 3 – Draft amendments to the General (GEN) module;

Appendix 4 – Draft amendments to the Conduct of Business (COB) module;

Appendix 5 – Draft Amendments to the Collective Investment Rules (CIR) module;

Appendix 6 – Draft amendments to the Glossary (GLO) module;

Appendix 7 – Draft amendments to the Markets (MKT) module;

Appendix 8 – Draft amendments to the Authorised Market Institutions (AMI) module;

Appendix 9 – Draft amendments to the Code of Market Conduct (CMC);

Appendix 10 – Draft amendments to the Islamic Finance Rules (IFR) module;

Appendix 11 – Draft amendments to the Prudential – Investment, Insurance Intermediation and Banking (PIB) module;

Appendix 12 – Draft amendments to the Fees (FER) module;

Appendix 13 – Draft amendments to the Anti-Money Laundering, Counter-Terrorist Financing and Sanctions (AML) Module and

Annex 1 – Questions in this consultation paper.

Part I - Introduction

8. In March 2021, the DFSA published CP138 on the regulation of Investment Tokens (previously referred to as Security Tokens), with the intention of:
 - a) Clarifying the application of the financial services regime to persons undertaking activities that involve, or relate to, Investment Tokens; and
 - b) Putting in place a consistent, risk based and proportionate application of financial regulation to products, services and activities involving Investment Tokens, which addressed:
 - i. investor and consumer protection needs;
 - ii. market integrity risks;
 - iii. financial stability risks; and
 - iv. crucially, anti-money laundering and counter terrorist financing (AML/CTF) considerations.
9. The DFSA received a large volume of comments in response to CP138. Most agreed with the proposals set out in that CP, with some offering further insights and/or seeking additional clarifications in certain areas of the draft rules. In response to this, the DFSA made minor changes and, in October 2021, the regime for Investment Tokens came into force.¹
10. At the same time as the DFSA was working on proposals for Investment Tokens, work was also being undertaken looking at Crypto Tokens, all other Tokens which are not Investment Tokens, for example, Cryptocurrencies, Stablecoins and Non-fungible Tokens (NFTs).
11. As part of this work, we have focused on the opportunities, challenges and risks that are presented by the use of crypto tokens and tried to understand those better. We looked to directions given by international standard-setters, including the Financial Action Task Force (FATF), Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) in respect of Crypto Tokens. We also looked at regulatory developments in other jurisdictions, including, globally, the UK, EU, Singapore, Japan, Bermuda, New York and Gibraltar, and, in the region, Abu Dhabi and Bahrain. Many were at different stages of development of their regulatory response in this area, with some only licensing and supervising Crypto Tokens from an AML/CFT perspective.
12. Lastly, we have also spent a lot of time talking to market participants, including crypto custodians, exchanges, and other market participants to get a better understanding of how the market works and what activities are being undertaken.
13. This work has led to the formulation of the proposals presented in this CP. The proposals we have put forward address not only AML/CFT risks in respect of trading, clearing, holding or transferring Crypto Tokens, but are broader as we do not believe that regulation of these issues alone will sufficiently mitigate the risks we have identified. Rather, given the increased use of Crypto Tokens as a medium for financial transactions,

¹ <https://dfsaen.thomsonreuters.com/rulebook/notice-amendments-legislation-september-2021-0>

and their connectivity to the mainstream financial system via trading facilities, for example, there are additional issues that need addressing.

- Therefore, the DFSA has also formulated proposals to address risks relating to, for example, consumer protection, market integrity, custody and financial resources for service providers.

Part II - Token Taxonomy

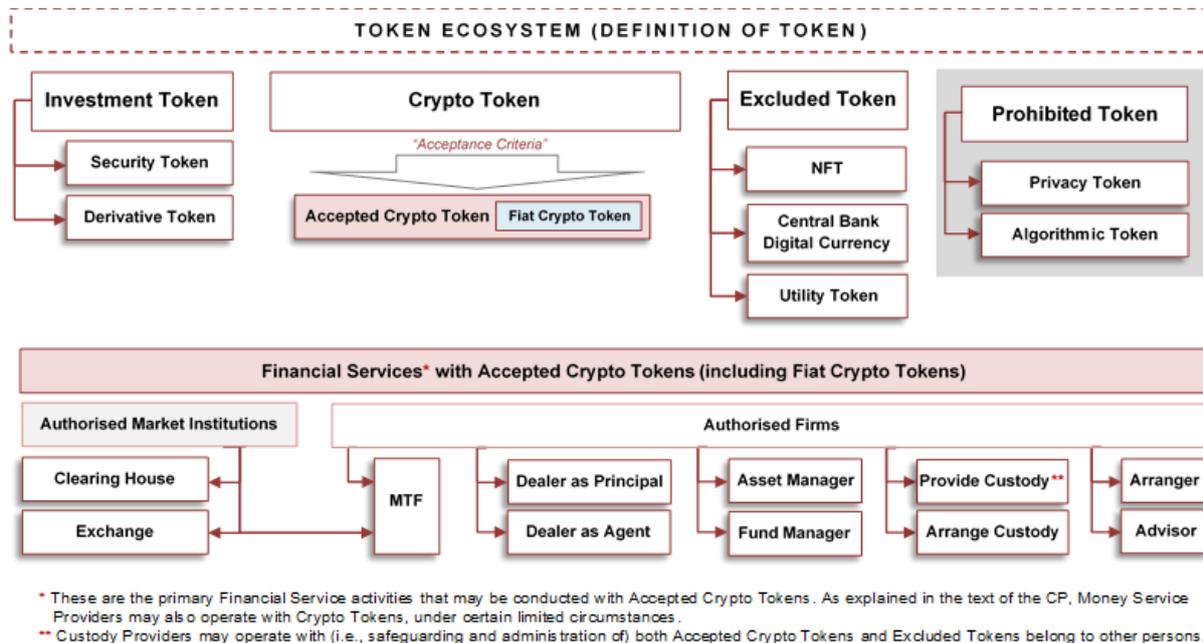
A. What is a Token?

- In CP138, we proposed a definition of a Token, which has now been adopted and is set out in the Glossary (GLO) module:

A Token is a cryptographically secured digital representation of value, rights or obligations, which may be issued, transferred and stored electronically, using Distributed Ledger Technology (DLT) or other similar technology.

- Other definitions and terms relating to a Token are used by the international community of regulators, but they all essentially have the same elements as set out above, in that they are cryptographically secured, a digital representation of value or rights, and use DLT or similar technology.

- The diagram below illustrates the different classification of Tokens and how they fit into our current, and proposed regime:



B. Crypto Tokens

- Crypto Tokens are a class of Token of which there are many types, all differing in size, purpose, and use case. For the purposes of this CP, and our proposed regime, we are proposing a broad definition of a Crypto Token as follows:

A Crypto Token is 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.

19. Given the pace of developments in this market, we believe that it is important to have a broad definition in order to future proof our regulatory approach. The following are the main types of Tokens that will fall within our proposed definition of a Crypto Token.

(i) Cryptocurrencies

20. Cryptocurrencies are a type of Crypto Token designed to be used as a medium of exchange, giving the holder either no, or limited, rights for a claim against the creator/offeror. Cryptocurrencies are usually a co-product of their native blockchain, where a certain consensus mechanism is used to validate transactions on the blockchain. As a result of the consensus mechanism, additional blocks are added to the chain, where the validators are rewarded with additional Cryptocurrencies (e.g., process of mining).² Examples of Cryptocurrencies include Bitcoin, Ethereum and Solana.
21. Some Cryptocurrencies may not have their own blockchain, in which case they “piggyback” on an existing blockchain, using the smart contract and endogenous computation functionality of the hosting blockchain. An example of such a platform with its own Cryptocurrency is Ethereum, examples of other Cryptocurrencies using that network are Polygon and Chainlink.

(ii) Hybrid Utility Tokens

22. Hybrid Utility Tokens are Crypto Tokens that share some characteristics with Cryptocurrencies, but can also provide certain rights to the holder, usually in the form of discounts and early subscription options on products and services offered on that blockchain.
23. The most common Hybrid Utility Tokens are created by a trading facility whereby the holder is entitled to discounts on trading fees and commissions. Hybrid Utility Tokens can be created and offered to the public directly through an Initial Token Offering (ITO), where the funds raised are used to develop the blockchain product or service. Examples of a Hybrid Utility Token include Filecoin, Huobi Token and Basic Attention Token.
24. We are aware that some of these Crypto Tokens described may exhibit different characteristics over time. For example, a Crypto Token that initially has features of a Hybrid Utility Token may acquire features of an Investment Token, and thus may need regulation under the DFSA’s regulatory regime.

(iii) Asset Referenced Tokens

25. Asset Referenced Tokens are a type of Crypto Token that, in order to maintain, or reduce volatility in its price, has its value determined by reference to a single *fiat* currency, another Crypto Token, a commodity, or any other combination of assets.
26. The most common type of Asset Referenced Tokens are *Fiat* Crypto Tokens, which have their value pegged one-to-one against a *fiat* currency, usually the US dollar. As we discuss later in the CP, certain *Fiat* Crypto Tokens that meet our proposed criteria will

² This relates to a consensus mechanism following the Proof-of-Work model. In Proof-of-Stake, the consensus mechanism will not generally create new Crypto Tokens, but instead – network participants will stake their Tokens to validate transactions on the blockchain.

be considered Accepted Crypto Tokens, which can then be used for providing Financial Services in or from the DIFC.

27. There may be Asset Referenced Tokens that are not purporting to maintain a stable price but are directly referencing spot prices of the underlying commodity, and thus demonstrating characteristics of a Commodity. In this case, the instrument in question may be considered a tokenised commodity and fall within our Crypto Token regime unless it meets the definition of another type of Investment such as a Derivative relating to a Crypto Token.
28. Depending on the design, Asset Referenced Tokens may take on characteristics of a Fund, where they are not purporting to maintain a stable price but are referencing assets that are pooled and investors are entitled to receive income from the managed pool of assets. If this is the case, then they will be an Investment, i.e., a Unit of a Fund and subject to our Collective Investment Fund regime.

Proposal 1 – Crypto Tokens

29. We propose to set out a broad definition of a Crypto Token as described in paragraph 18.

Please see draft Article 44A of the Regulatory Law at Appendix 1 and draft GEN 3, App 2.3.1, App 2.5 at Appendix 3.

Question 1:

Do you agree with the proposed definition of a Crypto Token set out in paragraph 18? If not, why not?

C. Excluded Tokens

30. There are certain Tokens which will not be brought into the definition of a Crypto Token and, thus, will not fall within the scope of these regulatory proposals. We have called these “Excluded Tokens,” and they will consist of Utility Tokens, NFTs and Central Bank Digital Currencies (CBDC). The following sets out a further explanation of these categories of Excluded Tokens.

(i) Utility Tokens

31. Utility Tokens are a type of Token that have a specific use case within a closed ecosystem. These can be used by the holder only to pay for, or receive, early access or discount on a product or service (whether current or proposed), and the product or service is provided by the issuer of the Token or of another entity in the issuer’s group.
32. For example, Tokens used within a confined non-financial ecosystem (such as gaming platforms) will fall into our definition of Utility Token, which is an Excluded Token. These Tokens are not brought into our regime.
33. We are aware, however, that there could be circumstances where a Utility Token may come within our regulated proposals, where they take on characteristics of a Hybrid Utility Token, i.e., being used, or intended to be used, as a medium of exchange or for payment or investment purposes. This may happen, for example, when a Utility Token develops secondary trading markets and/or uses cases beyond the issuer’s platform or that of their group. We will monitor these developments and consider whether these Utility Tokens will fall within our regulatory perimeter.

(ii) Non-fungible Tokens

34. A NFT is a type of unique Token that relates to an identified asset (e.g., art, a collectible, other object of intellectual property) and is used to demonstrate the ownership or provenance of that asset. While these types of Tokens can be traded in various marketplaces, and be accumulated speculatively, they are not readily interchangeable and the relative value of one NFT to another, each being unique, cannot be ascertained by means of comparison to an existing market or equivalent assets.
35. We are proposing to exclude NFTs from the scope of our current proposals on the basis there is no Financial Service being provided. However, this comes with a strong *caveat* that this exemption will depend on the characteristics of the NFT and its function, and not what terminology or marketing terms are used. For example, if objects are pooled together to produce and distributed accumulated returns to holders, then those NFTs may take on the characteristics of a Fund and may fall into our regulatory framework on the grounds of being an Investment (i.e., a Unit of a Fund).
36. We urge creators and any other service providers (e.g., offerors, dealers, auctioneers) to take due care in order not to make a public offer or provide a financial service relating to a NFT in or from the DIFC without properly considering whether it is subject to regulation. As this is a rapidly evolving space, we will continue to monitor NFTs and their function and characteristics.
37. We are also considering whether we should designate NFT creators and service providers, who would fall outside the scope of these proposals, as a Designated Non-financial Business and Profession (DNFBP) in the DIFC. This would subject them to AML/CFT requirements, including having to carry out Business Risk Assessments and Customer Due Diligence (CDD). While the FATF, for example, has not recommended this, in their most recent Guidance on Virtual Asset Service Providers (VASPs), they have recommended countries to look at the application of the FATF Recommendations to NFTs on a case-by-case basis. We would invite views on the AML/CFT risks in this area and whether this is something we should look into further. Highlighting any practical difficulties that NFT creators and or service providers may face in complying with AML/CFT obligations would also be helpful.
38. We would welcome views on whether NFTs should be brought within the scope of financial regulation. The DFSA would not generally regulate the creation, marketing and sale of artwork, but we are interested to hear arguments on whether the tokenisation of interests, and the potential uses to which NFTs can be put, do require regulation.

(iii) Central Bank Digital Currencies

39. A digital representation of a currency issued by a government, for example, is commonly referred to as a CBDC. These would not be included in the scope of these proposals, in the same way that the DFSA does not currently regulate *fiat* currency.

Proposal 2 – Excluded Tokens

40. We are proposing to exclude the following Tokens from our regime:
 - a) NFTs;
 - b) Utility Tokens; and
 - c) CBDCs.

Please see draft GEN App2.5 at Appendix 3 and draft AML Rule 3.2.1 at Appendix 13.

Questions:

- 2. Do you agree with our proposal to exclude from regulation the Tokens listed in paragraph 40? If not, why not?**
- 3. Do you think that NFT creators and service providers should be designated as DNFBPs in the DIFC?**

D. Prohibited Tokens

(i) Privacy Tokens and Devices

41. Privacy Tokens and Devices are used, or have features that are intended to be used, to hide, anonymise, obscure or prevent the tracing of the holder of a Token, a transaction relating to a Token or the parties to a transaction. All these features make it virtually impossible to identify accurately the holder or beneficial owner of a Token or to trace a chain of transactions. On this basis, we propose to ban these types of Tokens and Devices and introduce a prohibition that no public offer or promotion of Privacy Tokens shall take place in or from the DIFC, and no person may provide any Financial Service that involves Privacy Tokens or Devices in or from the DIFC.

