

CRYPTO-TRADING IN THE ABU DHABI GLOBAL MARKET – READY FOR BUSINESS

On 25 June 2018, the Abu Dhabi Global Market (ADGM) published its rules and accompanying guidance for a crypto business regulatory framework. The exciting new regime will permit firms to apply for a license to operate a "crypto asset business" in the ADGM, including broker-dealer activities, operating an exchange and acting as a crypto asset custodian, but in each case in respect of the most well-established and traded crypto-currencies. The new regime presents a market leading set of regulations designed to be in tune with how crypto firms operate, but recognising the key risks posed to investors and the financial system.

With this regime, the ADGM Financial Services Regulatory Authority (FSRA) has established itself as one of the world leading regulators in the crypto-market. Its rules and guidance set out a newly created regulated activity of operating a crypto-asset business and a new type of regulated firm, to be governed by a technology focused conduct of business rulebook developed in conjunction with industry participants.

The new rules should be of particular interest in several jurisdictions with similar self-contained rulebooks to the ADGM, such as the UK.

The FSRA had consulted on the proposed rules in April, in which Clifford Chance participated, and the finalised rules and guidance take industry feedback into account. The framework reflects the positive approach we have seen from the UAE financial free zones in responding to market demands for licensing of fintech business.

Firms can obtain a license to:

- Conduct brokerage
- Buy and sell for their own account (by way of business)
- Provide advice on crypto trades
- Operate an exchange and/or act as a "crypto asset custodian".

Key issues:

- ADGM crypto business licensing regulations and guidance were published on 25 June 2018 after industry consultation. A new class of regulated activity has been created for "operating a crypto-asset business", with its own tech focused conduct of business rules for broker-dealers
- The regime is limited to "Accepted Crypto Assets" only, likely to be made up of the top 5 crypto-currencies in the first instance. Full AML rulebook applies
- The new rules open the door for first regulated crypto exchanges in the region.

The official regulated activity for any such firm would be "operating a crypto asset business" (OCAB). Such activities will, however, only be limited to "Accepted Crypto Assets" being a prescribed list to be published by the FSRA, taking into account several factors. These include: security profile of the token; exchange connectivity; liquidity/volatility and the underlying distributed ledger technology; as well as a maturity/market cap threshold, initially of US\$4 billion (which would likely mean one or more of BTC, ETH, XRP, BCH, EOS and LTC to start with). Licensed OCAB firms will need additional approvals to introduce new Accepted Crypto Assets into their scope of activities. Firms authorised to conduct crypto-asset business currently will only be permitted to deal in these Accepted Crypto Assets. There are no proposals to license ICOs.

The regulations set out succinct but comprehensive 'conduct of business requirements' for crypto asset business whilst applying the existing regulations for other types of business where relevant. The regulations focus on the following core areas to mitigate the risks to investors:

- AML (full rules apply)
- Consumer protection (enhancement to conduct rules including detailed disclosure requirements)
- Technology governance (detailed systems and control requirements)
- Exchange rules (existing MTF1 rules broadly apply to crypto-exchanges)
- Custody rules (existing rules will apply to custody of crypto assets as client assets).

The application of certain traditional financial services rules to OCAB will require some novel thinking, such as in the application of suitability assessments for advised sales. In the context of traditional investments with recognised characteristics, suitability presents a well-trodden path of assessing an individual's circumstances and portfolio against investment performance data and risk factors. In the context of crypto assets, where investors are looking beyond pure speculation, lack of data on historical correlations of asset classes and expected future performance data will make a traditional portfolio assessment much more challenging. In addition, we await to see how certain specific aspects of the traditional financial services rules for MTFs, such as in relation to volatility-induced circuit breakers, can be applied in a crypto asset context.

The new rules also include a requirement for OCAB holders to create a "Crypto Asset Compliance Policy", which must be "as robust as possible" and cover the crypto asset specific requirements in the rules. Technology is required to be subject to regular and thorough testing and upgrades. References are also made to network security standards and encryption algorithms being in line with accepted international standards. Such aspects are undoubtedly critical aspects in the protection of crypto investors.

