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Cryptoasset Industry to Be Regulated in the U.K. and EU

By [Arun Srivastava](#), [Nina Moffatt](#) & [Konstantin Burkov](#)

The cryptoasset sector will become subject to anti-money laundering regulation in the U.K. and EU from January 2020. Industry participants with activities in the U.K./EU or who provide services to customers in those jurisdictions now need to:

- assess whether their activities are within scope of the new laws;
- note that while EU laws apply to crypto-to-fiat exchanges and wallet providers, U.K. laws are likely to go much further covering crypto-activities that do not involve fiat currencies as well as utility tokens;
- consider the geographic reach of the new laws. Activities carried on outside the U.K. might be caught where providing access to U.K. customers; and
- develop an AML Compliance Programme complying with strict EU standards and obtain registration with the relevant local regulator.

EU Regulations

The European Union's Fifth Money Laundering Directive ("5MLD") will shortly introduce regulation of the cryptoasset sector from an anti-money laundering ("AML") perspective. It is the first Pan-European Law dealing with the characterisation and regulation of cryptoassets.

The 5MLD requires Member States to apply AML obligations to cryptoasset exchanges (involving an exchange between crypto and fiat currencies) and to custodian wallet providers. European jurisdictions must introduce local legislation implementing the 5MLD by January 2020.

In April 2019 the U.K. Treasury issued its Consultation on the Transposition into U.K. law of the Fifth Money Laundering Directive. HM Treasury notes that cryptoassets remain an attractive asset class for those involved in unlawful activities. Their pseudo-anonymous nature, their accessibility online and their global reach make it possible for criminals to obfuscate the source and purpose of funds. HM Treasury sets out in its Consultation proposals for revamping the U.K.'s AML laws in the context of the transposition of the 5MLD provisions relating to cryptoassets. In many respects the U.K.'s proposals go materially beyond the requirements of the 5MLD, and HM Treasury has been influenced in this respect by recent developments at the level of the Financial Action Task Force ("FATF").

The Financial Action Task Force

In October 2018 FATF announced that it had adopted changes to the FATF Recommendations on Combatting Money Laundering in order to clarify how the FATF Recommendations apply to financial



activities involving cryptoassets. These changes were implemented through an amendment to Recommendation 15 (New Technologies) and changes to the Glossary.

The principal change made by FATF was to require that jurisdictions ensure that “*virtual asset service providers*” are made subject to AML requirements including conducting customer due diligence, ongoing monitoring, record-keeping, and reporting of suspicious transactions. FATF also recommended that virtual asset service providers should be licensed or registered and subject to monitoring to ensure compliance. However, this Recommendation relates to licensing only for AML and CTF compliance purposes as opposed to for broader financial services regulatory type obligations such as consumer and investor protection safeguards.

The changes made add to the Glossary new definitions of “*virtual assets*” and “*virtual asset service providers*”. FATF states that the latter category includes participants such as exchanges, certain types of wallet providers, and providers of financial services for ICOs.

The definition of a “*virtual asset service provider*” is broad covering:

1. exchange between virtual assets and fiat currencies;
2. exchange between one or more forms of virtual assets;
3. transfer of virtual assets;
4. safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets; and
5. participation in and provision of financial services related to an issuer’s offer and/or sale of a virtual asset.

In contrast, as explained below, the 5MLD requirements apply only to exchanges (involving the exchange between crypto and fiat currencies) and wallet providers. The 5MLD therefore covers only two of the above five activities.

U.K. Anti-Money Laundering Regulation for Crypto Activities and ICOs

The new rules mean that cryptoasset businesses within scope will have to register for supervision within the requirements of applicable AML and CTF laws. In the U.K., this is likely to be with the Financial Conduct Authority.

The 5MLD has the effect of amending the Fourth Money Laundering Directive (“4MLD”) so that in most European countries cryptoasset providers will become subject to the local law implementation of the 4MLD. In the U.K., this will mean applying to them the requirements of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (ML Regulations).