(ii) Algorithmic Tokens

42. Algorithmic Tokens are designed to achieve price stability through balancing the circulating supply of the Token. This usually entails behind-the-scenes corrections to the supply and demand inputs to arrive at higher or lower equilibrium points. In other words, these Tokens use a method which can issue more coins when its price increases and buy them off the market when the price falls. These mechanisms are not immediately transparent to users, markets, and regulators, and may not enable us to exercise effective oversight and supervision or users to understand how the value is corrected.
43. On this basis, we propose to ban these Tokens and introduce a prohibition that no public offer or promotion of Algorithmic Tokens shall take place in or from the DIFC, and no person may provide any Financial Service with Algorithmic Tokens in or from the DIFC.

Proposal 3 – Prohibited Tokens

44. In light of the above proposals, we are proposing to ban the following Tokens:
 - a) Privacy Tokens and Devices; and
 - b) Algorithmic Tokens.

Please see draft GEN Rules 3A1.1(b)-(d), 3A.2.2 and 3A.2.3 at Appendix 3.

Question 4:

Do you agree with our proposals in paragraph 44? If not, why not?

E. Accepted Crypto Tokens

(i) Introduction

45. There are currently more than 2500 Crypto Tokens (and growing) traded in mainly unregulated markets today. Many of these tokens have little to no liquidity, offer limited price discovery and are extremely susceptible to price manipulation. We consider that there need to be some constraints in respect of what types of Crypto Tokens can be permitted, in order to prevent potential higher-risk activities relating to illiquid or less mature Crypto Tokens, at least in the beginning of this regime, until we become more familiar with the different types of Crypto Tokens and their operations.
46. We can see from our benchmarking that other regulators have adopted an approach that limits the types and numbers of Crypto Tokens that can be used in their jurisdictions, for example, the FRSA at ADGM, the Central Bank of Bahrain and the New York Department for Financial Services. We see merit in this, and intend to set out proposals that adopt a similar approach.

(ii) Accepted Crypto Tokens

47. On this basis, the DFSA is proposing to introduce an “Accepted Crypto Token” approach. This means that any Person wanting to provide a Financial Service in or from the DIFC, in relation to a Crypto Token or a Crypto Token Derivative, will only be able to do so if the Token is an Accepted Crypto Token, i.e., if the DFSA has accepted it for use in the DIFC. This restriction will also apply to public offers or financial promotions relating to Crypto Tokens or Crypto Token derivatives.
48. For the purpose of determining whether a Crypto Token is an Accepted Crypto Token, and thus suitable for use in the DIFC, the DFSA proposes to consider the factors set out below. Crypto Tokens will be assessed against factors a) – e), and *Fiat* Crypto Tokens against factors a) – f).
49. The set of factors below are of an indicative nature only, setting out our regulatory expectation as to what a Crypto Token shall be able to demonstrate in order for us to be able to consider its suitability. We have not prescribed specific weights or degrees of importance in one factor over another, as that will depend on specific characteristics of the Crypto Token. A Crypto Token failing to meet a single criterion does not mean it is automatically unacceptable. Our assessments will be on a case-by-case basis, but relying on the factors below as our guiding principles.

a) Regulatory status of the Crypto Token in other jurisdictions and the appropriateness of centralised or decentralised governance arrangements:

- status of being green-listed, or otherwise approved as suitable for trading, by regulatory authorities in other jurisdictions;
- history of regulatory examinations elsewhere, in relation to the Crypto Token, over cybersecurity, AML, legal or other regulatory issues;
- presence of regulatory requirements in the jurisdiction where the Crypto Token was established, where the issuer, developing team, foundation, or other key persons behind the Crypto Token are located; and
- where completely decentralised, adequacy of governance arrangements built into the underlying protocol, or the systems and controls in place within a centralised structure, to manage governance risks and conflicts of interest.

b) Size, liquidity and volatility of the Crypto Token, as demonstrated through regulated or unregulated markets internationally:

- maturity of the market in the Token, long history of secondary trading, track record of being traded across different service providers, markets and jurisdictions;
- total supply of Tokens issued, market capitalisation of Tokens traded, pre-determined schedules for issuing or burning Tokens, inflationary or deflationary mechanisms;
- factors affecting the supply and demand in the Token, transparency around significant events affecting price, levels of price volatility and returns; and
- The market liquidity of the Token, daily and weekly trading volumes, changes in the liquidity profile in response to market stress.

c) Sufficient transparency around the technology, protocols and significant stakeholders in the ecosystem around the Crypto Token:

- publicly available information on the developers, founders, miners, significant holders of the Crypto Token, and other key persons behind the project;
- whitepaper publications clearly setting out the propose, use case, development path for the Crypto Token, history of prior initial offerings to the public and the use of funds raised through such offers;
- ability of public access to the blockchain protocol, the workings of the consensus mechanism, open access to records of live updates to the blockchain, publication of smart contract and technology audit reports; and
- ability to hold records of identification, in relation to holders of cryptographic, traceability of Crypto Token balances and transactions, absence of privacy devices and mixer mechanism that may enhance anonymity in the system.

d) Adequacy and suitability of the technology used in relation to the Crypto Token:

- the type of blockchain used, access permissions and rights to amend the protocol, consensus mechanisms and associated environmental costs;
- smart-contract availability, endogenous computational capability, native-Token features and ability to host piggyback Tokens on the blockchain;
- interoperability across various blockchains, limitations associated with transaction validation volumes, timings and costs; and
- technological solutions to collect and protect privacy of user information, monitoring and maintenance of records on user transactions.

e) Risks associated with the use of the Crypto Token, and appropriateness of controls to mitigate these risks:

- AML/CTF risks, whether there is sufficient transparency relating to the Token, and whether there are adequate systems and controls in place to address AML/CTF and broader financial crime risks;
- cybersecurity risks and mitigation controls, history of hacks and thefts involving the Crypto Token, near-miss events and losses from cyber security failures;
- custody risk, systems and controls around wallet management, track record of user compensations arising from operational failures in custody management;
- settlement risk and mitigation measures, efficiencies and limitations in achieving settlement finality when transacting with the Crypto Token, use of external gateways in achieving finality; and

- operational risk and defence mechanisms, systems and controls to prevent, detect and address faulty codes, quality assurance process and risk-reaction systems.
- f) Adequacy arrangements around the reserves, stabilisation and redemption mechanisms of a Crypto Token that purport to be used as a Fiat Crypto Token:
- ability to maintain a stable price by reference to *fiat* currency, price volatility maintained within immediate proximity from the peg (generally, up to 10 basis points) for extended periods of time, absence of price risk associated with holding the Crypto Token;
 - reserves being held in segregated accounts with properly regulated banks or custodians in jurisdictions that meet the FATF standards;
 - reserves solely consisting of cash, where only an insignificant proportion (generally, up to 10 percent) may be held in high-quality liquidity assets, and the reserves are denominated in the reference currency;
 - reserves are greater than the volume of Crypto Tokens in circulation, at all times, which is confirmed by a reputable external auditor through detailed reports published at a reasonable frequency;
 - the Crypto Token cannot be used (i.e., advertised or promoted as an alternative to *fiat* money) beyond the realm of the Financial Services provided to users by regulated entities; and
 - that a person is clearly responsible and liable to the investors of the Crypto Token.

(iii) Acceptance process

50. A person applying for a Crypto Token to be an Accepted Crypto Token, such as the operator of an Exchange or a Multilateral Trading Facility (MTF) or the issuer/creator³ of the Crypto Token, will have to submit details⁴ of the Crypto Token, and an assessment of it against the factors listed above. We note that these factors are by no means exhaustive; if there is other relevant information supporting the use of the Crypto Token, it should also be included.
51. There will be a waiting period while the DFSA deliberates on Crypto Token applications. However, we will engage with relevant parties as to the expected timeframe. Following deliberations, the DFSA will announce whether a Crypto Token is an Accepted Crypto Token or not. A list of Accepted Crypto Tokens will be made available on the DFSA website.⁵
52. If a Crypto Token is rejected, it will be rejected on the basis that the DFSA is not reasonably satisfied that the Crypto Token is suitable for use in or from the DIFC. If the DFSA proposes to reject an application, it will give the applicant an opportunity to make representations in accordance with Schedule 3 to the Regulatory Law 2004. There will then be no appeal from that decision although we may review this once the DFSA has more experience in the operation of this process.
53. For clarity, we do not expect Authorised Persons to make an application to the DFSA if they wish to use a Crypto Token that is already on the Accepted Crypto Token list. Rather, that Crypto Token will be available for immediate use.

³ An issuer in this context is the original issuer of the Crypto Token.

⁴ We will develop an appropriate form for this notification.

⁵ To note, the name of the applicant will not be disclosed.

54. Authorised Persons must immediately notify the DFSA if they become aware of any new event or development that may result in a Crypto Token no longer qualifying as an Accepted Crypto Token. Upon receiving such a notification, or based on its own analysis and at its own initiative, the DFSA may revoke the Accepted Crypto Token status of a Crypto Token, if we reasonably believe that, having regard to the suitability factors, the Crypto Token is no longer suitable for use in the DIFC. In this case, the DFSA will inform the market and remove the Crypto Token from the Accepted Crypto Token list. Authorised Persons should provide sufficient time to their users wishing to unwind their positions and divest their Crypto Tokens that are no longer Accepted Crypto Tokens.

Proposal 4 – Accepted Crypto Tokens

55. We propose to:
- a) introduce an Accepted Crypto Token approach as set out in paragraph 47;
 - b) adopt an Accepted Crypto Token approval process as set out in paragraphs 50 to 53;
 - c) require Authorised Persons to notify the DFSA if they become aware of significant developments that may result in the Crypto Token no longer qualifying as an Accepted Crypto Token; and
 - d) revoke Accepted Crypto Token status if we reasonably believe that, having regard to the listed criteria, the Token is no longer suitable for use.

Please see draft Articles 44A and 62(5A) of the Regulatory Law at Appendix 1, draft GEN Rules 3A.1, 3A.2.1, 3A.3, 11.10.21 at Appendix 3.

Question 5:

Do you agree with our proposals in paragraph 55? If not, why not?

Part III - Financial Promotions

56. Article 41A of the Regulatory Law 2004 (Regulatory Law) contains the Financial Promotions Prohibition. Under that Prohibition, Financial Promotions, that is the marketing of financial products and Financial Services, cannot be undertaken unless the requirements relating to marketing in GEN Chapter 3 are met. These permit Financial Promotions to be made or approved by Authorised Persons and, in very limited circumstances, made by other persons, subject to additional requirements.
57. As we have done for Investment Tokens, we propose to apply the Financial Promotions Prohibition to persons making Financial Promotions in relation to Crypto Tokens. We will also include prohibitions relating to Financial Promotions for Crypto Tokens that are not Accepted Crypto Tokens, Algorithmic Tokens and Privacy Tokens. We also propose to expand the current definition of a Financial Product to include a Crypto Token.

Proposal 5 – Financial Promotions

58. We propose to apply the Financial Promotions requirements in GEN 3 to all activities related to the marketing of Crypto Tokens and to expand the definition of a Financial Product to include a Crypto Token.

Please see draft GEN Rule 2A1.1, Rule 3.2.1 Guidance 7, and Rule 3.3.1(j) at Appendix 3.

Question 6:

Do you agree with our proposal in paragraph 58? If not, why not?

Part IV Regulatory requirements in relation to Crypto Tokens**A. Incorporation and branching**

59. Given the global nature of services relating to Crypto Tokens, and the differing approaches to the regulation of providers offering these services, we are proposing that all entities intending to offer financial services in relation to Crypto Tokens must establish in the DIFC as a Body Corporate and be incorporated under DIFC Law. This means that only subsidiaries of foreign financial institutions (i.e., no branches, including Representative Offices) will be allowed to set up to offer Financial Services in relation to Accepted Crypto Tokens in or from the DIFC. We may revisit this position if and when it becomes appropriate to do so.⁶
60. We would also remind that firms who want to establish in the DIFC and offer Financial Services in relation to Accepted Crypto Tokens that they must comply with GEN 6.5. This means that the day-to-day management and oversight of the business must be carried out in the DIFC, and we would also expect the main operational, control, management and administrative arrangements to be conducted in the DIFC.

Proposal 6 – Incorporation and branching

61. We propose to require those wanting to provide Financial Services in relation to Accepted Crypto Tokens to establish as a Body Corporate and be incorporated under DIFC Law.

Please see draft GEN Rule 7.2.2(7) at Appendix 3 and AMI Rule 2.2.2A, 2.3.1(c), at Appendix 8.

Question 7:

Do you agree with our proposal in paragraph 61? If not, why not?

B. Providing Financial Services in relation to Crypto Tokens*(i) Financial Services*

62. We are proposing to extend the scope of the following Financial Services activities to allow for the provision of services in relation to Crypto Tokens:
- a) Dealing in Investments as Principal;
 - b) Dealing in Investments as Agent;
 - c) Arranging Deals in Investments;
 - d) Managing Assets;

⁶ Many service providers are not currently subject to regulation, are subject to light touch regulation, or are subject to AML/CFT regulation only.

- e) Advising on Financial Products;
 - f) Operating an Exchange;
 - g) Providing Custody;
 - h) Arranging Custody;
 - i) Operating a Clearing House; and
 - j) Operating an Alternative Trading System.
63. This means that any of the Financial Services listed above will be able to be carried out making use of Accepted Crypto Tokens.⁷ We are also proposing to make changes to the AMI and COB modules, to allow for the trading and clearing of Accepted Crypto Tokens. Please see Section C below for further details on these proposals.
64. This also means that all the relevant Rules and Guidance found in, for example, GEN, COB, CIR, AML, PIB, IFR, and GLO⁸, and other parts of the DFSA Rulebook will be applicable, subject to additional requirements (set out below). We have also introduced a number of new terms to cover this expanded scope: for example; “Crypto Token Business”, “Crypto Token Derivative” and “Client Crypto Token”.
65. As noted under Proposal 6, we are not proposing to allow Representative Offices to promote any Crypto Token-related products or services. This is due to the online nature of these products and services and the inability to understand exactly where that product or service is being provided.
66. Following queries received, including comments in response to CP138, we will give further consideration to crowdfunding platforms and their ability to use Crypto Tokens. This will be considered as part of the planned review of the crowdfunding regime. Until then, we are not proposing to allow Operators of Crowdfunding Platforms to provide any products or services involving any Crypto Tokens.
67. Lastly, we are considering whether Authorised Firms may hold Accepted Crypto Tokens for their own account on their own balance sheet, and what the treatment of these exposures should be. The BIS has issued preliminary proposals on the prudential treatment of credit institutions’ exposures to Crypto Tokens⁹. The range of proposals span across governance and risk management requirements, regulatory disclosures, liquidity and capital adequacy standards. A notable feature is the proposal to deduct (or risk-weight at 1250%) any exposures to Tokens from regulatory capital. We propose to adopt these standards, and will adjust our regime in line with them, when they are finalised and issued.
- (ii) Variation of licence*
68. An Authorised Person seeking to provide one or more of the Financial Services listed above in relation to Crypto Tokens would need to apply to the DFSA to vary, or amend, their DFSA licence. Firms will also have to perform, as per the Accepted Crypto Token

⁷ While not set out in the list of Financial Services activities in paragraph 62, a Fund Administrator can provide services in relation to Crypto Tokens, for example, where it provides services to a Fund investing in Crypto Tokens.

⁸ This list of modules is not exhaustive.

