FEEDBACK STATEMENT ON CP143 REGULATION OF CRYPTO TOKENS

17 October 2022

PREFACE

Why are we issuing this Feedback Statement?

1. Periodically, the DFSA issues Feedback Statements to explain the conclusions reached, and the final rules put in place, on matters which we have consulted on. We do this, where we think it is helpful to:

    a. share with stakeholders the responses we received to a particular consultation;

    b. illustrate the matters that the DFSA has considered in reaching any conclusions; and

    c. explain changes from proposals consulted on, where the reason for these changes may not otherwise be obvious from the final rules.

Who should read this Statement?

2. This Feedback Statement ('the Statement') is likely to be of interest to:

    a. all Authorised Persons, Registered Auditors and Designated Non-Financial Businesses and Professions (DNFBPs);

    b. applicants or potential applicants to become any of these; and

    c. advisers to any of the above.

Terminology

3. Where defined terms are used in this Statement they are identified by the capitalisation of the initial letter of a word or of each word in a phrase below or in the Glossary Module (**GLO**). When acronyms are used, they are defined in the Glossary section. In all other cases, the expressions used have their natural meaning.

What happens next?

4. The rules discussed in this Statement, arising from the consultation on CP143, have been made by the DFSA Board. The rules commence on 1 November 2022.

Introduction

5. In March 2022, the DFSA published Consultation Paper 143 – Regulation of Crypto Tokens (CP143), which set out proposals for a regulatory regime for persons seeking to provide Financial Services in respect of Crypto Tokens. This was a second consultation paper in respect of the regulation of Tokens, with the DFSA having consulted on the Regulation of Investment Tokens in 2021.

6. Our intention in respect of these consultations, and our accompanying regulatory proposals, is to foster innovation in this area in a measured, responsible and transparent manner while still meeting our regulatory objectives. We have been conservative, but as we gain further experience in this area, considering measures adopted by International Standard Setters, and developments in other markets, we will consider further changes to the regimes we have adopted, if appropriate.

Part 1: Feedback to CP 143

7. The DFSA received 23 sets of comments from a range of stakeholders in response to CP143, including Authorised Firms in the DIFC, crypto businesses, law firms and others. A list of respondents is included as Annex 1 to this Statement. Given the breadth of comments received, we believe we needed to set out and explain our thinking in areas where changes were made, or where we had reasons not to make changes in respect of the proposals we consulted on, which we have done in this Statement.

8. Most respondents supported our proposals, with many providing further insights or seeking additional clarifications of, and refinements to, our proposals. The feedback we received resulted in some changes to the proposed rules, but in a way that clarified our position and removed potential ambiguities. No major amendments were made that would materially change our proposed regime for regulating Crypto Tokens, except as highlighted in Part 1, Section 2: Recognition of Crypto Tokens.

Part 2: Future work on Crypto Tokens

9. We also set out in this Statement our thoughts around some other policy issues relating to Crypto Tokens, which we plan to explore further as part of future public consultations (see Part 2). This includes looking at areas such as Staking, DeFi and AML/CTF issues such as the Travel Rule.

Part 3: Implementation

10. Lastly, we set out how we will deal with those applying to the DFSA to get licensed to provide products and services in respect of Crypto Tokens, where we expect firms to display a readiness in terms of human capital and resources to prepare for regulation.

PART 1: FEEDBACK ON CP 143

Section 1. Classification of Tokens

A. Token Taxonomy

11. We did not make any major changes to the classification, and definition, of Tokens that were presented in CP143. Having said that, we will monitor the market as it develops in the DIFC, and follow international regulatory developments, to ensure that we have put in place the right definitions and delineations around different types of Tokens.

12. We did, however, make some minor changes, for example, in respect of our approach to Central Bank Digital Currencies (CBDCs), so we have updated our chart of Token taxonomy in the DIFC (Chart 1), and provided more detailed guidance (Table 1) in the final rules about the Token taxonomy, which we briefly summarise below.

Chart 1. Token taxonomy in the DIFC

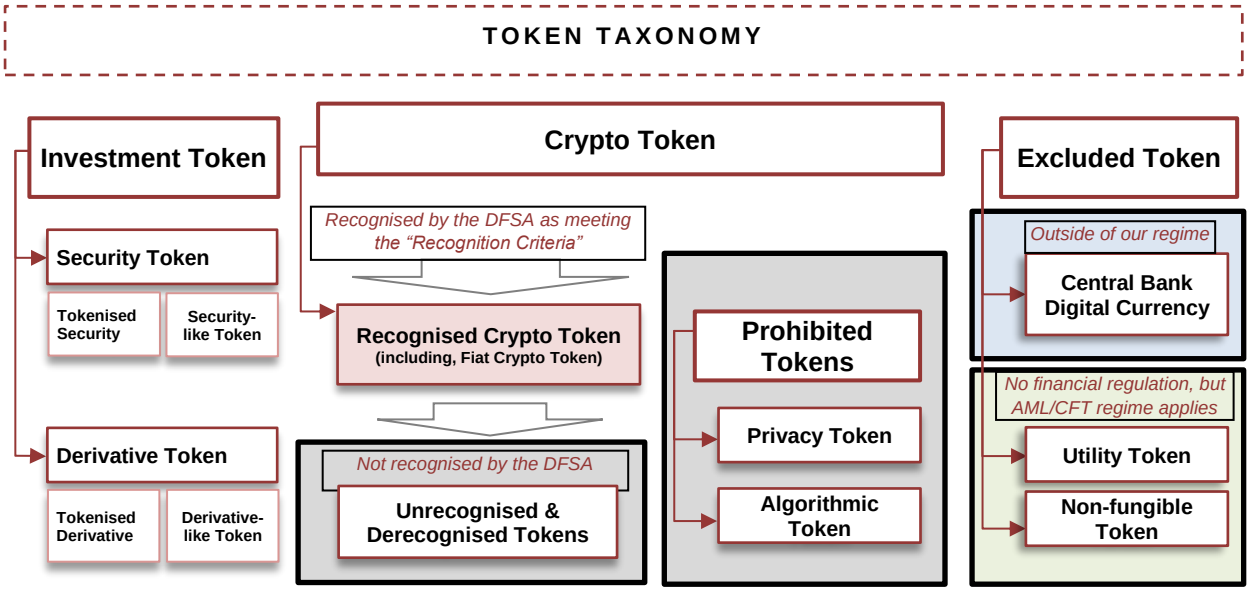

Table 1. Provides further context on the Token taxonomy (colour coding in Table 1 relates to Chart 1 above). Further details on the application of these rules are provided in relevant sections in this Statement.

Recognised Crypto Tokens	○ Financial Services and activities[1] can be carried on in relation to Crypto Tokens that are Recognised. This means Tokens that the DFSA has recognised as meeting the criteria in GEN 3A.3.4. Carrying on those services or activities is subject to compliance with relevant DFSA requirements. ○ We set out more detail in Part 1, Section 2, but we plan to introduce an "initial list" of Recognised Tokens (which meet our recognition criteria in GEN 3A.3.4) that will be put on our website at the commencement of the regime. This means that these Tokens will not need to go through separate recognition via the formal recognition process.

[1] GEN 3A.2.1 sets out in detail the activities that are prohibited where a Crypto Token is not recognised, including not only Financial Services but also promotions, public offers and certain other activities.