As well as becoming subject to supervision for compliance, cryptoasset firms within scope will have to introduce AML policies, procedures, and controls. These include matters such as mandatory customer due diligence/KYC on customers, obligations to monitor transactions, the reporting of suspicious transactions, training, record keeping, staff vetting, and the registration of senior individuals involved in the business with the local regulator.



A key aspect of the HM Treasury Consultation is that the U.K. Government is considering materially gold-plating the EU rules to cover the following matters not covered by the 5MLD:

- The U.K. may apply regulation to all digital assets and not just crypto-currencies (including, utility tokens);
- U.K. laws might apply extra-territorially to service providers outside the U.K. providing services to persons in the U.K.; and
- The U.K. might apply regulation to exchanges which do not involve exchange of crypto to fiat currency.

The U.K. is committed to transposition by January 2020 notwithstanding any Brexit developments.

5MLD

The 5MLD extends AML regulation to activities carried on in relation to “*virtual currencies*”. For these purposes a “*virtual currency*” is defined as a digital representation of value that is not issued or guaranteed by a central bank or public authority and not necessarily attached to a legal currency and does not possess the legal status of currency or money and which can be transferred, stored, and traded electronically.

Two broad categories of activities carried on in relation to virtual currencies are made subject to AML regulation under the 5MLD. These are:

- Cryptoasset exchanges that are engaged in exchange services between cryptoassets and fiat currencies; and
- Custodian wallet providers who provide services to safeguard cryptographic keys on behalf of customers, to hold, store, and transfer virtual currencies.

Providers of these services will become “obliged entities” under European Money Laundering rules and must implement anti-money laundering controls, policies, and procedures.

Assets Covered

The U.K. has adopted the taxonomy of “*exchange tokens*”, “*security tokens*”, and “*utility tokens*” in approaching the categorisation of cryptoassets.

As stated above, the 5MLD extends AML regulation to “*virtual currencies*”, whereas the HM Treasury Consultation proposes going further than this and covering all three categories of cryptoassets referred above (exchange, utility, and security tokens).

Activities Covered

Exchange providers under the 5MLD will be regulated where they provide exchange services between crypto and fiat.

The HM Treasury is considering broadening this out to include crypto-to-crypto exchange service providers, peer-to-peer exchange service providers, cryptoasset automated teller machines, the issuance of new cryptoassets (e.g., through ICOs), and the publication of open-source software (which includes but is not limited to non-custodian wallet software and other types of cryptoasset related software).

The approach that the Treasury is taking is more in line with the approach advocated by FATF under the amended Recommendation 15.



The Treasury Consultation notes that the greatest risk in relation to cryptoassets arises at the point of exchange, where value can be recognised and can further be used to obfuscate the true source of the assets and funds. It is on this basis that the U.K. Government is proposing to extend regulation beyond crypto-to-fiat exchanges and also include the broader range of activities referred to above which all involve the process of exchange.

Cross-border Business

U.K. anti-money laundering rules presently apply to activities carried on in the U.K.

Recognising the international nature of the crypto business, the HM Treasury consultation proposes extending the reach of U.K. AML laws to providers who are located outside the U.K. The Consultation notes that the new U.K. rules could be circumvented if service providers locate themselves outside the U.K. If so, they might not perform customer due diligence/know your customer checks or implement other controls to mitigate AML risks. The Government is seeking views on whether the new U.K. rules should therefore apply extra-territorially to prevent such circumvention.

Concluding, from January 2020 providers of services in relation to cryptoassets will be subject to regulation in the U.K. and other European countries for AML compliance. This is likely to be a first step in the process of introducing broader regulations in this area. For many industry participants this will mean a significant change to a presently unregulated business. Firms will need to devote additional resources to these matters and the customer experience will be less frictionless. On the other hand, the introduction of regulation will help mitigate risks and potentially open up new possibilities for cryptoasset service providers to work with previously sceptical partners.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Chris Daniel
1.404.815.2217
chrisdaniel@paulhastings.com

London

Arun Srivastava
44.020.3023.5230
arunsrivastava@paulhastings.com

Konstantin Burkov
44.020.3321.1009
konstantinburkov@paulhastings.com

Nina Moffatt
44.020.3023.5248
ninamoffatt@paulhastings.com