⁹ <https://www.bis.org/bcbs/publ/d519.htm>.

proposals, an assessment against the factors listed and submit the details of any type of Crypto Token for which they are seeking DFSA approval. If the Crypto Token is already on the Accepted Crypto Token List, further approval will not be required.

69. We expect, as part of our supervisory reviews, to see the following information:
- a) changes made to the Regulatory Business Plan (RBP) to describe the basis of, and rationale for, the proposed change to offer Crypto Token Business;
 - b) updates to the Business Continuity Plan (BCP) and AML Risk Assessments to reflect the Financial Services to be offered in respect of Crypto Tokens; and
 - c) revised financial information, including consideration of whether the firm's regulatory capital, for example, may be affected.
70. We would want to see thorough, well thought out updates and changes to existing RBPs, BCPs and manuals, which address the risks identified in this market. We would also remind Authorised Persons that they will need to ensure that they meet GEN 7 requirements relating to fitness and propriety, compliance arrangements and, importantly, that Authorised Individuals have the appropriate expertise and competence to carry out their roles.
71. Lastly, we would remind Authorised Firms engaging with Crypto Tokens as part of their Arranging or Dealing activities that they should not design or structure their operations, user interface, website, marketing materials and any communication in a way that may create any impression that they are running a trading facility for Crypto Tokens. For that, they would need to get the relevant licence. The use of terms such as 'marketplace', 'market' and 'platform' to describe services offered is unhelpful and potentially misleading and we propose to restrict the use of these, and similar, terms.

(iii) Providing Money Services

72. The DFSA's Money Service regime was introduced in January 2020 to allow a variety of (previously prohibited) activities to be carried out in or from the DIFC. We took a cautious approach to that regulation and have always been clear that this regime did not include any activities involving Crypto Tokens, although digital currencies that are legal tender could form part of that. Since then, we have had interest from Money Services firms who want to offer their clients access to payments, remittances, and wallet services both in *fiat* currency and in Crypto Tokens.
73. At this stage, we are not intending to allow Money Services firms to provide services relating to both *fiat* currency and Crypto Tokens as we believe more time is needed for that sector to fully embed, and apply, the current Money Services requirements.
74. However, we acknowledge that blockchain technology can have many advantages over traditional ways of making transfers or executing payments. With that in mind, we are proposing that Money Service Providers are permitted to use blockchain (and associated native Tokens required to operate on the blockchain) for a limited purpose. This would be where the blockchain and native Tokens are used as a technology platform that is a back-office operation, without exposing the client to the Token.
75. This would be on the basis that:
- a) they are only used for the purposes of money transmission or executing payment transactions;

- b) the originator and beneficiary of these transactions continues to operate in *fiat* currency; and
 - c) there is no exposure for the Client to the Crypto Tokens used in the process.
76. We would invite views on the practicalities of allowing such an activity to happen, and any other risks that would need to be addressed.

(iv) Providing Financial Services in relation to Accepted Crypto Tokens and Excluded Tokens

77. We are not proposing to allow any Authorised Persons to provide services in relation to both Accepted Crypto Tokens and Excluded Tokens from the same legal entity. This is to avoid any confusion that Excluded Tokens are regulated in a similar manner to Crypto Tokens, or that both services fall under the same regulatory umbrella and scrutiny. However, we are interested to obtain views on whether licenced Custodians should be allowed to provide services in relation to both Accepted Crypto Tokens and Excluded Tokens.

Proposal 7 – Providing a Financial Service in relation to Crypto Tokens

78. We propose to:
- a) allow the Financial Services listed in paragraph 62 to be provided in relation to Crypto Tokens;
 - b) not allow Operators of Crowdfunding Platforms to use Crypto Tokens in the provision of products or services;
 - c) not permit any Representative Offices to market activities related to Crypto Tokens;
 - d) not allow any Money Service Providers to provide services in relation to Crypto Tokens, other than to allow them to use DLT and native Tokens within the limitations in paragraphs 74 & 75; and
 - e) not allow any Authorised Person to provide services in relation to both Crypto Tokens and Excluded Tokens. However, we seek views on whether a licenced Custodian should be exempted from this proposal.

Please see draft Article 44A of the Regulatory Law at Appendix 1, draft GEN Rules 2.2.10F(c), 2.6, 2.7, 2.8, 2.9, 2.10, 2.11.1(4), 2.13, 2.17, 2.18, 2.22, 2.26(4), 3A.1.1(c), 3A.2.4 and 3A.2.5 at Appendix 3 and draft COB 15.7.5 at Appendix 4.

Questions:

8: Do you agree with our proposals in paragraph 78? If not, why not?

9. Should Custodians be allowed to provide Financial Services in relation to both Accepted and Excluded Tokens? If not, why not?

79. Sections C - E propose additional regulatory requirements in respect of:
- a) Venues which allow for the trading and clearing of Accepted Crypto Tokens;
 - b) Collective Investment Funds; and

- c) Safeguarding and administration.

C. Requirements for venues which allow for the trading and clearing of Crypto Tokens

(i) Operating a trading venue

80. The DFSA regime allows for the following activities for the trading of Investments:
- a) a Person can conduct the Financial Service of Operating an Exchange and to do so must be licenced as an AMI; and
 - b) a Person can conduct the activity of operating a Multilateral Trading Facility (MTF) or an Organised Trading Facility (OTF) and to do so must be licenced as an Operator of an Alternative Trading System (ATS), or be licenced as an AMI and operate an MTF on the basis of an endorsement on its licence.
81. In CP138, we extended these Financial Services to include activities related to Investment Tokens. We have not identified any major differences between the trading of Investment Tokens and Crypto Tokens. Therefore, we propose to extend these Financial Services even further to allow for the trading of Accepted Crypto Tokens.
82. However, we would propose to limit the trading of Crypto Tokens in the following ways:
- a) we are not proposing at this stage to allow trading of Crypto Tokens through an OTF due to the discretionary rules associated with this model. Crypto Token markets are at a nascent stage of development, have direct-access membership for Retail Clients (which is discussed later in this CP) and, most importantly, were initially created to be decentralised from any intrusive authority. We have not seen in our benchmarking study a jurisdiction that has proposed to use a discretionary trading model for trading;
 - b) we are proposing to explicitly prohibit AMIs or MTFs from trading on own account, against proprietary capital, in the market venue that they are operating
 - c) we are not minded to allow the same operator to organise a trading venue for Crypto Tokens and Investments or Investments Tokens from the same legal entity.¹⁰ However, there may be particular trading facilities that are properly resourced, have appropriate Chinese walls, expertise and understanding to manage these risks, in which case, we will look at the applications and take a case-by-case decision; and
 - d) we do not propose to allow any trading facilities to operate under the Innovation Testing Licence (ITL). However, we may place some restrictions and conditions on trading venues, at least in the early stages of their operations, until we get more comfort in their ability to meet our regulatory requirements.

Proposal 8 – Operating a trading venue

83. We propose to extend the current regime for trading and clearing of Investments and Investment Tokens to allow for the trading of Crypto Tokens with the following limitations:

¹⁰ These markets are very different (for example, the governance, management skills and knowledge and risk frameworks required) and so any operator of an AMI or ATS that wishes to trade both Investment (and Investment Tokens) and Crypto Tokens would be required to do this through separate legal entities.

- a) trading of Crypto Tokens may not take place on an OTF;
- b) trading on own account by the operator of the market is prohibited on that venue;
- c) the ITL cannot be used for trading activity in Crypto Tokens;
- d) an operator may not combine the trading of Crypto Token and Investment (Token) within the same legal entity structure (unless proper arrangements are in place).

Please see draft GEN section 2.17, 2.18 and 2.22 at Appendix 4, draft COB Rule 9.7.1 at Appendix 4, and draft AMI Rule 5.8.1 at Appendix 8.

Question 10:

Do you agree with the proposals set out in paragraph 83? If not, why not?

(ii) Clearing and Settlement

84. When formulating our policy approach in CP138, we acknowledged that, in essence, issues related to clearing and settlement of traditional securities are not significantly different from those related to post-trade processes involving Tokens. Material differences arise from the use of decentralised ledgers and blockchain technologies used for clearing and settlement, and whether emerging technologies are capable of removing any settlement or counterparty risk inherent to the trading process.
85. In CP138, we then discussed the differences between private (centralised) and public (decentralised) blockchains, and how these might affect the profile of known risks in the post-trading environment.¹¹ Given the high risks associated with fully decentralised finance, we concluded that the DFSA would still require full accountability to address settlement, counterparty, market integrity and consumer protection risks in the post-trade equation.
86. However, considering the plethora of technological solutions available to operators for designing their clearing and settlement processes (such as off-chain settlement systems, smart contracts and atomic swaps, interoperability solutions between Token and cash environments, order internalisation mechanisms), we agreed to adopt a case-by-case approach when it comes to assessing the appropriateness of clearing and settlement arrangements implemented by the operator.¹²
87. In this CP, we do not intend to divert from our initial policy position but intend to clarify our expectations as to what proper clearing and settlement arrangements will look like for trading venues trading Accepted Crypto Tokens.¹³ Effectively, we still expect to see a Clearing House interposing itself between counterparties to the trade. Alternatively, we expect to see an air-tight blockchain solution in place that removes the known risks between counterparties to the trade, effectively taking on the role of traditional Central

¹¹ See paragraphs 50-54 and 110-121 of the DFSA's CP138.

¹² Operators of trading venues are required to comply with proper clearing and settlement arrangement requirements in AMI 6.10 and COB 9.6.11, depending on whether the operator is licenced as an AMI or Authorised Firm, respectively. Operators must ensure that users and members having access to its facility are informed of their arrangements.

¹³ We also note that, where clearing and settlement in Investment Tokens is not materially different from the post-trade environment around Crypto Tokens (i.e., decentralised ledgers, use of blockchain technology, title transfer and custody through digital wallets), any proposals provided here will be applicable to both Investment Tokens and Crypto Tokens. We had indicated in CP138 that we would provide further guidance on this topic, which we are doing as part of this paper.

Securities Depositories and Securities Settlement Systems.¹⁴ More details are set out below.

Scenario A: Central Counterparties

88. The first port of call for a trading venue operator is to have proper Central Counterparty (CCP) arrangements to clear the trades against. In many ways, we expect that this would be similar to the traditional model, which generally involves prior netting of transactions. This is where clearing members receive a 'cash leg' and a 'security leg' instruction for all transactions executed by their clients on that day, with the novation of the transactions, if the clearing house assumes the role of the central counterparty.
89. In this instance, if the operator of the trading venue is licenced as a MTF, they should clear the trades against a Clearing House regulated by the DFSA or obtain analogous services from an appropriately regulated entity to carry out that function. If the operator is set up as an AMI, they may choose to clear the trades externally through a DFSA-regulated Clearing House (or an equivalent overseas entity) or, alternatively, apply themselves to also act as a Clearing House.
90. Having said that, in reality, we are not aware of a clearing model for Crypto Tokens where the operator would mitigate counterparty risk by novation of matched contracts through the introduction of a CCP. We realise that due to a combination of various reasons (lack of coherent regulation, absence of service providers, immature technologies and business models, interpretability issues between *fiat* and token markets), operators may not be able to demonstrate proper clearing arrangements through a CCP, at this stage. Where this is not possible, for reasons beyond an operator's control, we will look into the remaining scenarios below to satisfy ourselves of the appropriateness of the operator's post-trade systems-and-control arrangements.

Scenario B: Technological excellence

91. We do not rule out the possibility that now, or at some point in the future, we may receive applications from operators of trading venues who are able to demonstrate technological excellence that overcomes the current limitations of transaction settlement. Effectively, this would mean demonstration of real-time on-chain functionality that leads to an immediate reflection of trades across various blockchains, with instant settlement finality and irrevocability of trades. In this instance, we would conclude that the operator, irrespective of being licenced as an AMI or MTF, would satisfy our clearing and settlement requirements in the relevant parts of the AMI and COB modules.
92. However, despite popular beliefs that blockchain technologies are able to achieve technological excellence in the meaning described above, we have not seen, in our fact-finding exercise, any operator that would have successfully implemented a real-time on-chain settlement model. Quite the opposite, until workable solutions are found around the fundamental problems of distributed ledgers (e.g., scalability, security, high fees, environmental costs), we might not see a real-time on-chain settlement process soon.
93. At the moment, settlement and counterparty risk is not completely removed from the market, and the risk (when it comes to spot trading, at minimum) is largely sitting within trading counterparties. We have seen examples where an operator will provide a

¹⁴ Currently, under our licensing regime, an AMI licenced as a Clearing House may perform the functions by becoming a central counterparty to the transactions (CCP), or by operating a Securities Settlement System (SSS) or Central Securities Depository (CSD), with the latter two being facilities where transactions are recorded or cleared, without the operator of the facility stepping in as a counterparty.

disclaimer to their clients, stating that orders and transactions may show a “pending” status due to delays in blockchain validation process, which – from what we have seen – may take between 1 and 6 hours (up to 48, in rare cases) on most occasions. The operator will often explain to their clients why some trades may fail, for example, due to double spending attempts, insufficient balances, or network latency.

94. We do not know how reliable these arrangements are and at what frequency and magnitude they fail, causing potentially harm to token markets and consumer. A single failure in a trade may not have serious consequences for a client that trades occasionally, but failures in multiple trades may have significant consequences for a Professional Client or a Market Counterparty who may have lined up various orders in a trading strategy. We have observed that rapid and extreme declines in Crypto Token prices have consistently coincided with a large number of delayed and cancelled transactions, often times as many as to cause disruption in the daily operations of leading token trading facilities internationally.

Scenario C: Capital requirements

95. We believe that the vast majority of (mostly unregulated) trading venues operating internationally would fall into this scenario. This is where the operator is unable to clear the trades against a CCP or demonstrate a real-time on-chain settlement arrangement. Thus, transactions are usually cleared off-chain, while it can then take several hours, if not longer, before the relevant blockchains are updated to reflect the latest transactions.
96. In this case, we believe that it is unacceptable for the settlement and counterparty risks to be outside of the operator’s accountability. The known risks should not be sitting with trading counterparties for the reasons described in the scenario above. Moreover, in order-matching markets, trading counterparties do not usually know who they are trading against, and so are not in a position to price their risk before entering into a transaction.
97. We expect that the operator, irrespective of being licenced as an AMI or a MTF, should hold sufficient financial resources (‘clearing guarantee fund’) to cover the settlement and counterparty risk from the system. We would expect the operator to:
- a) assess the risks associated with clearing and settlement on the trading venue;
 - b) calculate the amount of the clearing guarantee fund that they need to hold;
 - c) recalibrate the figures in base and stress scenarios, for both spot and futures trades;
 - d) at all times, maintain enough capital resources to cover any draw-downs on the fund, over and above the buffers required to meet the minimum regulatory capital; and
 - e) on an annual basis, present for the DFSA’s approval their methodology for and results of assessing the clearing and settlement risks, calculating the fund, designing the stress scenario, and planning the level of capital adequacy.
98. Upon the assessment of these arrangements, we may ask the operator to present additional information or submit new reports, as well as require them to stop certain operations or hold more capital and liquidity, where required.
99. Without limiting the application of our general systems and controls requirements, as well as technology rules applicable to token operations, we will expect that the operator

has additional arrangements to control the clearing and settlement risk in order to minimise the chance of draw-down on the clearing guarantee fund. This would include, at minimum:

- a) on-chain periodic clearing and settlement arrangements, where intra-day is the default option for the reflection of trading activity on any blockchain;
- b) account monitoring tools to detect users who are more likely than others to fail on their orders, and enforce dissuasive actions against them (e.g., higher trading fees, penalties, temporary trading suspensions);
- c) technology solutions that enable pre-validation checks and control over both legs of the trade, for example, through a temporary hold on accounts and private keys of trading counterparties;
- d) where pre-validation controls are failing, adequate margin requirements or other mechanisms that could act as a defence against default, either technical or financial; and
- e) procedures for dealing with technical disruptions, for cancellation, amendment or correction of orders or matched transactions, or for unwinding trades, where needed.