Recognised Fiat Crypto Tokens	○ Financial Services and activities can be carried on in relation to Fiat Crypto Tokens that are Recognised. This means Tokens that the DFSA has recognised as meeting the criteria in GEN 3A.3.4 (1), (2)(a)-(e) and 4(a)-(e). Carrying on those services or activities is subject to compliance with relevant DFSA requirements.
Prohibited Tokens, Unrecognised and Derecognised Tokens	○ Carrying on any financial service or other activity with Prohibited Tokens (Privacy Tokens or Algorithmic Tokens) is strictly prohibited.[2] ○ The same restriction applies to the following tokens, subject to the exception in the last bullet point below: - Unrecognised Crypto Tokens, being Crypto Tokens that have not been assessed and recognised by the DFSA as meeting the recognition criteria referred to above; and - Derecognised Crypto Tokens, being Crypto Tokens whose recognition status has been revoked by the DFSA due to the Crypto Token no longer meeting the recognition criteria. ○ The only Financial Service that may be carried on in relation to unrecognised and derecognised Crypto Tokens is the provision of custody, by an appropriately licenced Authorised Firm.
Non-fungible Tokens (NFT) and Utility Tokens (UT)	○ NFTs and UTs that fall within the precise definitions in the DFSA Rules are Excluded Tokens and are outside the scope of regulation under the DFSA regime, except as specified below.[3] ○ Issuers of NFTs and UTs and person who are providing services in relation to NFTs or UTs (e.g., auction houses, issuance platforms, safekeeping services) are required to register with the DFSA as a DNFBP and comply with the AML regime in both the UAE and DIFC.[4] ○ Issuers are not required to register as a DNFBP if all issues involve transactions of USD 15,000 or less. No threshold exists for NFT or UT service providers to register as a DNFBP, except that the requirement does not capture a service provider that is only providing technology support or technology advice to a NFT or UT issuer. ○ Authorised Firms are not permitted to provide services with NFTs and UTs, except for custody where a firm is a licensed custodian. Authorised Firms who wish to operate with these Tokens may do so by establishing a separate legal entity (to note, the separate entity may be required to register as a DNFBP) and ensuring proper separation of that activity from their regulated business. ○ Should a UT or NFT display characteristics beyond the precise definitions set out in GEN, they are likely to fall under DFSA regulation, as a Crypto Token or an Investment Token. Consequently, any Financial Service provided with these Tokens will be regulated and require appropriate DFSA authorisation.

[2] See GEN 3A.2.2 and 3A.2.3.
[3] See GEN A2.5.3 and A2.5.4.
[4] See AML 3.2.1.

Central Bank Digital Currencies (CBDC)	○ We have excluded CBDCs from our Crypto Token regime and not restricted their potential use[5]. If, and when, CBDCs are launched and rolled out, we will further consider whether we need to amend our regime to address CBDCs in a way that is appropriate.

To assist market participants to appropriately classify the type of Token they intend to operate with, and whether it will be permitted in the DIFC, we have created an illustrative "Token Decision Tree." Please see Annex 2.

B. Crypto Tokens

13. As expected, we received many comments about our proposed definition of a Crypto Token, the terminology we used, and why it was not perfectly aligned to the Virtual Asset definition used by the Financial Action Task Force (FATF).

14. Aside from the usual elements (e.g., use of distributed ledgers, cryptographically secured, digital representation of value), which various jurisdictions use to define what is usually referred to as a Virtual Asset, Digital Asset, Crypto Asset, or other name, there is currently no internationally accepted definition for these instruments. The definition used by the FATF seems to be the most universally accepted one, which many jurisdictions have referred to in coming up with their own definitions and designations.

15. Our definition is broadly aligned with that of the FATF, with the differences being that we changed "*used*" to something that is "*used or intended to be used*" and added *"used as a medium of exchange"* to further clarify the application. This is because, for example, some Crypto Tokens may be used as a medium of exchange in buying or selling other Crypto Tokens.

16. When it comes to other definitional elements, i.e., *"used for payment or investment purposes"*, our definition repeats that of the FATF. The rest are minor differences, mainly in terminology.[6]

Fiat Crypto Token

17. Parallel use of the terms "*Asset Reference Token*" and "*Fiat Crypto Token*" in CP143 caused confusion, with some respondents thinking that these were another type of Token, rather than a sub-category of Crypto Token. We reflected on the dual use of these terms and concluded that it did not serve any purpose in the regime. Consequently, we removed any references to "*Asset Reference Token*" and defined "*Fiat Crypto Tokens*" as a class of Crypto Token the value of which is determined by reference to a fiat currency or a combination of fiat currencies.[7]

18. Just like any other Crypto Token, Fiat Crypto Tokens must undergo a recognition process for them to be permitted to be used in the DIFC. In addition to the standard set of criteria for all Crypto Tokens, Fiat Crypto Tokens must also meet additional requirements in GEN 3A.3.4(4), such as requirements about the adequacy and independent third-party verification of reserves and the stability of the Tokens relative to the reference currency. Other Crypto Tokens which purport to reference their price against any asset, other than fiat currency, will not be considered a Fiat Crypto Token. These Crypto Tokens will fall into the wider definition of Crypto Token, unless they are a Derivative Token or a Security Token (for example, a Unit of a Collective Investment Fund).

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5 See GEN A2.5.2.
6 See GEN A2.5.1.
7 See GEN A2.5.5 and underlying guidance for the definition of Fiat Crypto Token.

19. Apart from other general uses, a Fiat Crypto Token that is Recognised by the DFSA may, if specified conditions are met, be used for two other purposes in the DIFC. First, Money Services firms may only use Fiat Crypto Tokens to provide money transmission and payment execution services. They may not provide any other services involving a Crypto Token.[8]

20. Second, Fiat Crypto Tokens may also be used for the process of clearing and settlement by a Clearing House. Usually, only Fiat currencies are used as a money settlement instrument in the post-trade environment. However, taking into consideration the use of blockchain technologies for on- and off- chain clearing, we have stated that certain Fiat Crypto Tokens may be used by Clearing Houses, subject to the Token meeting additional governance and risk management criteria set out in AMI 7.2.5A.

C. Excluded Tokens

Non-fungible Tokens (NFT)

21. We consulted on a narrow definition of NFT, which remains in place.[9] This means that a Token must meet strict requirements to be considered as an NFT. Any deviation from the NFT characteristics in that definition is likely to result in that Token being a Crypto Token or, depending on the arrangements, an Investment Token (for example, a Unit of a Collective Investment Fund).

22. We have added further guidance, and added several examples under the NFT definition to help market participants determine whether or not the Token they wish to use is an NFT. One of the deciding factors is the unique and non-fungible nature of the Token, which must relate to, and represent, an identified asset, such as art, music, or another collectable item. Further, the unique Token must be used to prove the ownership or provenance of the asset. An example of a common departure from the unique nature of the NFT is the process called "fractionalisation", where the Token is distributed to multiple persons, or relates to different reference assets. Quite often, fractionalisation leads to the development of network effects around the Token, leading to liquid secondary markets, and the Token being *"used for investment purposes"*. This is where the NFT demonstrates a key characteristic of the Crypto Token definition.

23. We also added further guidance explaining our views about the "NFT" label that many Tokens in the crypto industry are given, despite having characteristics different from a real NFT. Just because something is called an NFT does not make it one. We will take a "*substance over form*" approach in determining whether a certain Token is an NFT, as we see many instances where a Token is called an NFT but operates like any other Crypto Token or Investment Token. We will not be relying on the labels alone.

<u>Gaming Tokens</u>

24. We received many questions on Gaming Tokens, asking whether these Tokens were in or outside of our regulation. This will of course depend on the features of the Token, for example, a Gaming Token could be considered to be a NFT if it is unique and represents ownership of identified characters or elements of a particular game. Alternatively, it could be considered to be a UT, if it is traded in the closed-loop gaming ecosystem. The key question will be whether the Token meets the narrow definition of a NFT or UT.

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[8] See GEN 3A2.5(1).
[9] See GEN A2.5.3 (and the underlying guidance) for the definition of a Non-Fungible Token.

25. Some other games may accept Crypto Tokens on their platform (pay-to-play model) or provide winning rewards (play-to-earn model) to their community. For example, a game may be rewarding, holding, selling, or buying Crypto Tokens on their platform, in which case we may view the gaming platform as providing, or holding itself out as providing, a Financial Service (for example, taking custody of users' Tokens, or operating a market). In this case, the Crypto Token would have to be recognised by the DFSA and the service provider would have to hold the appropriate Financial Services licence.