The compliance requirements for OCAB firms are detailed and will require extensive engagement with the FSRA throughout the licensing process to demonstrate compliance with traditional conduct of business,

¹ Multi-lateral trading facility.

systems and controls and AML rules. There should be evidence that the systems and software to be used by the OCAB firm are sufficiently robust. A clear take-away from the guidance accompanying the rules is that they have been developed in a manner intended to fit with the established practices and "industry" standards for crypto-businesses operating globally.

Capital requirements will equate OCAB firms to "Recognized Exchanges" (6 or 12 months' operating expenses with additional capital requirements which the FSRA may specify depending on any unique risks). Unlike certain other regimes globally, capital requirements will need to be met in fiat currency and not crypto assets.

AML and KYC standards may present a necessary challenge for traditional crypto operators offering quick access to wallet tools. With the full AML rulebook applying, an existing business moving into the ADGM may have issues in on-boarding/re-KYC'ing clients to ADGM standards that require more comprehensive and up to date ID information and proof/source of wealth assessments. The guidance highlights that the FSRA does not consider it appropriate for OCAB holders to use simplified CDD when conducting crypto asset activities. However, as noted above, the FSRA has made efforts to support firms in their guidance by reference to crypto specific tech tools to assist in compliance requirements – such as in respect of the requirement to monitor the origin and destination of crypto-funds.² In addition, it remains to be seen how the full AML rulebook can be applied to decentralised exchanges (DEX) whilst still retaining the obvious benefits that come with DEXs.

Custody rules reflect market practice for crypto-business

FSRA guidance runs through the market approaches of multi-signature wallets and off-line/air-gapped key storage facilities. The guidance also notes that requirements for clients to self-custody crypto assets presents material risks for investors and will need detailed disclosure up-front of such implications. We expect that custody processes and guidance will need to be updated as international practices emerge, reflecting a balance of private key security vs quick trade functionality.

A big step for both OCAB firms and the FSRA will be the establishment of crypto exchanges now provided for under the rules. Crypto-asset exchanges will be licensed in a manner similar to MTFs. However, there are not currently regulated MTF platforms in the ADGM or DIFC and therefore such a license will be both a first in terms of crypto assets being exchanged and a first from a market supervision perspective for the region. The FSRA has included a number of sensible oversight requirements demonstrating it will be heavily involved in monitoring exchange operations. For example, the settlement of crypto-trades vs internal exchange ledgers must be live tested and demonstrated to its satisfaction.³ The FSRA acknowledges that firms will need to commit

² The FSRA guidance notes how firms may refer third party services capable of identifying tainted wallets addresses and tracking crypto assets through multiple transactions

³ Whilst we note the heightened risk for front-running amongst certified exchanges, the limitation of the ADGM regime to the top five crypto-currencies should mitigate this issue in the short term (given their daily trading volume). However, this will be a necessary consideration if the size of business through the exchange could impact the market for the relevant crypto-currency in the future.

substantial resources within the ADGM to license an exchange. We expect OCAB firms to license as broker-dealers/custodians utilising other exchanges in the first instance whilst building up this capability.

The cryptocurrency exchange market has recently seen growth in the demand for decentralised exchanges. Such exchanges keep more to the decentralised philosophy of blockchain by not having a market making central authority that governs and controls trades. Rather, trades are recorded on the relevant blockchain ledger itself and the "central authority" is a smart contract platform which executes trades in accordance with bids and offers by market participants. As the new rules do not distinguish between centralised exchanges and DEXs, they may need to be revised in order to account for this growth in due course.

The future for the rulebook

The global perception of the ADGM's rulebook will be a key test. We expect international regulators to recognise the regime as reasonably robust and overseen by a dedicated ADGM team of experts applying international AML standards. This will be supported by the number of cross border cooperation agreements the ADGM has with other regulators. We also note a number of firms, from local start-ups to international operations, are already in discussions to submit licensing applications.

That being said, thorough assessments will be required by OCAB licence applicants and the FSRA in ensuring satisfaction of the regulatory requirements. We expect the FSRA to adopt a rigorous approach, with its international credibility at stake.

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