100. We acknowledge that, in some cases, compliance with the above requirements may be achieved in ways that are technically different from what we have specified, but in essence similar in order to ensure the same regulatory outcome. In those cases, we will engage with the operator of the trading venue to understand how these requirements can be met.

101. Exemptions may need to be allowed in this situation, for example, in respect of less liquid Crypto Tokens, and we will need to work with the trading facility to understand how these exemptions will apply.

102. We also intend to look closely at the quality of disclosures made to clients of the trading venue about the clearing and settlement arrangements in place, and the operator's accountability in that sense. Unambiguous and clear communication will likely lead to a satisfactory regulatory outcome.

Settlement instruments

103. One of the friction points in the market infrastructure of blockchain-based finance is the inability to host *fiat* currency on trading venues, and vice versa. The introduction of *Fiat-Crypto Tokens* came about to bridge the gap between the two different settlement platforms. However, regulators around the world have approached *Fiat-Crypto Tokens* with caution. Rightly so, as there are not many arrangements that can meet any minimum requirement for transparency, stability or financial soundness.

104. At the same time, we understand that *Fiat-Crypto Tokens* are a necessary instrument for on/off ramp access to wallets and market, as well as a means for transfers of Crypto Tokens across blockchains. With that in mind, we have put forward minimum criteria, as we describe earlier in this CP, through which we will assess the suitability of these Crypto Tokens that can be used in or from the DIFC.

105. We note that, although not many regulators have put forward specific requirements around *Fiat-Crypto Tokens* and their use in Crypto Token markets, we aim to future-

proof our regime and permit the use of *Fiat*-Crypto Tokens as an instrument for clearing and settlement purposes. To do so, we must first assess that the *Fiat* Crypto Tokens can be considered an Accepted Crypto Token. Secondly, we will consider expanding the money settlement requirements in AMI 7.2.5 to include a *Fiat* Crypto Token as a permitted instrument for settlement purpose. The Accepted Crypto Token must be void of any market, credit or liquidity risk on a global basis, in order to truly become a cross-border settlement instrument. Apart from the requirements in AMI 7.2.5, which we will consider expanding for AMIs operating with Crypto Tokens, we would like to consult on this issue and gather market sentiment whether the industry is using qualifying *Fiat* Crypto Tokens, both from the perspective of technology and regulation.

106. In our benchmarking, we refer to the FSB's recommendations on global Stablecoin arrangements and the BIS consultative report on the application of principles for financial market infrastructures to Stablecoin arrangements. According to FSB and BIS, Stablecoin arrangements need to develop certain characteristics in order to develop into global settlement arrangements (GSA):
- a) comprehensive governance framework with a clear allocation of accountability for the functions and activities of the GSA;
 - b) effective risk management frameworks with regard to reserve management, operational resilience, cyber security, AML/CFT and 'fit and proper' requirements;
 - c) robust systems for collecting, storing and safeguarding data, as well as appropriate recovery and resolution plans;
 - d) comprehensive and transparent disclosures on the functioning of the GSA, including with respect to its stabilisation, reservation and redemption mechanisms;
 - e) settlement finality features, demonstrated through clear definitions of technical finality and the point of irrevocability, transparent mechanisms for reconciling misalignments between technical settlement and legal finality; and
 - f) money settlement features, demonstrated with absence of market, credit or liquidity risk, including through a direct legal claim on the issuer or in the underlying reserve assets, timely convertibility at par into other liquid assets, clear and robust process for fulfilling holders' claims in both normal and stressed times.
107. We conclude, that in order for a *Fiat*-Crypto Token to be used as a money settlement instrument, we would expect the token to meet our suitability criteria and demonstrate the FSB/BIS characteristics in order to qualify as a settlement instrument, alongside *fiat* currency.

Proposal 9 – Clearing & settlement

108. We propose that:
- a) operators of a trading venue have an option to demonstrate the appropriateness of their clearing and settlement arrangements through involvement of a CCP, or use of technology excellence that removes settlement and counterparty risk from the system;
 - b) alternatively, the operator will be expected to have a clearing guarantee fund, the workings of which needs to be presented for the DFSA's approval (additional

systems and controls will apply to minimise the risk of draw-down on the fund); and

- c) Crypto Tokens accepted by the DFSA may be used as a money settlement instrument together with the traditional way of settling with *fiat* currencies.

Please see draft AMI 6.10 and 7.2.5A at Appendix 8.

Question 11:

Do you agree with the proposals we have set out in paragraph 108? If not, why, and what alternative would you suggest?

(iii) Clearing House

109. At this point in time, we have not observed any material differences, in terms of technology or governance, between clearing of Investment Tokens or Crypto Tokens.¹⁵ Therefore, we intend to extend the capacity of the existing AMI licence for a Clearing House to clear trades not only in Investment Tokens, but in Accepted Crypto Tokens, as well. To that end, we will amend the instrument admission rules in AMI 5.8 to accommodate Crypto Tokens. Admission rules for clearing should be the same as those for a conventional trading facility.
110. We have noted that some Crypto Tokens are riskier in nature than Investment Tokens, and so a Clearing House, which acts as a CCP, must adjust its risk management framework when it comes to the assessment of credit and market risk, especially if trading activity takes on a significant level.

Proposal 10 – Clearing House

111. We propose to amend AMI 5.8 to accommodate the clearing of Crypto Tokens.

Please see draft GEN 2.18 at Appendix 3, and AMI Rules 5.8.1 and 7.1 Guidance 4 at Appendix 8.

Question 12:

Do you agree with the proposal in paragraph 111? If not, why not?

(iv) Direct access to Crypto Token trading venues

112. Direct access to trading venues has historically not been allowed, rather access was based on an intermediated model of trading limited to Authorised Firms or a Recognised Person. In CP138, we proposed allowing direct access members to trade Investment Tokens provided the operator of the trading facility had adequate systems and controls in place to address, for example, market abuse, AML/CFT and consumer protection. These requirements are now set out in AMI 5A.3 (for AMIs) and COB 14.2 (for MTFs), setting out that an Operator must (this list is not exhaustive):

¹⁵ In the case of Crypto Tokens, acting as a Central Counterparty is the only Clearing House activity relevant to Crypto Tokens, as providing a Securities Settlement System or acting as a Central Securities Depository are relevant only to Investments and Securities. For Crypto Tokens, transfers of the Crypto Tokens take place by means of Distributed Ledger Technology or other similar technology.

- a) treat each Direct Access Member as its Client;
 - b) ensure that its Business Rules clearly set out the duties owed by the trading facility and how they will be accountable for any failure to fulfil those duties; and also the duties owed by the Direct Access Members and how they will be accountable for any failure to fulfil those duties;
 - c) put in place appropriate redress mechanisms;
 - d) have prominent disclosure of the risks associated with DLT for trading and clearing, particularly those relating to Digital Wallets and the risks relating to holding private cryptographic keys.
 - e) clearly identify those accessing the facility for trading, and to undertake appropriate CDD to address ML/TF risks;
 - f) put in place mechanisms to detect and address market manipulation and abuse;
 - g) have mechanisms to identify and distinguish orders that are placed by persons using direct access to trade in Tokens and, if necessary, the ability to stop order of, or trading by, persons allowed direct access; and
 - h) set out clear lines of accountability, and disclosure of investor redress mechanisms, available to persons trading on the facility.
113. As the market for the trading of Crypto Tokens is predicated on access being granted directly to users, not via intermediaries, we propose to adopt a direct access model for the trading of Crypto Tokens. However, we would invite comment on whether this approach causes any difficulties, or if there are gaps that we have not identified.
114. While not directly relevant to these policy proposals, when we consulted in CP138, we asked if direct member access should be allowed in respect of conventional trading markets as well as in respect of Investment Token markets. We received support for this proposal, and we would like to take the opportunity to say that we will handle any applications to provide direct access in respect of conventional trading markets on a case-by-case basis.

Proposal 11 – Direct access to Crypto Token trading venues

115. We propose to allow a direct access trading model for the trading of Accepted Crypto Tokens and seek comment on whether this approach causes any concerns that need to be addressed.

Please see draft COB Rule 9.3.1(1) and section 15.3 at Appendix 4 and draft AMI Rule 5.7.2(1) and section 5B.3 at Appendix 8.

Questions:

- 13. Do you agree with our proposal to permit direct access members to trade on venues offering Accepted Crypto Tokens?**
- 14. Are there any other concerns which need to be addressed in permitting direct access members to trade on venues offering Accepted Crypto Tokens? What are they, and how should they be addressed?**

*(v) IT Security*Technology governance

116. In CP138, we proposed technology governance requirements covering the DLT, or similar technology, adopted by the operator of a trading venue. These are set out in COB 14.1 and referred to in AMI 5A.2. They include requirements for the trading venue to have regard to, for example, procedures to deal with forks (hard or soft), security measures and procedures for the safe storage and transmission of data. We intend to apply the same measures to operators who providing Crypto Token trading venues.

Independent audit of technology governance

117. In CP138, we also put forward a proposal for an independent technology audit to be carried out to provide assurance to the Board of the trading venue, and to the DFSA, that the technology governance requirements were indeed met and adhered to.¹⁶
118. We got feedback on those proposals from respondents who said that the audit requirement should be optional due to the costs involved, that the “big four” did not have capabilities in this area, and that self-certification should be an option. We disagree - we did not believe that an audit requirement like this should be optional, given the dependence on technology in Crypto Token trading venues. We would also like to clarify that this audit does not have to be undertaken by a large audit firm but can be provided by an independent cybersecurity specialist with the relevant expertise. However, we appreciate that this is a rapidly evolving area and propose, as is our normal practice, to monitor emerging international best practice in this area.
119. Therefore, we intend to apply the requirement for an annual technology audit to be carried out, and the associated requirements relating to the relevant expertise of the auditor, the production of a written report, and the submission of the audit report to the DFSA, to all operators of Crypto Token trading venues.

Proposal 12 – IT Security

120. We propose to require all operator’s of Crypto Token trading venues to put in place technology governance requirements as per paragraph 119 and to carry out an annual technology audit report while submitting the report to the DFSA as discussed in paragraphs 117 – 119.

Please see draft COB sections 15.2 and 15.8 at Appendix 4, and draft AMI sections 5B.2 and 5B.6 at Appendix 8.

Question 15:

Do you agree with our proposals set out in paragraph 120? If not, why not?

(vi) Proper Markets

121. The current DFSA requirements set out that an operator of a trading facility is required to have rules and procedures to ensure only Investments (Securities or Derivatives) in which there is a ‘proper market’ are traded on its venues¹⁷. The proper market concept encompasses information relating to the relevant Investments being available to persons

¹⁶ COB 14.5

¹⁷ See COB 9.6 and AMI 6.2.

dealing in them on an equitable basis, including pre-trade and post-trade orders, adequate controls to manage volatility (e.g., due to speculation), and so on, and adequate mechanisms to discontinue, suspend or remove investments that do not meet the proper markets requirements.

122. We considered these requirements in respect of Investment Tokens in CP138, where we noted there could be some practical difficulties in their application, where there are delays in confirmation of transactions (preventing disclosure in real-time) for various reasons when using DLT, for example, due to a fork, resulting from a change to the protocol used in the DLT application used by the operator of the market, or due to the average time that it may take to add new blocks on purely decentralised blockchain platforms.
123. Following that CP, we chose to apply these requirements, and said we would address any practical issues, as they arose, with guidance. We propose to take the same approach for Crypto Tokens, but again would seek views on whether there are areas which require additional rules or guidance to address practical issues arising as a result of DLT or similar technology.

Proposal 13 – Proper Markets

124. We propose to apply the Proper Markets requirements to trading venues trading Accepted Crypto Tokens and seek comment on whether there are any practical issues which need to be addressed with such a proposal.

Please see draft COB 9.2.1(1)(e) and section 9.6 at Appendix 4, and draft AMI section 6.2 at Appendix 8.

Question 16:

Do you agree with our proposal to apply the Proper Markets requirements to venues that trade Accepted Crypto Tokens? If not, what practical issues do you foresee with such a proposal and what alternative would you suggest?

(vii) Business Rules and Operating Rules

125. Under the current regime, the relationship between persons trading on an AMI or ATS, who are regulated intermediaries, is governed by the Business Rules or Operating Rules of the relevant AMI or ATS. With the proposal to allow Direct Access Members to trade on these venues, where Accepted Crypto Tokens are admitted for trading, some of the obligations that are placed on the intermediary need to be adjusted (as we did for Investment Tokens), so that these obligations become the obligations or duties of the operator of the venue.
126. We propose to adopt the same obligations for Crypto Tokens as set out in AMI 5A.3 and COB 14.2 and which include:
- a) undertake a client classification of each Client;
 - b) enter into an agreement with direct access Clients to ensure that those Clients comply with the business or operating rules of the venue/operator; and
 - c) undertake monitoring to ensure that Clients having direct access abide by the business or operating rules.

127. We would also propose that the operator of an AMI or MTF sets out any access restrictions in the business or operating rules, for example, that an Exchange or MTF should not be accessed by any person subject to a restricted jurisdiction (i.e., due to their nationality and/or place of residence).

Proposal 14 – Business Rules and Operating Rules

128. We propose that the requirements relating to business or operating rules of an AMI or MTF as set out in AMI 5A.3 and COB 14.2 be applied where venue allows buyers and sellers to be direct access participants on that trading venue.

Please see draft COB Rules 9.3.1(1)(e) and section 15.3 at Appendix 4 and draft AMI Rules 5.6.1, 5.7.2(1)(d) and section 5B.3 at Appendix 8.

Question 17:

Do you agree with our proposal to apply the requirements relating to Business and Operating Rules, subject to adaptations, to operators of trading venues where they allow direct access members? If not, why not?

(viii) Admission Criteria

129. As set out in Part II, we are proposing an Accepted Crypto Token approach which means that any person proposing to conduct a regulated activity in relation to a Crypto Token or make a public offer of the Crypto Token, will have to perform an assessment against specific criteria and submit the details of each Crypto Token for which they are seeking DFSA approval. The DFSA will then need to consider the submission and decide whether to approve or not approve that Crypto Token for use in the DIFC (unless it is already on the Accepted Crypto Token list).
130. This proposal results in the need to amend some of the current requirements, found in AMI 5 and COB 9, in respect of trading on an AMI or an MTF in order to allow for the trading of Accepted Crypto Tokens.