Utility Tokens (UT)

26. We have adopted a narrow definition of a UT, and provided further examples and guidance in GEN to assist market participants to determine whether or not a Token is a UT.[10] A common misconception in the market is where a cryptocurrency is labelled a UT (for example, we have observed a number of unregulated crypto exchanges create UTs), despite that Token having clear characteristics of a Crypto Token that is used or intended to be used for investment purposes. Similar to our approach to NFTs, we will not be relying on labels used and will adopt a "*substance over form*" approach when classifying Tokens as per the definitions in our rules.

Registration as a Designated Non-Financial Business or Profession (DNFBP)

27. We would like to draw the attention of the wider crypto industry to our intention to bring creators (issuers) and service providers (e.g. auction houses, issuance platforms, safekeeping services) for both NFTs and UTs within the DFSA's AML/CFT regime. In CP143, we consulted on the option of bringing only NFT creators and service providers within the scope of our DNFBP regime. Respondents pointed out (and rightly so) that UT creators and service providers should also be included to counter the potential ML risks and to provide a level playing field.

28. As a result, we have set out, in AML 3.2.1, that a person who carries on the business or profession of issuing, or providing services related to, a NFT or UT must apply to the DFSA to be registered as a DNFBP. An exclusion applies, in the case of an issuer, if each issue involves a single transaction, or series of multiple interrelated transactions that are equal to or less than USD 15,000 in value; or in the case of a service provider, where the service constitutes solely technology support or technology advice to an issuer. For the sake of clarity, a NFT exchange, either operating in a centralised or decentralised manner, would not be viewed as solely providing a technology service, because it would also be bringing together buyers and sellers who wish to transact in NFTs.

29. Persons operating with NFTs and UTs should be aware that there is no transitional rule when it comes to the registration as a DNFBP with the DFSA. We will expect relevant issuers and service providers in NFTs and UTs (especially those already in the DIFC) to register as a DNFBP with the DFSA from the commencement date of the Crypto Token regime (see Part 3), or face potential enforcement action.

Combining Token business

30. To avoid any confusion or misconception among customers about whether regulatory safeguards (for example, conduct or prudential protections) apply in relation to NFTs and UTs, we have prohibited Authorised Firms from providing services relating to these Tokens. The only exception being that a licensed custodian in the DIFC may safeguard and administer these Tokens on behalf of their clients.[11] If an Authorised Firm wishes to offer services with these Tokens, they will need to establish a separate legal entity to ensure

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[10] See GEN A2.5.4 (and the underlying guidance) for the definition of Utility Token.
[11] See GEN 3A.2.4 (and the underlying guidance) for the exact application of this prohibition.

proper separation of these activities from their regulated activities, and ensure that they have the appropriate approvals to provide these services, i.e., that they are registered as a DNFBP in the DIFC for AML purposes.

Central Bank Digital Currencies (CBDC)

31. Our definition of Excluded Token includes another category of Token, i.e., a Token that *"represents digital currency issued by any government, government agency, central bank, or other monetary authority"* (commonly referred to as a Central Bank Digital Currency, or CBDC). In contrast to NFTs and UTs, CBDCs are not prohibited for use by Authorised Firms.[12] Firms and their clients will be able to use CBDCs, if and when created by any government and made available to the public.

D. Prohibited Tokens

32. There were several requests by respondents for Algorithmic Tokens, Privacy Tokens and Privacy Devices not to be classified as "*prohibited*". The main argument was that this would limit the market and potentially mean the DIFC was not as competitive as other jurisdictions. We did not, however, find these comments persuasive – competition cannot and should not be based solely on the number of Tokens available for use. The use of these Tokens and devices remains prohibited.[13]

VPN, not a Privacy Device

33. We had a respondent seek clarification on whether the use of VPNs would constitute a Privacy Device in the context of the Crypto Token regime. Our definition of Privacy Device was not intended to capture VPNs, which are used to conceal the geolocation and the true IP address of the computer accessing the internet network. Prohibiting the use of VPNs was not intended and would go beyond the AML justification for deciding to ban Privacy Devices. We have therefore provided clarification in GEN that a VPN is not a Privacy Device.[14]

Un-hosted wallet, not always a Privacy Device

34. We also had questions about Privacy Devices and whether self-custody wallets would come under this category and therefore be prohibited. We are aware that self-custody and the use of un-hosted wallets are topics that have drawn increased attention with the advent of DeFi and popularity of decentralised exchanges. Although we have not yet set out our regulatory strategy towards DeFi, we thought it would be helpful if we clarify in this Statement what self-custody is, how un-hosted wallets are treated under our proposed Crypto Token regime, and note further policy consultations that we may publish on this topic.

35. Self-custody of Crypto Tokens, in our rules, is defined in COB 15.4.1(c) as "holding and controlling of Crypto Tokens by their owner, through the owner holding and controlling the public and private cryptographic keys relating to the Crypto Tokens".

36. Un-hosted wallets are usually accommodated by decentralised exchanges, crypto ATMs or other online services, where the user takes ownership, control and possession of their Tokens and only accesses the hosted service at the time of sending or receiving Tokens. Un-hosted wallets may also be provided by centralised exchanges as an alternative to taking custody over the users' Tokens. When exercising self-custody, the user will usually hold their Tokens (i.e., wallet addresses and private keys) on their hard-drives, cloud

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[12] See GEN A2.5.2 (and the underlying guidance).
[13] See GEN 3A.2.2 and GEN 3A.2.3.
[14] See GEN 3A.1.1(c).

services, print form, or other physical media.[15] Self-custody provides more control to the user when it comes to safe and secure control over the Tokens.

37. Under our regime, safekeeping and administration of a user's Crypto Token constitutes a provision of a Financial Service, and any firm seeking to provide such a service must obtain a licence from the DFSA to provide custody, in compliance with our regulatory regime. Where a DFSA-licensed custodian chooses to allow un-hosted wallets, then our custodial regime would not apply in relation to that specific client and their Tokens. Nevertheless, this does not alleviate the custodian from complying with our custody and AML regime when transacting with that customer.

38. As already stated, the provision of any Financial Service with Crypto Tokens requires an appropriate Financial Services licence from the DFSA, and any unlicensed activity in the DIFC is strictly prohibited.[16] Whether it is an unregulated decentralised exchange[17] offering hosted or un-hosted wallets to their customers in the DIFC, or a crypto ATM allowing users to transfer their Tokens, or other online solutions positioning themselves as a service to transact with wallets, all of these services will likely constitute a Financial Service and require a licence. Therefore, while self-custody using an un-hosted wallet does not constitute a Privacy Device, the Financial Service of providing digital wallet services will need to be authorised and regulated by the DFSA.[18]

Section 2. Recognition of Crypto Tokens

A. Rationale for Recognition

39. We highlight that no Financial Services or activities can be undertaken with a Crypto Token unless it is recognised by the DFSA. This extends to Derivatives transactions relating to Crypto Tokens, and to Funds or portfolio managers that invest directly or indirectly (e.g., through other fund structures, including ETFs, or indices) in Crypto Tokens. This is one of the key areas that drew most attention from the industry in response to our consultation.[19]

40. Many respondents did not agree with the approach to have Crypto Tokens "*recognised*" by the DFSA, suggesting that the industry was better placed to assess whether a Crypto Token was suitable and/or viable. However, none of the arguments persuaded us that a change was needed. A Crypto Token business has an innate incentive to operate with as many Tokens as possible, as a way of maximising profits from transaction fees and other forms of income when their clients are using these Tokens. This natural drive for more business creates an unmanageable conflict of interest if the provider were responsible for selecting what Crypto Tokens to offer services in relation to. Under the current economic conjuncture in the crypto industry, where there is limited public information on any given Token and where exchanges, for example, do not have a long-demonstrated track record of compliance history, we remain of the opinion that it is too early for firms to self-certify the types of Crypto Tokens they can use.

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15 There are alternative arrangements for reaching a middle ground in terms of sharing responsibility for safekeeping of Tokens between the service provider and the user. One of those methods is the multi-signature arrangement, where, for example, 2 out of 3 signatures are required to access a user's wallet, such that one signature is held with the user, second signature is held with the service provider, and the third signature is provided to an independent third party entrusted by the user.

16 See Art. 41 of the Regulatory Law (DIFC Law No. 1 of 2004) for our general prohibition against unlicensed activity.

17 A DIFC company involved in the establishment and running of a decentralised exchange will almost certainly need to be licensed by the DFSA. The same is true for the other examples given here – a company operating a crypto ATM or a meta-mask website operated from the DIFC.

18 See COB 15.4.1 for the definition of Digital Wallet Service Provider.

19 See GEN 3A.2.1(1) for the exact wording of the prohibition.

41. While we acknowledge that self-certification is a path that regulators in some jurisdictions (e.g., New York Department of Financial Services) have chosen to pursue, until further developments and the accumulation of a more internationally-driven compliance culture within the crypto industry, we will not be adopting this approach. We do not rule out that it might happen in the future.

42. Nevertheless, we received some helpful suggestions to improve our Crypto Token recognition criteria, which included:

    a. clarifying the setup and structure of the criteria, which has now been improved for clarity, and includes dedicated criteria grouped into six main areas – regulatory status, transparency and public information, market depth, technological resilience, risks and controls;[20]

    b. adjusting the reserves, stabilisation and redemption criteria for Fiat Crypto Tokens, where we require the value and composition of the reserves to be demonstrated (predominantly consisting of cash), those reserves to be segregated and held with a properly regulated bank or custodian, the reserves to be verified by an independent qualified third party expert and information to be published at least quarterly on the value and composition of the reserves; and

    c. allowing for certain information not to be provided to the DFSA where it is not possible to obtain the information or it is not relevant, by adding in such phrases as "where possible" and "where applicable", where the information required under a certain criterion may not always be available.

B. Recognition Process

43. We were surprised to see many respondents suggest that the recognition process would be overly burdensome for an applicant to go through. As a regulator, we would always expect Authorised Firms to understand their products and perform a comprehensive risk assessment before offering any services in these products to their clients.[21] Therefore, we do not think that Authorised Firms or applicants who have the right compliance culture would find it difficult to get the right information for the recognition application process. Further, the recognition process is not a replacement for the level of diligence that we would always expect an Authorised Firm to carry out.

44. We were also asked to provide more information about the operational side of the recognition process, and how we envisaged it working, where we receive one or multiple applications for recognition of the same Crypto Token. We have considered these scenarios and clarified the operational steps we will take when receiving recognition applications, as follows.

45. In line with its power under GEN 3A.3.7(2), the DFSA will generally issue a notice on its website of the fact that it has received an application for recognition of a specific Token. This way, other persons and firms will be aware that the DFSA is currently reviewing an application in relation to the Token that they may be interested in providing Financial Services with. We do not rule out the possibility that other firms may choose to send duplicate applications on the same Tokens, either because they have not seen the DFSA's notice, or they have reasons to believe that their application will provide better information to help us make a positive assessment.

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[20] See GEN 3A.3.4 (and the underlying guidance) for the list of Crypto Token recognition criteria. Persons seeking to apply for a Token to be recognised will be required to submit a Recognition application form which will be available on the DFSA website.

[21] We have set out our expectations in paragraph 6 of the guidance under GEN 3A.2.1.

46. Duplicate applications, while potentially being an operational burden, may also be a source of invaluable insight on the same Token, but from a different applicant's perspective. Therefore, the DFSA will address duplicate applications on a case-by-case basis, depending on the marginal value associated with the additional application, and communicate back to the applicant accordingly.

47. The DFSA will not set a specified timeframe for reviewing recognition applications as this will greatly depend on the quality of the information and analysis presented by the applicant. Undeniably, there will be a learning curve both for the regulator, and for the applicants, when it comes to working through recognition applications. When the review process becomes operationally more predictable, the DFSA may publish provisional timeframes for recognition applications on its website, together with the notice of having received a new application for a specific Token.[22]

48. It is important for the industry to note that our six-month transitional arrangements in GEN 10.5 are designed to provide certain Authorised Firms with sufficient time for compliance, that is where they were already providing a service relating to Crypto Tokens immediately before the commencement of the regime. One of the consequences of this transitional arrangement is that Authorised Firms may continue providing that same service with Crypto Tokens **for only six months**. Firms should allow sufficient time to submit their Crypto Token recognition applications and have them assessed by the DFSA before the transitional period ends, or they will be required to cease offering any products and services relating to those Tokens.

Pre-Recognised Crypto Tokens

49. We had, prior to publishing CP143, spent a considerable amount of time thinking about whether we would create an initial list of Crypto Tokens that would be "pre-recognised" and become immediately available to be used when the regime comes into force. This is something we have seen several other regulators produce, and we thought it could solve some practical issues we had identified, for example, providing the market with a starting point where they could be providing Financial Services with a set of pre-recognised Crypto Tokens.

50. We have weighed up the pros and cons raised by respondents to CP143 and we have decided to create an initial list of Recognised Crypto Tokens that will not need a separate recognition via the formal application process. In other words, the Crypto Tokens on the list will be recognised from when the regime comes into force.[23] We will only include Crypto Tokens on this list where we are satisfied that they meet the recognition criteria in GEN 3A.3.4. While the rule states that we have 30 days after the Crypto Token regime has come into force to publish this list, we intend to publish it when the regime comes into force on 1 November.

51. It is important to note that this list will be a one-off exercise, and the list cannot be expanded in the future by any means. The DFSA may alter the one-off list only where it is necessary to do so due to a change in the name of a Crypto Token, or if the Token no longer meets the Recognition criteria. In the case of a fork affecting a Crypto Token, the DFSA will undertake a review to be satisfied that the Crypto Tokens resulting from the fork will still meet the criteria for use in or from the DFSA.

Recognised Crypto Tokens

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[22] Under GEN 3A.3.7(3), the DFSA may include such information in the notice as it considers appropriate.
[23] See GEN 3A.4.

52. In line with GEN 3A.3.7, the DFSA will publish a notice on its website every time a new Crypto Token has been recognised for use in the DIFC. We will also update our list of Recognised Crypto Tokens (published on our website), to include that Crypto Token. Firms should refer to the list on the DFSA website as the only official list of Crypto Tokens that can be used in the DIFC.

53. The DFSA will also publish a notice where it decides not to recognise a Crypto Token i.e. if it is not satisfied that the recognition criteria are met.[24] Such transparency should help potential applicants avoid submitting an application for a Token that has previously been refused, or to make a better-informed decision about whether sufficient time has passed since the refusal and whether circumstances around the Crypto Token have improved enough to justify another application for recognition of the Token.

Forks and air-drops

54. In response to our consultation, we were asked to clarify whether forked or air-dropped Tokens would also have to be (re) assessed against the recognition criteria and consequently appear on the DFSA's Recognised Crypto Token list.

55. We have considered these scenarios and can clarify that – where a Recognised Crypto Token forks – the DFSA will need to re-assess and conclude whether one or both Tokens coming out of the fork are to retain their recognition status.[25] The course of action will naturally depend on the effect of the fork on the existing Crypto Token. If the original Recognised Crypto Token has been altered, then a recognition application will need to be submitted to the DFSA with updated information on the Token. If the original Crypto Token has not been altered, then no new application will need to be lodged. Any new Crypto Token, other than the original Token, resulting from the fork will have to go through the recognition process.

56. Given that Forks are usually planned and prepared, and anticipated for, well in advance, applicants should aim to identify any proposed forks and expected effects when applying for initial recognition (if possible), so that a recognition process for the fork can be properly planned for.