References to Reporting Entities

131. The Listing Rules in MKT contain a range of qualifying and ongoing criteria that need to be met by a Security and the issuer (or the person responsible for the listing application) of those Securities to be eligible for admission to the List, and to maintain such admission.¹⁸ Once listed, the Reporting Entity is required to ensure that all necessary information and facilities are available to its shareholders to enable them to exercise the rights attaching to their holdings on a well-informed basis.
132. There are no Reporting Entities in respect of Crypto Tokens, or not as we typically know them, as the process for issuing a Crypto Token is different. The person or persons developing or providing technology for the creation of the Crypto Tokens are usually (if not always) not the person or persons offering those Crypto Tokens or applying to list and trade those Crypto Tokens on a facility. Further, Crypto Tokens are generated by a competitive and decentralised process (mining), which involves rewarding individuals for their services. Therefore, on the face of it, it does not appear that these requirements (designed for traditional issuer companies) would apply to those who create and/or issue Crypto Tokens. Further, as per the proposals in Part II, the DFSA is planning to approve

¹⁸ MKT Chapter 9

“Accepted Crypto Tokens” that meet certain criteria thus negating many of these requirements.

133. On this basis, we propose not to apply the Reporting Entity and Listing requirements for Crypto Tokens and seek input on any practical implications of this proposal.

Proposal 15 – Admission criteria

134. We propose to:

- a) amend the criteria set out in AMI 5.8 and COB 9.4 to allow for the trading of Crypto Tokens; and
- b) not apply the requirements in MKT in relation to Reporting Entities and Listing and seek feedback on the practical implication of this proposal.

Please see draft COB Rules 9.2.1(1)(c) and 9.4.1 at Appendix 4 and draft AMI Rule 5.8.1 at Appendix 8.

Question 18:

Do you agree with the proposals we set out in paragraph 134? If not, why not, and what practical difficulties do you think would arise?

(ix) On-going disclosures

135. Unlike traditional securities, the value of Crypto Tokens do not directly depend on the financial performance of an issuer. Typically, there is not a body corporate behind the issuance of these Crypto Tokens and, when there is, it is not the cash flows generated and dividends distributed by these firms that impact the price. The price will generally depend on the interaction of the demand and supply forces, which are driven by users’ adoption of the solution offered within that Crypto Token, or the promising nature of the technology uses, or pure speculation.
136. In order to make an informed judgement whether to buy or sell a Crypto Token, clients of a trading facility need on-going information on factors that may impact the price of the Crypto Token they are holding or about to purchase. We believe that, in addition to requiring a Key Features Document (set out in paragraph 185), and permitting the disclosure of the Crypto Token whitepaper, on-going information should be made available by the trading facility to their clients, including information that is up-to-date and relevant to the user.
137. On this basis, we are proposing that an AMI or ATS, at a minimum, make the following data available (on any channel through which they do Crypto Token-related business) in relation to each Accepted Crypto Token offered on their platform:
- a) total supply of the Accepted Crypto Token, including where the supply is set to increase/decrease following a pre-defined path;
 - b) total number and market capitalisation of the Accepted Crypto Token being traded on markets globally;
 - c) the workings and schedule of any inflationary/deflationary mechanisms (i.e., issuing and burning Crypto Tokens) taking place, other than through the normal mining process;

- d) total number of the Accepted Crypto Token being held by the developing team, held in reserves for rewards and other promotional mechanisms, or otherwise locked away from the total supply; and
 - e) the breakdown of largest holders in the Accepted Crypto Token across the native / largest blockchains (those holding 10% or more of total supply).¹⁹
138. This is not an exhaustive list; if an operator wishes to publish additional, relevant and up to date information regarding the Accepted Crypto Tokens traded on their venue, they can do so. We may also make refinements to this list in the light of experience.

Proposal 16 – On-going disclosures

139. We propose than an operator of a trading facility provides on-going disclosure to clients of the facility as set out in paragraph 137.

Please see draft COB Rule 15.4.3 at Appendix 4, and draft AMI Rule 5B.4.3 at Appendix 8.

Question 19:

Do you agree with the proposals for on-going disclosures? If not, why not?

D. Collective Investment Funds

(i) Name of Fund

140. We are proposing that a Fund will only be able to hold itself out, either in its marketing material or offer documents, as being a Crypto Token Fund if its main purpose is investing in Accepted Crypto Tokens.

(ii) Disclosures

141. Where Units in a Fund are offered to the public, a Prospectus must be produced as per the requirements in CIR 14. When developing our proposals for Investment Tokens, we added further disclosure requirements, which can be found in CIR 14.3 and MKT App 7, where the:
- a) Units in a Fund were Security Tokens, or
 - b) where 10% or more of the gross asset value of the Fund Property consisted of Investment Tokens.
142. We are aware that there are Funds that hold Crypto Tokens, which may make up either all the Fund Property or a percentage of the Fund Property. In this instance, we would also propose to apply additional disclosure requirements to be included in the Prospectus.
143. Unlike our approach for Investment Tokens, we are not proposing to apply a *de minimis*²⁰ threshold for these additional requirements for two main reasons:

¹⁹ An operator will not be required to disclose the identity of the holder in point e) if they have taken reasonable steps to obtain that information but have been unable to.

²⁰ Additional rules (namely, disclosure requirements) were applied if more than 10% of the underlying assets were Investment Tokens.

- a) Crypto Tokens represent a nascent industry, which is neither mature nor transparent enough for markets to easily decipher; and
 - b) some Crypto Tokens pose serious challenges when it comes to valuation. In the absence of reliable valuation methods and highly volatile prices, it would be practically impossible to set a certain threshold and monitor the compliance with additional requirements when that threshold is breached, and then met, on an ongoing basis.
144. In addition to complying with the CIR requirements relating to a Prospectus²¹, we would also propose to apply the following requirements in MKT App7.1.2(a), (c), (e), (h), (i), and (j) to a Fund that has Accepted Crypto Tokens as Fund Property. The information includes, for example, information about:
- a) the essential characteristics of the Accepted Crypto Token or Crypto Tokens that make up the Fund Property, and if relevant, the rights and obligations it or they give the holder;
 - b) details of the DLT that is used to issue, store or transfer the Accepted Crypto Token;
 - c) cybersecurity risks associated with the Unit holding the Accepted Crypto Token or Crypto Tokens, and whether there is a risk of loss of them in the event of a cyber-attack, and details of the steps that have been, or can be taken, to mitigate those risks;
 - d) details of other risks associated with the use of DLT, particularly those relating to the Custody of the Accepted Crypto Token or Crypto Tokens and the susceptibility of private cryptographic keys to misappropriation; and
 - e) any other information relevant to the Accepted Crypto Token or Crypto Tokens held in Fund Property that would reasonably assist a prospective investor in making an informed decision about investing in that Unit.
145. The extra information requirements are by no means exhaustive, and we may make further refinements to this list in the light of experience.
146. Further, we would expect in the case of an Information Memorandum for an Exempt Fund or Qualified Investor Fund where the Fund Property consists of Crypto Tokens, that a Professional Client would reasonably expect to find in that document the information specified in MKT App7.

(iii) Valuations

147. When developing our regime for Exchange Traded Funds (ETFs), we introduced a requirement for an ETF Fund Manager to only use an index or a benchmark provided by a Price Information Provider (PIP) that met certain criteria in the CIR module. This was to enhance the transparency and objectivity of the valuations provided by that Fund Manager.
148. A PIP can be a reporting agency, or an index or benchmark provider which constructs, compiles, assesses, or reports, on a regular and systematic basis, prices of Investments,

²¹ CIR 14.3.

rates, indices, commodities or figures, which are made available to users, including a Fund Manager.

149. While there are a range of websites, indices and valuation firms that set out valuations of Crypto Tokens, they can differ in respect to the information they disclose and the valuation criteria they apply. On this basis, we propose to require a Fund Manager who uses a PIP, to use a PIP that meets the criteria set out in CIR App 9. We would invite comment on any practical difficulties this may bring.
150. We would also note that, as we get a better understanding of this market and discuss with Fund Managers their approach to valuations, we will come to a firmer view on pricing and the type of price references can be used for Accepted Crypto Tokens. We will, where relevant, issue further guidance, if we think it is necessary to do so.

(iv) Custody

151. A Fund Manager is required to select an Eligible Custodian if the Fund is to hold Crypto Tokens as per CIR 8.2.4. We would also propose that self-custody is not permitted on the basis that custody of Crypto Tokens is rather more complex than, for example, custody of Securities.

(v) Exempt and Qualified Investor Funds

152. If any Exempt or Qualified Investor Funds (QIF) invests in Crypto Tokens, then the requirements set out above relating to custody, restrictions on the use of the term Crypto Token Fund, and the use of a PIP will be applicable.

(vi) External Funds and External Fund Managers

153. Under the Collective Investment Law, a DIFC Fund can be operated by an External Fund Manager, and a DFSA-licenced Fund Manager can operate a Fund established outside the DIFC, provided the requirements in Chapter 6 of CIR are met.
154. We are proposing, at this point in time, that an External Fund Manager will not be allowed to operate a DIFC Fund that invests in Crypto Tokens, and that a DFSA-licenced Fund Manager will not be allowed to establish and operate an External Fund that invests in Crypto Tokens. This proposal is consistent with the requirement to have Crypto Token Businesses established in the DIFC, as set out in proposal 6.

(vii) Foreign Funds

155. Foreign Funds are not allowed to be offered, promoted, or marketed, in or from the DIFC, unless the relevant fund and its fund manager are subject to adequate comparable regulation in a jurisdiction acceptable to the DFSA; and the person undertaking the offer, marketing, or promotional activities relating to a Foreign Fund complies with the Prospectus disclosure, Foreign Fund marketing rules, and the Financial Promotions regime. It would be the obligation of the person wishing to market the Foreign Fund in or from the DIFC to take reasonable steps to satisfy themselves that the regulation of the fund in its jurisdiction is actually adequate comparable regulation.
156. We are proposing, at this point in time, that we will not allow the offer or marketing of a Foreign Fund that is a Crypto Token Fund in or from the DIFC. Similar to the points made in respect of External Funds and External Fund Managers, we are proposing to require all Crypto Token Business to be based in the DIFC. We can look at this position again as and when there are more comparable regulations in other jurisdictions.

Proposal 17 – Collective Investments Funds

157. We propose:

- a) that a Fund can only hold itself out, either in its marketing material or offer documents, as being a Crypto Token Fund if its main purpose is investing in Crypto Tokens;
- b) to add further disclosure requirements to a Prospectus if a Fund holds Crypto Tokens as per paragraph 144;
- c) to require a Fund Manager who uses a PIP, to use a PIP that meets the criteria set out in CIR App 9;
- d) to not permit self-custody if a Fund is holding Crypto Tokens;
- e) to apply the requirements to Exempt Funds and QIF as set out in paragraph 152;
- f) to not permit an External Fund Manager to operate a DIFC Fund that invests in Crypto Tokens, and to not permit a DFSA-licensed Fund Manager to establish and operate an External Fund that invests in Crypto Tokens;
- g) to not to allow the offering and marketing of Foreign Funds that are Crypto Token Funds.

Please see draft CIR Rules 3.1.15, 6.1.5, 6.2.3, 8.2.2(4), 12A.3.1(4), 13.1.1, 13.12, 14.3.1(1)(h), 15.1.5(e), 15.1.6(1)(d), A9.1.1 and A9.1.2 at Appendix 5, and draft MKT Rule App 7.1.5 in Appendix 7.

Questions:

20: Do you agree with the proposals set out in paragraph 157? If not, why not?

21. Have you identified any practical difficulties in respect of the requirements relating to PIPs? If so, how could these be addressed?

E. Safeguarding and administration

(i) Digital Wallets and Custodians

158. In CP138, we introduced the notion of a “Digital Wallet,” which provides the means by which persons can acquire, hold or transact with Tokens. This Wallet involves the storing/holding of public and private cryptographic keys that enable users to interact with DLT to transact and monitor their balances.²² In this CP, we set out that an Authorised Person who provides Digital Wallets would have to comply with the applicable requirements in the COB or AMI modules, as appropriate.

159. We also introduced an additional layer of technology and governance requirements to address risks associated with Providing Custody of Investment Tokens whereby a Custodian/Digital Wallet Service Provider would have to ensure that²³:

²² A public key allows other participants on a distributed ledger to send Tokens to an address associated with the public key. A private key provides full control of the Tokens associated with that public key.

²³ See COB 14.3.3 and AMI 5.4.

- a) any DLT application it uses in the provision of custody is resilient, reliable, and compatible with the relevant facility on which the Investment Tokens are traded or cleared;
 - b) it is able to clearly identify and segregate Investment Tokens belonging to different Clients; and
 - c) it has in place procedures to enable it to confirm Client instructions and transactions, maintain appropriate records and data relating to those instructions and transactions, and to be able to conduct a reconciliation of those transactions at appropriate intervals.
160. Additionally, a Custodian/Digital Wallet Service Provider would have to ensure that, in developing and using DLT applications, or other technology to Provide Custody, it considers the:
- a) architecture of the wallets;
 - b) security measures (including cyber security) and procedures for the safe storage and transmission of data relating to the crypto tokens;
 - c) cryptographic keys and wallet storage, taking into account password protection and encryption that are to be used;
 - d) methods of usage and storage of keys available under the DLT application used; and
 - e) procedures and protocols built into their operating rules to ensure the above.
161. We also outlined that, where custody is outsourced to a third-party, that provider would need to be an Authorised Person permitted to be a Digital Wallet Service Provider or a firm that was regulated by a Financial Services Regulator to an equivalent level as that provided for under the DFSA regime for Providing Digital Wallet Services.
162. Lastly, where a Client has self-custody of their Digital Wallet, we set out in CP138 that an operator of a facility that trades Crypto Tokens needs to ensure that the technology used for self-custody does not impair the integrity of its own technology for operating that facility and carrying out its obligations as the operator. Due diligence and testing and other procedures would need to be undertaken in relation to the technology used by or for the Client's for self-custody.
163. We propose to apply the same requirements to those providing custody of Crypto Tokens and, therefore, intend to adopt the same measures as set out in paragraphs 159 – 162. We also propose to require a technology audit to be carried out in respect of the above proposals as per the requirements set down in COB 14.5.
164. In addition, as already discussed earlier in this CP, we propose to add a prohibition in relation to any Privacy Devices. These may include digital wallets (e.g., mixer wallets) or mechanisms that are intended to hide, anonymise or prevent the tracing of Crypto Token transactions, or identity of parties to the Crypto Token transaction or the holder of a Crypto Token.

(ii) Administering Crypto Tokens

165. As set out above, the provision of Custody in respect of Tokens (both Investment and Crypto) is different from normal custody provision due to the use of DLT and the need to safeguard public and private cryptographic keys.
166. Another different element in the Custody of Tokens is in relation to the “administering” of the Crypto Tokens. This includes effecting transactions in the form of exchanging or transferring the Token between Wallets. There are additional risks associated with these transfers, including understanding what security provisions are used by the provider, what authentication and transaction safeguards are put in place, and what recourse is available against that provider in the event of, for example, a cyber incident that results in the loss or theft of an Accepted Crypto Token. In order to address these risks, we are proposing additional requirements set out below.

Client Agreements

167. An Authorised Person safeguarding and administering Accepted Crypto Tokens must include in the Client Agreement the following information:
- a) a breakdown of all fees and charges payable for a transfer of Accepted Crypto Tokens and when they charged;
 - b) information required to carry out a transfer;
 - c) the form and procedures for giving consent to a transfer;
 - d) an indication of the time it will normally take to carry out a transfer;
 - e) details of when a transfer will be considered to be complete;
 - f) how and in what form information and communications relating to transfer services will be provided to the Client, including the timing, frequency and language used and technical requirements for the Client’s equipment and software to receive the communications;
 - g) clear policies and procedures relating to unauthorised or incorrectly executed transfers, including when the Client is and is not entitled to redress;
 - h) clear policies and procedures relating to situations where the holding or transfer of Accepted Crypto Tokens may have been compromised, such as in the event of hacking, theft or fraud; and
 - i) details of the procedure the Authorised Firm will follow to contact the Client in the event of a suspected or actual hacking, theft or fraud.
168. These requirements are not exhaustive, other relevant information should also be provided to the Client when safeguarding and administering Accepted Crypto Tokens.

Additional obligations

169. An Authorised Person must adhere to additional requirements when safeguarding and administering Accepted Crypto Tokens, including;

- a) providing to its Client information in relation to when a transfer occurs, including providing confirmation to the Client regarding if the transfer was successful, the date of the transfer and the final fees and charges related to that transfer;
 - b) if an Authorised Person is responsible for any unauthorised or incorrectly executed transfers of Accepted Crypto Tokens, it must promptly address the issue and within 3 (three) business days put the Client's account to the state it would have been had the transfer taken place correctly;
 - c) if an Authorised Person restricts or stops a Client's access to its service, it must explicitly set out when this can happen in the Client Agreement, and only do this on reasonable grounds, including, for example, valid security concerns or suspected unauthorised or fraudulent use of the service;
 - d) if services are stopped, an Authorised Person must restore access, or offer another service, as soon as practicable after the reasons for restricting or stopping the service cease to be valid; and
 - e) if an Authorised Person becomes aware of a major operational or security incident, it must inform its Clients without delay and explain the measures it is taking to limit the effects of the incident.
170. We would also remind Authorised Firms carrying out an Accepted Crypto Token transfer of the importance of complying with all relevant rules in the AML module, for example, carrying out Customer Due Diligence on the parties to the transfer.
171. For an AMI that is also providing custody, these additional requirements are also applicable.

Proposal 18 – Safeguarding and administration

172. We propose to:
- a) adopt the same requirements for Crypto Token business that we put in place for Digital Wallet Service Providers in CP138, as set out in COB 14.3 and AMI 5A.4;
 - b) prohibit the use of Privacy Devices; and
 - c) adopt additional requirements as set out in paragraph 169.

Please see draft GEN Rules 3A.1.1 and 3A.2.2 at Appendix 3, COB sections 6.13, 15.5, App 2.1.1(e), App 2.1.8, App 6.3 – 6.8 and App 8 at Appendix 4, draft AMI sections 5.10 and 5B.5 at Appendix 8.

Question 22:

Do you agree with the proposals in paragraph 172? If not, why not?

F. Other crypto-related activities

(i) Issuance

173. We are aware that there may be stakeholders interested in issuing new Crypto Tokens in or from the DIFC. At this point in time, we are not planning to allow for the issuance of new Crypto Tokens; rather, we would prefer to focus on Crypto Tokens that have already been issued. However, we will consider this matter at a later stage, in the light

of our experience in regulating Crypto Tokens and inform the market of any change in policy.

(ii) Decentralised finance (DeFi)

174. We are aware of the significant increase over the last two years in so-called DeFi applications, which allow direct peer to peer activity, some of which could involve Financial Services, without intermediation, and the provision of offerings and products that closely resemble products and services in the traditional financial marketplace, through the deployment of software code. For example, there are applications, or dApps, running on blockchains, that enable users to obtain an asset or loan upon posting collateral. Others offer the ability to deposit a Crypto Token and receive a return. There has also been much debate recently about the extent to which such applications are truly DeFi, or instead are variations on existing centralised finance (or CeFi).
175. At present, the DFSA is considering the appropriate way to address the regulation of DeFi, in common with many other regulators globally, and thus have not made any proposals for DeFi regulation as part of this CP. However, we are aware that some DeFi projects will fit within our regulatory remit, for example Crypto Staking or DeFi trading venues, and if they are established in the DIFC and offer services in or from the DIFC, they will need to be authorised by the DFSA.
176. We would, however, welcome further views on the approach the DFSA should take to DeFi activities, which would be helpful to inform our further thinking.

(iii) Yield farming/staking

177. We are aware that it is common for certain crypto tokens to be lent for a variety of purposes. Some of this can be similar to conventional Securities Lending. In particular, it seems it is common in cases of Proof of Stake (PoS) consensus for validators to borrow crypto tokens from users to participate in the validation race for block rewards and/or other benefits. Users can stake their Crypto Tokens in a variety of different ways to seek to earn additional income,
178. Many of the so-called yield farming options available are conducted through DeFi apps and so, as noted above, would not be allowed for firms in the DIFC. We are minded not to allow any yield farming or staking activities but would welcome views on this.

Please see draft Markets Law Articles 8 (2), 11, and 12 at Appendix 2.

Questions:

23: Do you have any further views on potential regulation of DeFi activities? If so, what are they?

24. Do you agree with the proposals on yield farming and staking in paragraph 178? If not, why not and what alternative would you suggest?

Part V - Other regulatory requirements in relation to Crypto Tokens

A. Conduct requirements

(i) Disclosure

Risk warnings

179. There are a number of risks associated with trading, holding and using Crypto Tokens including, for example, price volatility, a lack of real underlying assets, the potential to lose money invested, a lack of information, the potential for fraud and financial crime, as well as and technical and operational failures. We are concerned that not all those engaging with Crypto Tokens are familiar with, or are even aware of, these risks.
180. There are requirements in COB 3.2.1 whereby Authorised Firms have to take reasonable steps to ensure that, when communicating with actual and prospective clients with regard to Financial Products and Financial Services, the communications are, and remain, clear, fair and not misleading.²⁴ Additionally, there are requirements that Financial Promotions must be clear, fair and not misleading. Our current regime, however, does not generally require Authorised Persons to provide specific warnings relating to risks associated with certain products and services.
181. While we do not think that risk warnings alone can address all the concerns we have, we do believe that their prominent disclosure, combined with appropriate disclosures (set out below), can help to direct users to the real risks involved when engaging with Crypto Tokens.
182. We are proposing the following risk warnings be prominently displayed on any channel used by the Authorised Person for Accepted Crypto Token business, stating that:
- a) Crypto Tokens are subject to extreme volatility and the value of a Token can fall as quickly as it can rise;
 - b) Clients may lose all, or part, of their money;
 - c) Crypto Tokens may not always be liquid or transferrable;
 - d) Investments in Crypto Tokens can be complex, making it hard to understand the risks with buying, selling and holding them;
 - e) Crypto Tokens can be stolen as a result of cyber-attacks; and
 - f) Investing in, and holding, Crypto Tokens is not comparable to investing in traditional Investments or Investment Tokens such as securities.
183. Where an Authorised Person presents any marketing or education materials, or other communication relating to a Crypto Token on a website, or any other communication channel, including social media, they must include these risk warnings in a prominent place at or near the top of each page of the materials or communication.
184. If this material is provided on a website or an application that can be downloaded to a mobile device, the warning must be statically fixed and visible at the top of the screen

²⁴ GEN Rule 3.5.1(1)(a).

even when a person scrolls up and down the page and included on each linked webpage on the website.²⁵

Key Features Document

185. Typically, when a Crypto Token is issued, the issuer or creator publishes a white paper. There is no prescribed approach for the information that is included in this document, and while it could be said that it broadly imitates a Prospectus, the information included tends to have a narrow focus on the technology used and the functionality of that Token, and far less focus on risks than would be helpful.
186. While such Whitepapers can be helpful, they are limited, so in order to cover the gaps we are proposing that Authorised Persons develop a KFD for each Accepted Crypto Token in relation to which they offer financial services.
187. The information provided in the KFD should include the following:
- a) information about the issuer and the design team behind the Crypto Token;
 - b) essential characteristics of the Accepted Crypto Token, including rights attached to the Token, the project or venture that is funded (if relevant);
 - c) information on the underlying technology used by the issuer, including details of the technology that is used to issue, store or transfer the Accepted Crypto Token;
 - d) information on the technology used by the Authorised Person, including protocols and technical standards adhered to;
 - e) details of how ownership of the Crypto Token is established, certified or otherwise evidenced;
 - f) how the Crypto Token will be valued (and an explanation of how this is carried out and what benchmarks, indices or third parties are relied on);
 - g) the risks related to the volatility and unpredictability of price of the Crypto Token relative to fiat currency, which may result in significant losses over a short period of time;
 - h) risks relating to fraud, hacking, and financial crime;
 - i) risks related to cybersecurity, including whether there is a loss of the Crypto Token in the event of a cyber-attack, and details of the steps that have been, or can be taken, to mitigate those risks; and
 - j) any other information relevant to the particular Crypto Token that would assist the client to understand the product and technology better and to make an informed decision.
188. The list is not exhaustive, it is designed as a base level of information that should be provided to clients or potential users of the service. We would urge all Authorised Persons to consider what other disclosures would be relevant considering the nature and risks of the products or services they are providing. Further, once we have

²⁵ These requirements are consistent with our position in respect of Restricted Speculated Investments in COB 6.16.5.

experience with the regime relating to Crypto Tokens, we will be able to explore the need for further standardisation of disclosure, if needed.

189. The KFD must be provided in good time to a person before the Financial Service related to the Accepted Crypto Token is provided, and it must be displayed on the website of the Authorised Person (or other delivery channel used, e.g., mobile application).
190. Further, repeated and duplicated disclosures to a Client are not needed if the KFD is the same as a previous disclosure that has been made to a Client, and there is no significant time gap between the previous disclosure and the current service.
191. Lastly, we would propose that where an operator of a trading venue provides a Crypto Token Whitepaper (or equivalent), for example, this could be the original Bitcoin or Ethereum white papers, that the operator should:
 - a) identify the authors of that Whitepaper (if known);
 - b) disclose prominently that it has not prepared the Whitepaper or verified the contents and;
 - c) that persons should take care relying on the information in the Whitepaper as it may be inaccurate and is likely to be out-of-date.

Proposal 19 – Disclosures

192. We propose that:
 - a) Authorised Persons offering Financial Services to Clients in respect of Accepted Crypto Tokens provide them with a KFD as per the requirements set out in paragraphs 187, in addition to entering in a Client Agreement with those clients as per COB 3.3; and
 - b) the operator of a trading venue publishes the relevant Accepted Crypto Token Whitepaper on its website and includes appropriate warnings that they have not verified the contents and that the information contained in the Whitepaper may be misleading or out of date.

Please see draft COB Rules 15.4.1, 15.4.2, 15.6.1 at Appendix 4, and draft AMI Rule 5B.4.1 and 5B.4.2 at Appendix 8.

Question 25:

Do you agree with our proposals in paragraph 192? If not, why not?

(ii) Client Classification

Net asset test

193. The “net asset” test for an Assessed Professional Client is set out in COB 2.3.7(1)(a), where it states that an individual needs to have net assets of at least USD 1 million as per the requirements in COB 2.4.2. This rule is very broad in terms of assets covered, potentially including any assets held directly or indirectly (except for the primary residence).

194. On one hand, we have concerns about Crypto Token holdings being considered in a net asset test due to their extreme volatility, and a lack of a clear valuation methodologies. On the other hand, we recognise that it would be rather unusual to create a category of Tokens, such as Accepted Crypto Tokens, within the regulatory regime but not recognise them in the net asset test.
195. We can see at least three possibilities here:
- a) not to recognise any Crypto Tokens as part of the net asset test; or
 - b) to recognise Accepted Crypto Tokens in the net asset test, with or without a haircut; or
 - c) to recognise any Crypto Tokens within the net asset test, with or without a haircut.
196. On this basis, we would invite comments, and views, on whether only Accepted Crypto Tokens should form part of a client's net assets, with an application of a 80% haircut on the current valuation.

Knowledge and experience test

197. The knowledge and experience test for an Assessed Professional Client is set out in COB 2.3.7(1)(b)(ii), which states that a client must have sufficient experience and understanding of relevant financial markets as per the requirements in COB 2.4.3. As the market relating to Crypto Tokens is a relatively nascent market, we do not think that many Clients will have a significant amount of knowledge and experience with Crypto Tokens to be able to pass a knowledge and experience test.
198. When we look to the detailed requirements in COB 2.4.3, on balance, we do not see a need to update them. Rather, we would prefer to observe how they are applied and, if we see poor practice in the market, we can consider if additional Guidance or more prescriptive Rules are required.²⁶

Proposal 20 – Client Classification

199. We propose to:
- a) Allow Crypto Tokens to contribute to a net asset test but on the basis that they are only Accepted Crypto Tokens and with a haircut of 80%; and
 - b) monitor how the knowledge and experience requirements in relation to Crypto Tokens are applied in practice in COB 2.4.3.

Please see draft COB Rule 2.4.2 at Appendix 4.

Question 26:

Do you agree with the proposals in paragraph 199? If not, why not?

²⁶ To note, we also see the direct link to the suitability assessment in COB 3.4.2 and the need to, amongst other factors, assess a Client's knowledge and experience. We will also monitor how this assessment is undertaken in respect of this requirement.

*(iii) Retail Client protections*Communication and marketing material

200. COB 3.2.6 sets out requirements in respect of past performance and forecasts, and states that an Authorised Firm must ensure that any information or representation relating to past performance, or any future forecast based on past performance or other assumptions, which is provided to or targeted at Retail Clients:
- a) presents a fair and balanced view of the financial products or financial services to which the information or representation relates;
 - b) identifies, in an easy-to-understand manner, the source of information from which the past performance is derived, and any key facts and assumptions used in that context are drawn; and
 - c) contains a prominent warning that past performance is not necessarily a reliable indicator of future results.
201. We are not sure it is possible to provide forecasts for Crypto Tokens (specifically in respect to Cryptocurrencies) based on past performance that are fair and balanced. There has been a significant amount of research done into this, but most agree that it is a very complex area to predict the future performance of an extremely volatile asset accurately.
202. We have also seen several examples of firms using, in their marketing material, past performance information for, in particular, Bitcoin. Such practices typically include picking a base reference well in the past and then saying how much 1 USD, or other currency, would be worth now, if it had been invested in Bitcoin at the past date. This tends to lead to very high figures (percentages) being quoted for the growth in the price of Bitcoin. While we are not disputing that these figures are correct, it is not at all clear how such a practice would pass the “fair and balanced” test set out in paragraph 199(a), how they would meet the overarching “clear, fair and not misleading” test that Firms need to apply to all their communications and marketing material,²⁷ or indeed how the information is supposed to be useful to Clients.
203. Such marketing material is aiming to play on the fear of missing out (or FOMO) of certain target markets. The impact of FOMO on retail trading in crypto and other markets has been much discussed elsewhere and we do not intend to repeat the debate here. But, of course, the target market has already missed out on the gains highlighted in the marketing material and, because past performance is not a guide to future performance, it is disingenuous of firms to imply that such performance will repeat in future.
204. Though Bitcoin performance over long periods (say 5 years plus) will always, at this point in time, lead to very positive growth figures, this is not the case if shorter time periods are used. If the figure for growth over 1 year was also given, then there would be several points at which performance would be negative.
205. While we would not typically depart from our approach set out in paragraph 200, we would ask whether, in this instance, there may be reasons to set out further proposals to outline our expectations in terms of what we would consider “fair and balanced”.