57. When it comes to air-dropped Tokens, the recognition approach to Crypto Tokens will be the same. Where firms are seeking to provide Financial Services with air-dropped Tokens, then an application for recognition will need to be filed with the DFSA before any activity is carried on with that Token. The origin of the Crypto Token, whether resulting from an airdrop, crowd sale, or a consensus mechanism, does not alter the necessity to apply for recognition. The only exception is the provision of custody, for which no recognition is required. A DFSA-licensed custodian may safeguard or administer almost any Token (be it forked or air-dropped), except for Prohibited Tokens.[26]

Ongoing monitoring

58. Some respondents were concerned at the consultation proposal that they should monitor the suitability of a Recognised Crypto Token and notify the DFSA if they become aware of any significant event, or development, which might lead to the Recognised Crypto Token no longer being suitable for use in the DIFC. We have clarified[27] that this requirement is a not a daily monitoring obligation on the firm. Instead, it is a call for firms to be vigilant, and

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[24] See GEN 3A.3.5 for the DFSA's right to refuse an application that does not meet the recognition criteria.
[25] See paragraph 3 in our guidance to GEN 3A.2.1 on the recognition processes following a fork.
[26] See paragraph 2 in our guidance to GEN 3A.2.1 on the air-dropped and forked Tokens used by a licensed custodian.
[27] See GEN 11.10.21 and associated guidance.

to monitor events and developments in relation to the Crypto Tokens that they are offering to their clients. We do not believe this to be disproportionate or burdensome on the firm. As noted earlier, we would expect firms, in the normal course of business, to make themselves aware of changes or significant developments in products that they offer to their clients.

59. There may, however, be certain Financial Service activities where the Authorised Firm is likely to have greater knowledge of developments relating to a Crypto Token. For example, this might occur where the firm is operating a Multilateral Trading Facility (MTF), is acting as a market maker or is providing advice on the Crypto Token. In such situations, we would expect the firm to have greater awareness of developments relating to the Crypto Token and therefore to be more likely to report adverse events or developments to the DFSA.

C. Derecognition Process

60. We were asked to provide further clarity on, and examples of, when a Recognised Crypto Token's status may be revoked and what action the DFSA would expect Authorised Firms to take. There also appeared to be concerns that revocations might be a common occurrence, where the DFSA would regularly revoke the recognition status at the first negative alert about the Crypto Token.

61. The DFSA may start a revocation process based on its own analysis, as well as upon receiving a notification from firms providing evidence that a Crypto Token may no longer meet the recognition criteria. The DFSA will carefully consider every scenario, and will normally only act where continued recognition of the Token is no longer compatible with the objectives that underlie the recognition criteria, such as consumer protection, market integrity, financial stability or the prevention of money laundering.

62. For example, falling prices of a Crypto Token should not of itself be a reason for derecognition. Rather, without limiting those circumstances, major hacks, technology failures, serious fraud or money laundering, lack of transparency, lack of verified information about reserves or a failure of redemption and stabilisation for a Fiat Crypto Token, may all act as potential reasons for revocation of the recognition status. Another strong reason for derecognition of a Crypto Token is where it demonstrates characteristics of a Security or Derivative, and therefore should be classified as an Investment Token and regulated as such.

63. Where we decide to derecognise a Crypto Token, we will publish a notice on the DFSA's website, and, if appropriate (depending on the circumstances leading to the revocation), specify a future date for the revocation to take effect that provides a transitional period for firms and their clients to cease providing (receiving) Financial Services relating to that Crypto Token.

64. Upon revocation, the only Financial Service that firms may continue to provide in relation to a derecognised Crypto Token is the provision of custody. A DFSA-licensed custodian may safeguard and administer Crypto Tokens even after their derecognition (unless the Tokens have become a Prohibited Token). We have elaborated on the revocation process in GEN Rule 3A.3.6 and the guidance to that rule.

Section 3. Recognised Jurisdictions

65. In accordance with GEN 3A.5, the DFSA may recognise another jurisdiction as having a regulatory regime for Crypto Tokens that is equivalent to the DFSA's regime. We will publish on the DFSA's website a list of regional and foreign jurisdictions that we have recognised as having an equivalent regulatory regime.

66. In making these assessments, we will look to legislation in that jurisdiction to see if it provides regulatory protections that at least are commensurate to, or more prudent than, the DFSA's Crypto Token regime. We will also look to ensure that appropriate arrangements are in place for the licensing of Crypto Token businesses, and that requirements are effectively and properly supervised and enforced. We are likely to ask applicants to provide information, and analysis, relevant to a jurisdiction to help with this assessment.

67. Due to the relative novelty of crypto markets and the lack of international convergence around best practices on how to regulate crypto activities, it may be difficult, if not impossible, to find other jurisdictions that will have an equivalent regime on all fronts (around licensing, supervision, and enforcement, and in relation to various Financial Services, simultaneously). We may recognise certain jurisdictions as being equivalent for only specific activities or services (e.g., jurisdiction X being equivalent for custody regulation, jurisdiction Y equivalent for trading regulation) or for specific types of Crypto Tokens (e.g. jurisdiction Z being equivalent for its regulation of Fiat Crypto Tokens).

68. A list of recognised jurisdictions may have several practical implications for certain activities, for example:

Branches

69. When considering whether an existing Authorised Firm, operating as a branch in the DIFC[28], should be permitted to provide certain Financial Services with Crypto Tokens without having to establish a legal entity in the DIFC, we will look to see whether the parent institution of the branch is, for example, authorised for Crypto Token business in its home jurisdiction. We will permit that branch to operate with Crypto Tokens only where there is appropriate regulation in the home jurisdiction of the parent entity. See Section 4 for further information on how we propose to treat branches.

Third-party Agents

70. An Authorised Firm licensed to provide custody may choose to carry out safe custody of Client Crypto Tokens in a segregated client account or may enter into a safe custody agreement with a Third-Party Agent (TPA) that is either a DFSA Authorised Firm, or a suitable non-DIFC custodian.

71. The suitability of the non-DIFC custodian is assessed against a number of factors, among which is the requirement for that firm to be subject to regulatory protections that are, at minimum, equivalent to those in the DIFC.[29] If a TPA is used, then we will expect the locus of regulation for the foreign TPA to be on the list of Recognised Jurisdictions.

Section 4: Financial Services Activities

A. DIFC Incorporation and Branches

72. Given the lack of regulation of Crypto Tokens internationally, no real tests of cross-border regulatory cooperation, the lack of clear legal structures for some crypto businesses and no reliable records of capital support between crypto firms and their operations abroad, our

[28] To note, this means branches that exist and are authorised as at the date of commencement of the regime.
[29] See COB 14.3.4 and COB A6.5 for our specific requirements relating suitability of Third-Party Agents.

starting point, as clearly set out in CP143, is that we want firms providing services in Crypto Tokens to be incorporated in the DIFC. This is so we can have proper oversight of those entities and that they have their management, and operational staff, situated in the DIFC. This will also establish clarity about which legal entity is providing the relevant service to the client and is liable for that service, and which regulatory protections apply to the service. We did, however, get many opposing responses on the branching restriction, asking whether we might be willing to make concessions, and allow certain branches to be able to provide services relating to Crypto Tokens.

Branches

73. We have reconsidered our views and identified certain conditions under which Authorised Firms in the DIFC, who are already operating as a branch of a foreign financial institution before the commencement of the new regime, may continue to operate as a branch and provide services relating to Crypto Tokens without needing to establish a DIFC Body Corporate.

74. These conditions are articulated in GEN 7.2.2(8) and include that the head office of the branch is authorised to carry on the crypto activity, and supervised, in a Recognised Jurisdiction (which was covered in paragraph 67), and there are proper capital and insurance arrangements in place to cover the risks that may arise from the DIFC branch. This concession does not apply to the following Financial Services, which must always be provided by a firm set up as a subsidiary, or headquartered, in the DIFC: Operating an Alternative Trading System (ATS); Operating a Clearing House, Providing Custody; and Dealing as Principal where acting as a Market Maker.[30]

Technology firms

75. Similarly, we are aware that the DIFC may be a jurisdiction of choice for technology or other companies that are supporting their parent or associate crypto companies in other jurisdictions. At what point this may constitute a Financial Service will depend on a combination of factors including: the actual activities being carried out in the DIFC, whether it holds itself out as actual or willing to engage in a Financial Services activity or solicits other persons to engage in a Financial Services activity; the size of the DIFC entity (e.g., in terms of staff in the DIFC, balance sheet, expenditures), and so on. This will require a case-by-case assessment by DIFC authorities, including the DFSA. We will also be considering, at a later point, whether we place the onus of responsibility on these technology providers in the DIFC to demonstrate to us that they are not providing a Financial Service by way of business.