²⁷ GEN 4.2.6.

Appropriateness Test

206. We are aware that many Financial Products are bought “execution only”, meaning there is no assessment as to the suitability of that product or service or recommendation provided. However, in our CP135 on Restricted Speculative Investments (RSI), we introduced a requirement for Authorised Firms to undertake an appropriateness assessment²⁸ prior to Dealing, to ascertain whether a Retail Client had the adequate skills and expertise relating to a product, and also to understand whether a Retail Client had the ability to absorb significant losses.
207. The appropriateness test, in our view, can be a key piece of consumer protection. While it is not an assessment of suitability, if designed correctly it can alert consumers where a product or service is not considered appropriate (i.e., where a Client may lack the knowledge and experience to understand the risks involved).
208. We believe there are many similarities between RSIs and financial services involving Crypto Tokens and Crypto Token Derivatives. For example, they are high-risk and there is the potential to suffer losses due to the volatility of the products.
209. On this basis, we propose to introduce a requirement for Authorised Firms who are providing intermediated services, such as arrangers or dealers, to carry out an appropriateness test before allowing a Retail Client to trade in relation to an Accepted Crypto Token or Crypto Token Derivative. We would also welcome views as to whether we should extend this test to other Authorised Persons who provide Financial Services related to Crypto Tokens, for example, operators of an AMI or MTF?
210. In carrying out an appropriateness test, we do not want to see a “tick box” approach, rather we want to see a test that fully assesses whether the customer really understands the risks involved and whether the Accepted Crypto Token or Crypto Token Derivative product or service is appropriate for them.
211. Given this will be a relatively new requirement for many to implement and comply with, we have produced guidance relating to the factors that an Authorised Person must consider when assessing appropriateness for a Retail Client. Where an Authorised Person forms the view that it is not appropriate to provide a service or offer a product to a Retail Client, then that service should not be offered.
212. We have also recently seen the UK FCA’s Consultation Paper²⁹ where they propose a number of updated requirements in respect of certain products being offered to the market, for example, Crypto Tokens. For example, the FCA proposes to limit the “ease” of the test retakes, whereby they propose a firm cannot reassess the appropriateness of that investment for the same client for at least 24 hours. They also propose to introduce a rule that a firm must ask different questions each time a consumer is subject to the assessment. We would welcome views on whether we should add additional requirements, similar to those discussed by the FCA, to the proposed appropriateness assessment requirements set out in this CP.

Use of credit cards

213. Some firms’ business models may allow Retail Clients to use credit cards to fund their accounts to buy Crypto Tokens, etc. While we typically have not imposed restrictions on

²⁸ COB 16.6.3.

²⁹ <https://www.fca.org.uk/publications/consultation-papers/cp22-2-strengthening-our-financial-promotion-rules-high-risk-investments-includingcryptoassets>

the methods used to buy certain Financial Products, we have more recently taken a decision, in respect of Crowdfunding and RSIs, that Retail Clients are not able to use credit cards to fund their financial activity in relation to these products.

214. The reason for this ban is that the use of credit cards may encourage users to make speculative investments with money they do not have, attracting higher losses, interest rates and charges. For the same reasons, and especially given the extreme volatility of some Crypto Tokens, we propose to ban the use of credit cards by any Retail Clients to buy any Crypto Tokens or Crypto Token Derivatives or to fund their accounts and margins associated with these products. This will apply to all Authorised Persons who operate with Retail Clients.

Crypto Token Derivatives

215. We propose to introduce a range of Retail Client protections in respect of Crypto Token Derivatives. These products, in our view, can be extremely high-risk and there is potential to suffer large losses. On this basis, we propose to set out requirements that broadly align with the protections that are in place for Retail Clients trading RSIs.
216. First, we propose to limit leverage in respect of Crypto Token Derivatives to a maximum of two-to-one. This is in line with the requirement for trading RSI's which also sets a minimum initial margin to 50% of the value of the exposure a trade provides when the underlying asset is a Crypto Token.
217. Second, we propose to introduce margin close-outs, whereby an Authorised Person will have to ensure that the net equity in a Retail Client's account does not fall below 50% of the overall margin deposited in that account. If the net equity does fall below 50% of the overall margin deposited in that account, the Authorised Person must close all open positions in the Retail Client's account as soon as market conditions allow, in accordance with best execution requirements found in COB 6.4.2. We are aware that transitional arrangements may need to be considered and would invite views on the difficulties firms may face in complying with this proposal.
218. Lastly, we also propose to introduce negative balance protection to mitigate the risk of a Retail Client incurring large losses that exceed the funds in their account.

Incentives

219. We have seen many examples of inducements from many firms offering services in relation to Crypto Tokens, such as "open your account today bonuses", "refer a friend" bonuses, "top up your account" bonuses, trading volume/frequency bonuses, and various other gifts. A referral by friends, family and other contacts creates powerful social and emotional drivers to invest, with users often not looking into the risks properly because the referral is by someone they know, or wrongly assuming the product/service being promoted is credible for the same reason.
220. We are concerned that these types of incentives can unduly influence consumers' investment decisions and cause them to invest without fully considering the risks involved.
221. We looked at this issue when developing our policy approach for RSIs and took a decision to ban all offers of incentives to Retail Clients in COB 6.16.9. We propose to adopt this approach, including the applicable guidance, and prohibit the offering of incentives to a Retail Client by any Authorised Person in relation to any Crypto Token product or service.

Proposal 21 – Retail Client protections

222. We propose to:

- a) Invite views on the use of past performance information in any communication or marketing material aimed at Retail Clients;
- b) Require certain firms referred to in paragraph 209 to undertake an appropriateness assessment to be undertaken before allowing a Retail Client to transact with a Crypto Token;
- c) Invite views on whether other firms should be required to carry out an appropriateness assessment before allowing a Retail Client to transact with a Crypto Token;
- d) Prohibit the use of credit cards by Retail Clients to fund their account both in spot and Derivative trading;
- e) Restrict leverage offered to Retail Clients in relation to Crypto Token Derivatives as per paragraph 216; and
- f) Prohibit the offering of any incentives, including bonuses, rewards or gifts to Retail Clients by any Authorised Person in respect of any Crypto Token Business.

Please see draft COB Rules 15.7.1, 15.7.2, 15.7.3, 15.7.4, 15.7.6 – 15.7.8 at Appendix 4.

Questions:

27. Do you agree with the proposals in paragraph 222? If not, why?

28. Should we provide further guidance in respect of what we consider is “fair and balanced” in respect of past performance information in any communication or marketing material aimed at Retail Clients, if yes, why?

B. Prudential requirements

i) Provision of Custody

223. We are considering whether we need to increase the prudential requirements for Custodians to reflect the higher risks associated with holding, and transfer of, Crypto Tokens such as fraud, theft or hacks on wallets, which are not found with traditional Investments. Further, there are potentially large volumes of Crypto Tokens that will need to be held on behalf of Clients, including Retail Clients, and the role of the Custodian is expanded.
224. Currently, those who Provide Custody (other than to a Fund) have a base capital requirement of USD 500,000 and a 13-week expenditure-based capital minimum (EBCM). It is felt in this instance that this base capital requirement is too low, given the increased role, and we would propose to increase the capital requirement for those Providing Custody of Crypto Tokens to a base capital requirement of USD 1 million and an EBCM of 18 weeks expenditure.

Proposal 22 – Prudential requirements

225. We propose to require a Custodian that provides Crypto Token custody to have a base capital requirement of USD 1 million.

Please see draft PIB Rules 1.3.4(a)(i), 1.3.5(a)(iii), 3.6.2 and 10.3.1 at Appendix 11.

Question 29:

Do you agree with the proposal in paragraph 225? If not, why not?

C. Financial Crime

226. Preventing financial crime is a priority issue for the DFSA. The use of Crypto Tokens poses a higher risk of potential illicit activities, such as laundering money, tax evasion, or financing of terrorism and proliferation, due to the ability of the technology to effect anonymous transfer of funds between users; and mask the origin and destination of the flow of funds.
227. The risk can be exacerbated where technology allows transactions across many jurisdictions, involving multiple parties with differing degrees of AML/CFT regulations. This combined with the rapidly evolving nature of the technology, make it even harder for regulatory and enforcement agencies to identify and deal with perpetrators of illicit activities.

(i) FATF standards

228. FATF have been extremely active in this area, stating that more needs to be done in respect of the regulation and supervision of what they call VASPs.³⁰ They have identified key risks in this area:
- a) some Virtual Assets can operate in an anonymous or pseudo-anonymous manner, and can be traded via Virtual Asset Trading facilities that do not identify the origin or destination of funds;
 - b) the global reach of Virtual Assets and the fact they can be used to make cross-border payments and fund transfers;
 - c) the complexity of Virtual Asset Trading facilities, which often utilise several entities, spanning multiple countries, with multiple bank accounts, to transfer funds and/or execute payments; the evolution of DeFi – which avoids the traditional financial players; and
 - d) the differing degrees of AML/CTF controls or implementation of the FATF recommendations and standards across different jurisdictions.³¹
229. In early 2019, the FATF issued details on how to license and supervise VASPs by way of its Interpretive Note to Recommendation 15 – New Technologies.³² They followed this up with Guidance for a Risk Based Approach for VASPs.³³ The basis of this Guidance

³⁰ Virtual Asset Service Providers

³¹ We acknowledge that this is changing as more jurisdictions implement the FATF Recommendations in respect of Virtual Assets.

³² <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/public-statement-virtual-assets.html>

³³ <https://www.fatf-gafi.org/media/fatf/documents/recommendations/RBA-VA-VASPs.pdf>

is that VASPs are expected to identify, assess, and take effective actions to mitigate their ML/TF risks with respect to VAs.

230. More recently, the FATF updated their Guidance in 2021,³⁴ which provided updates in six main areas, where it:
- a) clarified the definitions of Virtual Assets and VASPs to make clear that these definitions are expansive and there should not be a case where a relevant financial asset is not covered by the FATF Standards (either as a VA or as a traditional financial asset);³⁵
 - b) provided guidance on how the FATF Standards apply to Stablecoins;
 - c) provided additional guidance on the risks and potential risk mitigants for peer-to-peer transactions;
 - d) provided updated guidance on the licensing and registration of VASPs;
 - e) provided additional guidance on the implementation of the ‘Travel Rule’; and
 - f) included Principles of Information-Sharing and Co-operation amongst VASP supervisors.

(ii) UAE legislation

231. In the UAE, the Federal government issued Decree-Law (26) of 2021 (the Decree) amending certain provisions of Law (20) of 2018 on Anti-Money Laundering and Countering the Financing of Terrorism. This updated Decree further aligns the Federal AML Legislation with the FATF Recommendations and makes it a criminal offence for any natural or legal person to be a VASP without a licence or registration from the appropriate regulatory authority. The penalty for this offence is imprisonment for a period of at least six months and/or a fine of between AED 200,000 and AED 5 million.
232. Effectively, this means that any financial activity with a Crypto Token that meets the relevant definition of a “Virtual Asset” in the AML legislation needs to be subject to registration and/licensing, irrespective of whether the activity is being provided in financial free zones (such as the DIFC), or the mainland UAE. The Federal Government is in the process of updating the associated Cabinet Resolution which will set out further requirements in accordance with the Decree.

(iii) AML/CFT compliance

233. The DFSA’s AML Module is applicable to all Authorised Persons that provide Financial Services in relation to Crypto Tokens. In addition to this, we would propose to apply the AML/CTF requirements set out in AMI 5A.3.2 (relating to Investment Tokens) to AMIs operating a facility for Crypto Tokens that permits Direct Access Members. We are aware that a significant number of transactions with Crypto Tokens happen on a “peer-to-peer”) basis. We propose to remind Authorised Persons that they are not permitted to provide services or products that are unknown or anonymous at any stage of their operations. We have already mentioned our intention above to prohibit Privacy Tokens and any Privacy Devices.

³⁴ <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html>

³⁵ We have addressed this issue earlier in this paper.

234. We would also remind all Authorised Persons that they are subject to all relevant Laws and Regulations published at the Federal level, and also should follow the FATF standards and guidance.
235. We are considering developing further guidance in this area to expand on what is already in the AML Module and to set out what Authorised Persons should consider whether providing a Financial Services activity in relation to Crypto Tokens. This would include, for example, further guidance in relation to adopting a Risk Based Approach, performing the customer and business risk assessments, and examples of the typologies where Tokens can be misused by criminals.

Proposal 23 – Financial Crime

236. We propose to:
- a) add the AML/CTF requirements set out in COB 14.2.3 and AMI 5A.3.2 (relating to Investment Tokens) to Authorised Firms operating MTFs, and AMIs operating a trading venue for Crypto Tokens, which permit Direct Access Members; and
 - b) remind all Authorised Persons to follow developments at a Federal Level and the FATF Recommendations and Standards.

Please see draft COB section 15.3 at Appendix 3 and AMI section 5B.3.2 at Appendix 8.

Question 30:

Do you agree with our proposals in paragraph 236? If not, why not?

D. Market Abuse

237. Part 6 of the Markets Law contains provisions dealing with the prevention of Market Abuse. These provisions apply to all Investments (including Investment Tokens), whether listed and traded, and include provisions designed to address fraud and market manipulation, use of fictitious devices, and insider dealing, for example. The DFSA's Code of Market Conduct (CMC) provides further guidance on how these provisions are applied.
238. We have considered carefully whether we should apply all of these requirements to Authorised Persons providing financial services in relation to Crypto Tokens, as some of the requirements may not naturally be applicable in a non-Investment context.
239. While there are other more general provisions in the GEN Module³⁶ which are designed to stop behaviours that are likely to undermine users' confidence in the DIFC market, we do not think they are detailed enough, nor are they tailored to the use of Tokens and the associated use of DLT.
240. Rather, we believe it is prudent to apply all the Market Abuse provisions in the Markets Law, and the CMC to all persons using Crypto Tokens,³⁷ and would ask, as we did in

³⁶ See GEN 4, the Principles for Authorised Firms such as Integrity and Market Conduct, as well as GEN 5.3.20, which sets out that an Authorised Person and its Employees do not engage in conduct, or facilitate others to engage in conduct, which may constitute a) market abuse, for example.

³⁷ Other regulators, for example, the FRSA at ADGM, have applied certain provisions of their Market Abuse provisions in their Financial Services and Markets Regulations 2015 to all Firms engaging in Accepted Virtual Assets.

CP138, if any further clarifications or enhancements are needed in order to address risks of market abuse relating to the distribution, trading, and holding of Crypto Tokens.

241. We have also identified additional areas of concern in respect of Market Abuse, such as the use of forums. We are aware that AMIs and MTFs will often offer a forum for discussion to provide a communication channel between users and/or the operator of a trading facility, for example, to ask questions about the operation of that facility. By establishing such a forum, instant and useful feedback is provided to a large group of Clients.
242. While we appreciate the usefulness of such a forum, we are concerned that it could be used for market manipulation purposes. On this basis, we propose to add a further requirement for an AMI and MTF to monitor a forum (if provided) and identify and remove posts that may contravene any Markets Law or CMC requirements.
243. We are also considering the implications of information dissemination in relation to Crypto Tokens through social media (such as Instagram, Twitter, or Facebook). We have seen some examples of behaviour on social media, whereby social influencers are paid, often by scammers, to help them pump and dump new Crypto Tokens, for example. We will monitor these types of developments as we implement our framework and consider if we need to add further guidance regarding our expectations in this area.

Proposal 24 – Market Abuse

244. We propose to:
- a) apply the Market Abuse provisions in the Markets Law and the CMC to operators of AMIs and MTFs trading Crypto Tokens; and
 - b) require AMIs and MTF Operators providing forums to monitor those forums and remove any posts if they contravene the Markets Law or CMC.

Please see draft Articles 54-65 of the Markets Law at Appendix 2, draft COB Rule 15.4.4 at Appendix 4, draft AMI Rules 5B.4.4 at Appendix 8, and draft CMC at Appendix 9.

Question 31:

Do you agree with our proposals in paragraph 244? If not, why not?

E. Islamic Financial Services

245. Islamic Finance requirements in the IFR module apply to persons conducting in or from the DIFC Islamic Finance Business.³⁸ In terms of those who want to provide financial services in respect of Crypto Tokens and hold themselves out as Islamic or Shari'a compliant, we propose to apply the requirements in IFR. We also propose to prohibit a person using the name "Islamic Crypto Token", unless it is indeed Shari'a compliant.
246. On that point, we are aware, however, that there is disagreement between Islamic scholars about the Shari'a compliance of Crypto Tokens, such as Cryptocurrencies, because they can be used for speculation (*maisir*), which is prohibited. In recent weeks, we have also seen a *fatwa* issued in Indonesia, declaring that all Cryptocurrencies are not Shari'a compliant.

³⁸ Any part of the financial business of an Authorised Person which is carried on in accordance with Shari'a.

247. Given the divergence in views, we would invite comments on whether there are measures the DFSA should be taking in this area, in addition to those currently set out in IFR Chapter 6.

Proposal 25 – Islamic Financial Services

248. We propose to apply IFR module to any financial service or product offering involving Crypto Tokens if they are, or held out as, Islamic or Shari'a compliant, and ask for views on whether there is anything further the DFSA needs to be doing in this area.

See draft Rules IFR 1.1.1(c) & Guidance 4, and 2.4 Guidance 10 & 11 – at Appendix 10

Questions:

- 34. Do you agree with our proposal in paragraph 248? If not, why not?**
- 35. Do you think there is anything else that the DFSA should be doing in this area given the differing views in respect to the shari'a compliance of Crypto Tokens?**

F. Cyber Risk Management

249. We propose to remind those engaging with Crypto Tokens to comply with the DFSA's framework and guidance on cyber security³⁹ whereby we expect all Authorised Persons to implement an appropriate framework to identify and mitigate cyber risks and to detect, respond to, and recover from cyber incidents. Further, we expect all members of senior management at both the board and executive levels need to be aware of their Firm's cyber vulnerabilities, and accordingly, provide the necessary resources, control, and oversight to manage the risk.
250. Further information on the Cyber framework can be found [here](#).

G. Fees

(i) Trading Venues

251. We have considered that, as we did for the Investment Token regime, fees applicable to the MTF operator need to reflect the additional amount of authorisation and supervisory work required in administering and monitoring the proposed regime relating to Crypto Tokens. In line with the rationale in CP138, we believe that a firm wishing to operate a MTF with Crypto Tokens should be subject to an application fee of USD 150,000 and an annual licence fee of USD 150,000
252. For an AMI wishing to operate with Crypto Tokens, the application and annual licence fees should also be in line with those imposed on an AMI/Exchange that trades Investment Tokens. That is, an application fee of USD 150,000 and an annual licence fee of USD 150,000. The same fees would apply to an AMI that wishes to operate a Clearing House involving Crypto Tokens. An applicant for an AMI licence, seeking to obtain an endorsement to operate an ATS/MTF involving Accepted Crypto Tokens, should pay an additional fee of USD 150,000.
253. Where a trading venue wishes to introduce a direct-access model, where access to the venue does not have to be intermediated by market participants, an annual recurring fee

³⁹ <https://www.dfsa.ae/what-we-do/supervision/cyber-risk-supervision/summary>

of USD 10,000 should apply, again in line with the rules for Investment Tokens. An additional fee of USD 20,000 will apply where the direct-access model involves Retail Clients (i.e., Retail Client endorsement fee).

254. The table below sets out a summary of the fees, after the adjustments proposed above, for an Authorised Firm or AMI seeking to provide Financial Services involving Crypto Tokens.

Fees – trading venues (USD)	Type	MTF	AMI/ Exchange	AMI/ Clearing House
Authorisation application	<i>One time</i>	150,000	150,000	150,000
Annual licence	<i>Recurring</i>	150,000	150,000	150,000
Direct-access membership	<i>Recurring</i>	10,000	10,000	10,000
MTF endorsement	<i>One time</i>	N/A	150,000	N/A
Retail Client endorsement	<i>One time</i>	20,000	20,000	20,000
Client Asset endorsement	<i>One time</i>	5,000	N/A	N/A

255. The annual fees for an AMI/Exchange and MTF reflect the risk associated with these activities, and the level of supervisory effort required to respond to this high risk. These figures have been set out with the implied level of activity that we would expect to be taking place in and out of the DIFC. However, when it comes to tokens, the trading culture has abolished traditional limitations related to direct membership, client classification, geographical borders, and time zones. Naturally, the level of activity in tokens may be significantly higher than we currently expect, leading to even more complex regulatory issues and supervisory efforts required. To address this issue, we propose to apply a significant trading fee to token-market operators when average daily trading volumes cross the proposed thresholds below. We also think that a fee related to the trading activity may deter the existing market practice of overstating the trading volumes taking place on Crypto Token markets internationally.
256. With no regime yet in place, it is extremely difficult to forecast the level of expected trading activity in or from the DIFC. To overcome this issue, we have looked at the average daily trading volumes taking place on leading token exchanges globally. In case we were to host a market operator from the top 50 venues, then we would expect the associated annual fee to be USD 800,000, corresponding to trading activity of USD 400m and above. The same logic applies to lower trading activity.

Average daily trading volume	Annual fee (USD)
400m < X	800,000
200m < X < 400m	500,000
100m < X < 200m	300,000
X < 100m	150,000

257. We note that derivative trades are not taken into consideration at the moment, because we have seen inflated figures in these markets, making it extremely difficult to analyse

and forecast genuine activity levels. Should we acquire additional information or are provided with valuable feedback in response to this consultation, we may include the level of derivative trading in the process for the determination of significant trading fee.

(ii) Other Financial Services Activities

258. Our proposed list of activities with Crypto Tokens is exhaustive and comprises the services in the table below. Due to the significant risks involved in these businesses and the amount of effort associated with licensing and supervising these firms, we are proposing to raise the annual supervision fees by a factor of up to 1.5, in line with the rate of change proposed for a MTF wishing to operate a Crypto Token trading venue.
259. We will continue to maintain the current level of application fees and not raise them, with a view to encourage the development of the token market in the DIFC. We believe that a higher number of Crypto Token intermediaries in the market will generally lead to healthier competition and lower intermediation fees for clients (hence, no proposed increase in application fees). At the same time, we do not believe that the DIFC financial market will need a higher number of AMIs and ATs operating multiple trading venues (hence, higher application fees than normal, as discussed earlier).

Fees – other activities (USD)	<i>Application fee</i>	<i>Annual fee</i>
Dealer as principal	40,000	70,000
Dealer as principal (matched)	25,000	35,000
Dealer as agent	25,000	35,000
Asset manager	25,000	35,000
Fund manager	10,000	15,000
Custodian	25,000	35,000
Arranger / Adviser	15,000	20,000

260. We do not intend to increase the fees for the Client Asset and Retail Client endorsements, which should stay at the same level of USD 5,000 and 20,000, respectively.

(iii) Variation of licence

261. An existing Authorised Firm or AMI, seeking to provide the financial services on their licence but involving Accepted Crypto Tokens, will need to apply to the DFSA for a variation of permission. Given the regulatory effort required to deal with such an exercise, we propose to charge a fee of:
- USD 40,000 to an existing AMI or MTF;
 - USD 20,000 to custodians and principal dealers;
 - USD 10,000 to other dealers, asset and managers, fund managers; and
 - USD 5,000 for advisers and arrangers.

(iv) Supplementary fees

262. We would like, first, to highlight FER 1.2.7, which allows the DFSA to charge supplementary fees in circumstances where it expects to incur substantial additional costs in dealing with an application, notification or conducting ongoing supervision. We anticipate that dealing with applications to provide financial services in relation to Crypto Tokens will require us to make use of FER 1.2.7 regardless of the discussion on fee adjustments. Similarly, the potential scale of some applicants is such that we would expect to continue to apply FER 1.2.7 as regards the ongoing supervision of Authorised Firms and AMIs.

(v) Accepted Crypto Token assessment

263. We explained earlier in the CP how the DFSA will apply a set of criteria to assess Crypto Tokens that stakeholders wish to use in or from the DIFC whereby only Accepted Crypto Tokens can become objects of Financial Services. We expect this assessment process will require significant regulatory effort. We also note that either the issuer or the Financial Service provider may apply to the DFSA to get a certain Crypto Token recognised as accepted. For that regulatory exercise, we propose to charge a fee of USD 10,000, as we believe the level of scrutiny will be analogous to assessing a prospectus in relation to a non-equity financial instrument (hence, an equivalent fee).

Proposal 26 – Fees

264. We propose to apply:
- a) the same authorisation fees to an AMI/Exchange and ATS/MTF that operates with Investment (Tokens) or Accepted Crypto Tokens;
 - b) annual trading activity fee to an AMI/Exchange and ATS/MTF, where their average daily trading activity crosses the proposed thresholds;
 - c) higher annual fees for other financial intermediaries wishing to operate with Accepted Crypto Tokens, while leaving the application fees intact;
 - d) different variation permission fees, depending on the risk and regulatory effort required with the assessment of the case; and
 - e) a flat one-time application fee to seek the DFSA's assessment of suitability in relation to a Crypto Token.

Please see draft FER Rules 2.1.2(2)(a) & (3), 2.1.5(1)(a), 2.1.5(2), 2.2.4(1)(a) & (2), 2.2.6 and 2.9A, 3.2(d), 3.4.4(b) at Appendix 11.

Questions:

- 36. Do you agree with our proposals in paragraph 264 relating to fees? If not, why not?**
- 37. Is charging fees to trading venues linked to the volume of trading a reasonable way to align fees with the DFSA's costs and a good way to discourage over-reporting of trade volumes? If not, why not?**

Part VI - Implementation and transitional arrangements

A. Implementation issues

265. We will not be accepting any applications for new or amended licences until this framework comes into force. You should not act on any proposals in this CP until the relevant changes are made. We will issue a notice on our website when this happens.
266. All applications seeking to conduct a Financial Services activity in relation to Crypto Tokens will be rigorously scrutinised.⁴⁰ We also expect to see well thought out RBPs, BCPs and AML Business Risk Assessments (or amendments to these documents if already authorised by the DFSA) that identify, for example, the risks in this market and how they will be managed. Further, we expect that those carrying out prominent roles in the Firm, such as a Compliance Officer or Money Laundering Reporting Officer, will have the right expertise and competence to carry out these roles.
267. Given the complexity of some of the activities associated with this proposed framework, it is likely that we will need to hold a number of meetings with applicants and the time it may take to obtain a Financial Services Licence could be lengthy.

B. Transitional arrangements

268. We are aware that some Authorised Firms in the DIFC are engaging in Crypto Token-related activities. We would invite those Firms to contact the DFSA (via "[Being Supervised](#)") to inform us of the activities, and the types of Tokens involved. We can then consider how those existing business arrangements can be brought into line with the regime.
269. We are also aware that there will be some applicants with existing Crypto Token-related business that will want to apply to the DFSA. We expect that there are likely to be some issues around Clients needing to be re-onboarded to meet DFSA requirements, for example, and will have to work through these issues with applicants.

⁴⁰ To note, in line with our normal approach, we are unlikely to accept any applications for variation of a Firm's licence if it is within 12-months of them receiving that licence.

Annex 1: Questions in this Consultation Paper

Question 1: Do you agree with the proposed definition of a Crypto Token set out in paragraph 18? If not, why not?

Question 2: Do you agree with our proposal to exclude from regulation the Tokens listed in paragraph 40? If not, why not?

Question 3: Do you think that NFT creators and service providers should be designated as DNFBPs in the DIFC?

Question 4: Do you agree with our proposals in paragraph 44? If not, why not?

Question 5: Do you agree with our proposals in paragraph 55? If not, why not?

Question 6: Do you agree with our proposal in paragraph 58? If not, why not?

Question 7: Do you agree with our proposal in paragraph 61? If not, why not?

Question 8: Do you agree with our proposals in paragraph 78? If not, why not?

Question 9: Should Custodians be allowed to provide services in relation to both Accepted Crypto Tokens and Excluded Tokens? If not, why not?

Question 10: Do you agree with the proposals set out in paragraph 83? If not, why not?

Question 11: Do you agree with the proposals we have set out in paragraph 108? If not, why, and what alternative would you suggest?

Question 12: Do you agree with the proposal in paragraph 111? If not, why not?

Question 13: Do you agree with our proposal to permit direct access members to trade on venues offering Accepted Crypto Tokens? If not, why not?

Question 14: Are there any other concerns which need to be addressed in permitting direct access members to trading on venues offering Accepted Crypto Tokens? What are they, and how should they be addressed?

Question 15: Do you agree with our proposals set out in paragraph 120? If not, why not?

Question 16: Do you agree with our proposal to apply the Proper Markets requirements to venues that trade Crypto Tokens? If not, what practical issues do you foresee with such a proposal and what alternative would you suggest?

Question 17: Do you agree with our proposal to apply the requirements relating to Business and Operating Rules, subject to adaptations, to operators of trading venues where they allow direct access members? If not, why not?

Question 18: Do you agree with the proposals we set out in paragraph 134? If not, why not, and what practical difficulties do you think would arise?

Question 19: Do you agree with the proposals for on-going disclosures? If not, why not?

Question 20: Do you agree with the proposals set out in paragraph 157? If not, why not?

Question 21: Have you identified any practical difficulties in respect of the requirements relating to PIPs? If so, how could these be addressed?

Question 22: Do you agree with the proposals in paragraph 172? If not, why not?

Question 23: Do you have any views on potential regulation of DeFi activities? If so, what are they?

Question 24: Do you agree with the proposals on yield farming and staking in paragraph 178? If not, why not and what alternative would you suggest?

Question 25: Do you agree with our proposals in paragraph 192? If not, why not?

Question 26: Do you agree with the proposals in paragraph 199? If not, why not?

Question 27: Do you agree with the proposals in paragraph 222? If not, why?

Question 28: Should we provide further guidance in respect to what we consider is “Fair and balanced” in respect of past performance information in any communication or marketing material aimed at Retail Clients, if yes, why?

Question 29: Do you agree with the proposals in paragraph 225? If not, why not?

Question 30: Do you agree with our proposals in paragraph 236? If not, why not?

Question 31: Do you agree with our proposals in paragraph 244? If not, why not?