B. Funds

76. We received many comments on our proposals on Funds but made few changes to what was set out in CP143. We did, however, provide some further clarifications, including:

    a. Asset Management – we have explained that any businesses? set up to manage assets that include Crypto Tokens must be established in the DIFC and consist only of Recognised Crypto Tokens;[31]

    b. Funds of Funds – the offering and marketing of Funds of Funds that contain Crypto Tokens, must consist of Recognised Crypto Tokens[32];

[30] See GEN 7.2.2(8)(b).
[31] See GEN 3A1.2 and 3A.2, and CIR 3.1.16.
[32] See GEN 3A.1.2, CIR 3.1.16 and CIR 15.1.5.

c. Exchange Traded Funds (ETFs) – the offering and marketing of ETFs that contain Crypto Tokens must consist of Recognised Crypto Tokens;[33] and

d. Where a Fund invests in another Fund or entity which has a total exposure to Crypto Tokens that does not exceed 5% of the gross value of the Fund or entity, then those Crypto Tokens do not have to be Recognised Crypto Tokens.[34]

Self-custody in relation to Funds

77. We had several respondents suggest that self-custody should be permitted for Funds, specifically for Exempt or Qualified Investor Funds (QIFs), as these Funds are typically subject to a less prescriptive regulatory regime. Our concern here is the way in which Crypto Tokens can be easily misappropriated, irrespective of the type of investor investing in the Funds. Therefore, the rules we consulted on remain, and no self-custody for Funds consisting of Crypto Tokens will be permitted.[35]

Disclosure threshold

78. We were asked why we would not consider a threshold for Crypto Token Funds, whereby a certain percentage of the Gross Asset Value (GAV) of a Fund holding Crypto Tokens would trigger additional disclosure requirements in a prospectus. We had, of course, included such a threshold for Investment Tokens of 10% of GAV before additional disclosure requirements were required.

79. We considered whether we should provide a threshold but decided against this for a few reasons. First, the volatility of Crypto Tokens, and the difficulty in setting an appropriate threshold to be met. Second, such a threshold might encourage a Fund Manager to create a Fund with Crypto Tokens below the threshold specified to avoid further regulatory requirements. Third, we are of the view that any level of Crypto Tokens in a Fund should trigger appropriate disclosures about those Crypto Tokens to investors.

Foreign and External Funds

80. We have retained our view that we will not allow Foreign or External Funds in relation to Crypto Tokens to be offered or marketed in or from the DIFC. Similarly, we will not allow an External Fund Manager to manage a Domestic (i.e. DIFC) Fund that invests in Crypto Tokens. This approach is based on the regulatory grip we think we need to have in relation to Crypto Businesses, and the lack of regulation that is currently in place in other jurisdictions[36]. When we see further appropriate regulation in this area in other jurisdictions, we may reconsider this position.

C. Trading venues

Types of trading venues

81. In CP143, we set out that a crypto trading venue could be operated as either an Exchange or an MTF. We have since reflected on this policy decision, and believe it is best that only a MTF be permitted to be used as a trading venue for Crypto Tokens.

82. This regulatory choice was mainly driven by the need to avoid any confusion that was shown in responses to CP143 as to the interplay between the GEN and COB Modules on one

[33] See GEN 3A1.2 and CIR 3.1.16.
[34] See GEN 3A1.2 and CIR 1.6.1.
[35] See CIR 8.2(4) and 12A.3.
[36] See CIR 6.1.6, 6.2.4 and 15.1.5.

hand, and the AMI Module on the other hand. Many other regulators, whose crypto regimes we have benchmarked ourselves against, have also chosen to limit the trading of Crypto Tokens to MTFs only. Therefore, either an Authorised Firm, or an AMI, that wishes to operate a market in Crypto Tokens will be able to do so using an MTF.

Appropriateness test

83. In CP143, we set out proposals for Authorised Firms providing intermediation services, such as arrangers or dealers, to apply an appropriateness test to Retail Clients wanting to trade in Crypto Tokens or Crypto Token Derivatives. We also invited views as to whether we should extend this test to other types of firms, such as an operator of an MTF.

84. We have reflected further on this issue and can see no reason why an operator of a MTF should not have to carry out an appropriateness test for providing services relating to Crypto Tokens. It seems a logical step that, by allowing direct (non-intermediated) retail access to these types of trading venues, we also require that the appropriateness test is carried out in relation to these clients by the MTF operator.[37]

Forums

85. In CP143, we proposed that when an operator of a trading venue organises a forum for its users, for example, to ask questions about the functionality of the venue, the forum is then closely monitored to identify and remove posts that may contravene market abuse requirements in the Markets Law and the Code of Market Conduct. A particular requirement we also proposed was that *"all persons using the forum had equal access to information posted on that forum."* A respondent questioned whether "persons using the forum" included the operator itself, explaining that the operator would naturally have access to different information and thus be unable to meet the requirements in COB 15.3.3. We have made a minor change to the text, which we believe makes it clearer that this excludes the operator providing the forum[38].

Trading on own account

86. We consulted on removing any room for an operator of the MTF to trade on own account on the same venue that it operates. We received feedback suggesting that there may be limited instances where the operator may want to trade on own account, including for their own portfolio management or hedging purposes. One respondent also queried whether the operator of the trading venue, who has issued their own Crypto Tokens, would be able to trade those Tokens against proprietary capital. We have clarified that trading on own account by the operator should not be permitted on their own venue under any circumstances[39].

87. Crypto exchanges elsewhere have reportedly been engaged in trading on their own venues, acting as a market maker in certain Tokens, and taking positions against their own clients under derivative contracts and spot trades. This raises concerns about conflicts of interest and market abuse (among other things). Where an operator of a MTF has issued its own Crypto Tokens, then those Tokens would first need to be recognised by the DFSA as acceptable for use in the DIFC. If recognised, then an operator of a Trading venue may allow those Crypto Tokens to be traded but they may not themselves trade them on their own venue. Until we have seen strong compliance culture in trading venues, we are not inclined to provide any concessions in this area.

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37 See COB 15.6.2 and AMI 5B.7.1.
38 See COB 15.3.3.
39 See COB 9.7.1 and AMI 5.4.4.

Section 5: Miscellaneous requirements

A. Technology Governance and Audit

88. We received requests to clarify further the DFSA's expectations for technology audits. We have done this, in COB 15.8, and adjusted our requirements and clarified our expectations that the technology audit should be an audit of a firm's compliance with the technology governance requirements in COB 15.7. We were, however, disappointed that some respondents argued against the use of technology audits, saying they were burdensome and unnecessary. We strongly disagree. A firm that has most of its operations relying on the use of technology and, in this case, DLT, must have good technology governance and ensure there is regular review of the adequacy of these arrangements by a qualified and independent third party.

B. Disclosure

89. There were a few areas where we wanted to strengthen the disclosure requirements for Fiat Crypto Tokens in response to comments provided, where we will require information about their regulatory status, reserves, and restabilisation and redemption mechanisms. These requirements have been added to sections on on-going disclosure in COB 15.3.2 and to the Key Features Document in COB 15.3.1 and 15.5.1.

C. Marketing and Financial Promotions

90. In CP143, we invited views on whether the market would like us to outline our expectations about what we would consider "fair and balanced" when providing forecasts for Crypto Tokens based on past performance.

91. Nearly all respondents asked us to provide Guidance in this area, which we have done[40]. Our focus was that firms should consider the time period shown, as we do not want to see time periods provided that may be skewed to show better performance. For example, we have seen advertisements relating to Bitcoin that show time periods over 15 years which show Bitcoin starting low (naturally) and rising high. We also do not want to see unfair comparisons being drawn between different financial products, for example, comparisons between Bitcoin and Tesla stocks. Examples need to compare 'apples with apples'.

D. Client classification

92. We received extensive feedback about the haircut that we had suggested for Crypto Tokens in the net asset test for Professional Clients. We have reflected on this and have softened the haircut from 80% down to 66% of the market value of the Crypto Token. However, we are limiting the scope of Crypto Tokens that may count towards the net asset test. Only Recognised Crypto Tokens may be taken into account when determining the monetary threshold for Professional Client status. This is consistent with the approach we have taken throughout this regime, that only Recognised Crypto Tokens can be used in the DIFC.

93. We were also asked how a firm may get a client to demonstrate ownership of the Crypto Token. It is up to the firm to decide an appropriate method of proving ownership in a Crypto Token. Firms may use a blockchain analytics firm, documentary evidence from a custodian, a demonstration of the client holding private keys in a hosted or un-hosted wallet, or any other method they deem reliable.

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[40] See COB 15.5 and associated guidance.

94. Lastly, a few respondents suggested that technical understanding of the Crypto Token features should also be considered part of the knowledge and experience requirements. We considered whether further requirements were needed in respect of consumer education by firms in this area. However, we decided against doing this. Rather, we will wait and evaluate the regime as a whole, post implementation, to see how this might be done in the most effective way.

Section 6: Transitional arrangements

95. As raised in CP143, we acknowledged the need to provide transitional arrangements for Authorised Persons in the DIFC who have already been engaging in Crypto Token activities before the new regime commences. On that basis, we have provided a six-month transitional period, which will commence on the date when the rules come into force – 1 November 2022 - found in GEN 10.5. To be clear, this applies only to persons who, before 1 November, were Authorised Persons and were carrying on a Financial Services activity relating to a Crypto Token. It also applies only to the continuation of those same activities (i.e. not to expand activities relating to Crypto Tokens). This is designed to provide a firm with time to obtain the necessary authorisations relating to that Crypto Token activity.

96. This transitional arrangement does not, however, relieve the firm from complying with key obligations such as the Principles for Authorised Firms, Financial Promotion requirements, Market Abuse provisions, AML requirements, provisions prohibiting misconduct (e.g. misleading, deceptive, fraudulent or dishonest conduct), and the prohibition relating to the use of Privacy Tokens[41].

97. Once the six-month period ends, no Financial Services activities relating to Crypto Tokens will be allowed unless the Authorised Person has the correct permissions from the DFSA and the Tokens in question are Recognised Crypto Tokens. We would urge firms that intend to rely on the transitional arrangement to talk to the DFSA as soon as possible and not leave it until later on in this transitional period. If firms leave this too late, there is a real risk that variations in licences may not be granted in time, in which case the firm would need to cease its Crypto Token business until the licence position was resolved.

Part 2: Future work on Crypto Tokens

98. There are certain areas where we expect our policy to evolve, and we intend to focus on as a follow up CP 143 such as AML, Staking and DeFi, which are set out in more detail below. At the same time, we will also follow market developments and international standard setters' policy closely, and see if this necessitates any other changes to the regime.

A. AML/CFT

99. As we set out in CP143, the UAE's Federal AML Legislation applies to all Crypto Token businesses in the DIFC (as well as the rest of the UAE). This includes Federal AML Law No.26 of 2021 amending certain provisions of the Federal AML Law No.20 of 2018, which applies AML/CFT requirements to Virtual Asset Service Providers (VASPs).[42] It also includes the Cabinet Resolution No.24 of 2022 which amends certain provisions of the Cabinet Resolution No.10 of 2019 and sets out more detailed requirements for VASPs.

100. In terms of the DFSA's AML approach, we have prohibited the use of Crypto Tokens and devices that are used to hide, anonymise, obscure or prevent the tracing of information. We have also expanded our DNFBP regime to include certain NFT and UT issuers and service

[41] See GEN 10.5 and associated guidance.
[42] For the purposes of the DFSA's AML regime, VASPS will typically be Authorised Firms or Authorised Market Institutions.

providers, who are outside of our general Crypto Token regime. These issuers and service providers will be required to comply with applicable AML/CFT requirements in the capacity of a DNFBP. Authorised Persons, as they currently do, are required to comply with all the applicable requirements in the AML module. This will include where they provide Financial Services relating to Crypto Tokens.

101. Undeniably, there are areas in our Rulebook (e.g., travel rule, account monitoring requirements, risk assessment, enhanced CDD, training) where we may need to provide more guidance for the industry. This guidance will have to consider the specific features of that industry and the technologies used. In doing this work, we are relying on the results of the AML/CFT national risk assessment and, based on that, our own risk assessment where we will judge what, if any, additional requirements and guidance should be introduced to initiate the higher risk associated with Crypto Tokens. If we do introduce additional guidance, this will be included in our next consultation on Crypto Tokens.

102. In the meantime, we would expect Authorised Firms looking to vary their licence, or new companies looking to apply for a DFSA Financial Services licence to carry out Crypto Token business, to ensure that their AML/CFT policies and procedures are effective in combatting ML/TF risks associated with their business model. These should be commensurate to the size and nature of the business activities. Our supervisory approach to Crypto Token business will be in line with our Risk Based Approach. Firms that pose greater ML/TF risks will receive an increased level of supervisory focus.

B. Prudential Treatment of Crypto Token exposures

103. Banks internationally are increasingly investing, either through funds or by direct exposures, in Crypto Tokens, while the prudential treatment of these exposures for regulatory capital purposes remains an open question.

104. In CP143 we suggested that banks in the DIFC, who may already have exposures to Crypto Tokens, follow the default option in the BIS proposals, whereby a full deduction (or risk-weighting of 1250%) applies to these exposures, regardless of whether in the banking or trading book. The BIS proposals have moved forward quite a lot since then. We will await the finalisation of Basel proposals by the end of this year and consult on the transposition of these recommendations into our PIB Rulebook. Until then, we expect that relevant firms would treat any direct crypto exposures for prudential purposes using the following formula from the latest BIS paper:[43]

Risk-weight of 1250% * MAX [Long Positions; Short Positions]

where gross positions to Crypto Tokens are kept under 1% of Tier One Capital.

C. DeFi Activities

105. In CP143, we touched on Decentralised Finance (DeFi) activities, some of which take place outside of the centralised crypto financial industry. We have introduced a requirement that Staking be permitted in the DIFC, where facilitated or arranged by DFSA-licensed entities, only where such activity is provided to non-Retail Clients and the purpose of staking is for the borrower to take part in the Proof-of-Stake consensus mechanism for a Recognised Crypto Token.[44]

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[43] https://www.bis.org/bcbs/publ/d533.htm.
[44] See COB 15.6.5.

106. DeFi, of course, is much broader than staking for PoS consensus and the risks posed by DeFi span from simple fraud to organised money laundering and sanctions evasion. We are experiencing a time where many regulators and standard setters are coming up with their, perhaps initial, but own strategy and way of thinking about DeFi. We, too, are working in this area with a view to presenting our regulatory strategy on DeFi in our next consultation on Crypto Tokens.

107. In the meantime, we would expect any DIFC-based firms involved in DeFi activities to think carefully about what they are doing and whether they need to be licensed by the DFSA to conduct some or all of their activities.

D. Staking

108. As set out above, we propose to allow Staking in or from the DIFC for operating a consensus mechanism. However, we are aware that there are other types of Staking activities which often (if not all) occur through DeFi protocols, which are often currently unregulated (although as noted above, they may actually need to be regulated).

109. We believe that, in order to capture this type of staking activity appropriately, we would probably have to create a new Financial Services activity and apply certain conduct and prudential requirements, for example, which would require further work to address concerns we have about the use of DeFi protocols and the type of clients that will access those services. On that basis, we intend to carry out more work in this area and include this issue in our next consultation on Crypto Tokens.

Part 3: Implementation

110. We expect considerable interest in this regime both from firms we currently authorise, who wish to vary their Financial Services licence, and from new firms, who are seeking to obtain a Financial Services licence in the DIFC. To assist interested firms to prepare, and our own workflows and resources, we set out below our approach regarding a licensing process for Crypto Token businesses from 1 November.

111. Our approach is designed to ensure the efficient allocation of our regulatory resources and to ensure we give appropriate attention to those businesses that are most prepared to effectively engage with the authorisation process and to operate a regulated Financial Services business.

A. Who needs to make a pre-application?

112. From 1 November, all firms who are currently providing, or want to provide, Financial Services in relation to Crypto Tokens in or from the DIFC will need to obtain the appropriate licence from the DFSA. In order to obtain this, firms will first need to submit a pre-application to the DFSA via the DFSA website. For the avoidance of doubt, this includes existing DFSA Authorised Firms that wish to obtain a Variation of their Licence to include Crypto Tokens.

113. If you are unsure if you need to submit a pre-application, for example, entities who are established in the DIFC but who are not regulated by the DFSA, we urge you to look at CP143, at this Feedback Statement and at the new rules relating to Crypto Tokens and GEN 2.2 in the DFSA Rulebook, which sets out the applicable Financial Services activities.

B. How do I submit a pre-application?

114. You will need to go to www.dfsa.ae/innovation and complete the “Crypto Pre-Application Form” that will be on that webpage from 1 November 2022.

115. In this Form we will ask for information about your firm that will help us determine your fitness and readiness to operate a Crypto Token business, amongst others, we will assess:

- your proposed business model and your understanding of the application the relevant DFSA Rules;
- the level and fitness of your human and financial resources; and
- the level of preparations you have undertaken to operate a regulated crypto token business (for example, we will assess whether you have prepared/implemented AML/CFT policies and procedures as per the DFSA's AML Module.

116. We expect all information provided to us to be up to date and specific to our request. Do not reuse old documents, or documents you may have submitted to other regulators as part of this process, unless you have thoroughly reviewed them and verified that they are relevant to our specific request.

117. It is important that you fully disclose the information we ask for. We take any non-disclosure of information that could impact our assessment seriously, especially if there is an attempt to mislead us. It is better to disclose information rather than withhold it.

118. We will then review the information provided. In making this assessment, if we do not believe that you understand the product or service you wish to provide, or do not have sufficient financial, technical or human resources, we will not accept an application for a licence or licence variation. Rather, we will then ask you to consider these areas again before submitting another pre-application form.

C. What if I do not submit a pre-application form?

119. Everyone needs to submit a pre-application form. If you are a DFSA Authorised Firm and were, immediately before the commencement of the regime, carrying on business relating to Crypto Tokens, you will have six months to obtain the appropriate approvals in order to continue to operate with Crypto Tokens (during which time you may continue to carry on that same activity). As set out in Part 1, Transitional Arrangements, we urge you to fill out a pre-application form as soon as possible after 1 November.

120. If you are a person in the DIFC who does not have a Financial Services licence, and is providing a Financial Services activity in relation to Crypto Tokens, you will have to submit a pre-application with the DFSA, and obtain the relevant authorisation. If you do not have a licence to do this, you will be in breach of the law and our rules.

Annex 1
Respondents to CP143

1. Aimichia Tech
2. Alvarez & Marsal
3. Amber Group
4. Binance
5. Block AG
6. Cantor Fitzgerald Europe
7. Coinbase
8. Global Digital Finance
9. HSBC Middle East
10. Index & Cie
11. Julius Baer Middle East
12. Karm Legal
13. MidChains
14. Ripple Labs
15. Simmons & Simmons
16. Standard Chartered Bank
17. StashAway Management
18. Swissquote MEA
19. Waystone Compliance Solutions

A further four respondents asked that their responses be kept confidential.

Annex 2

Token Decision Tree

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

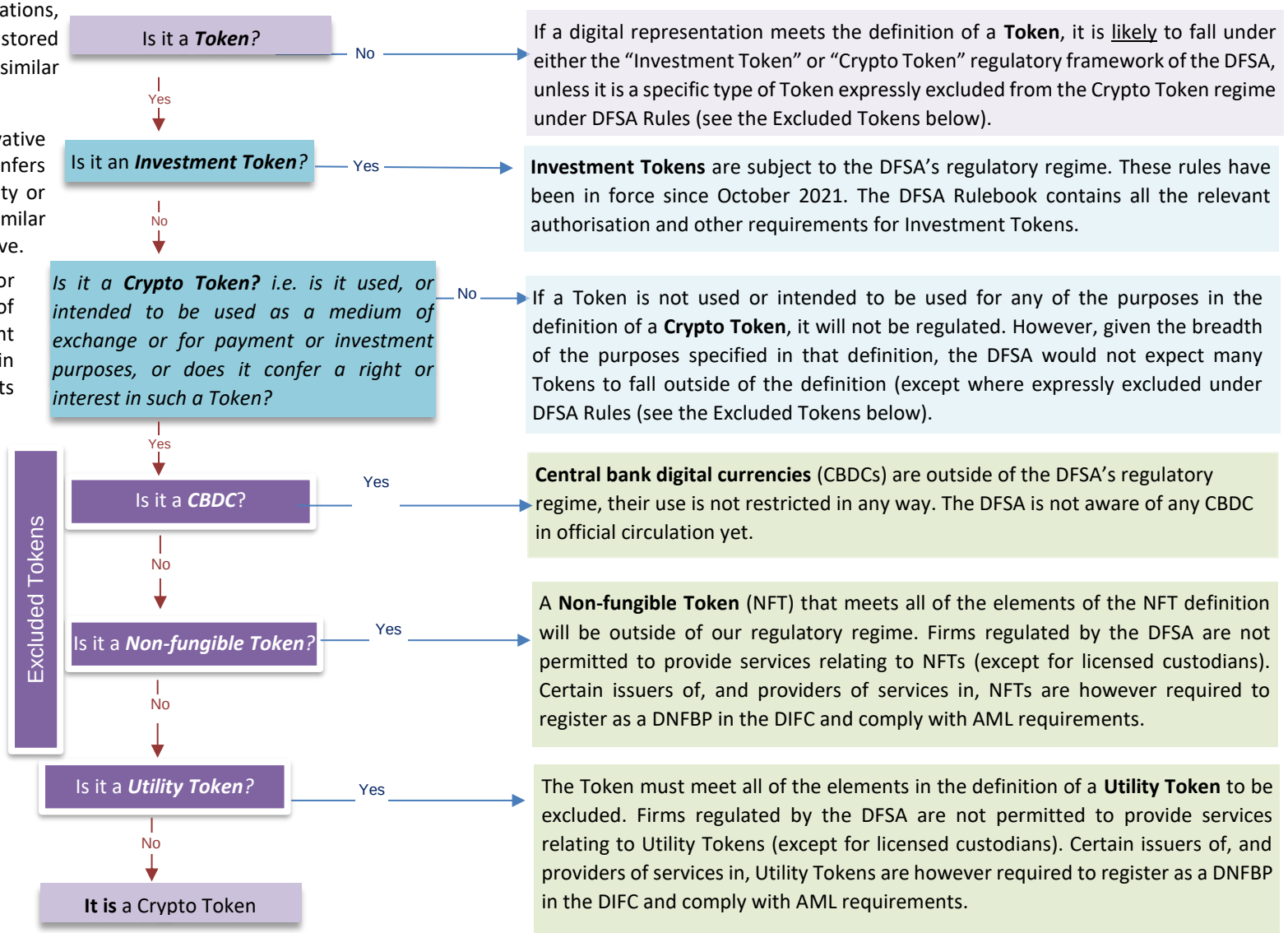
An **Investment Token** is a Security or Derivative in the form of a Token; or a Token that confers rights and obligations similar to a Security or Derivative; or a Token that has a similar purpose or effect to a Security or Derivative.

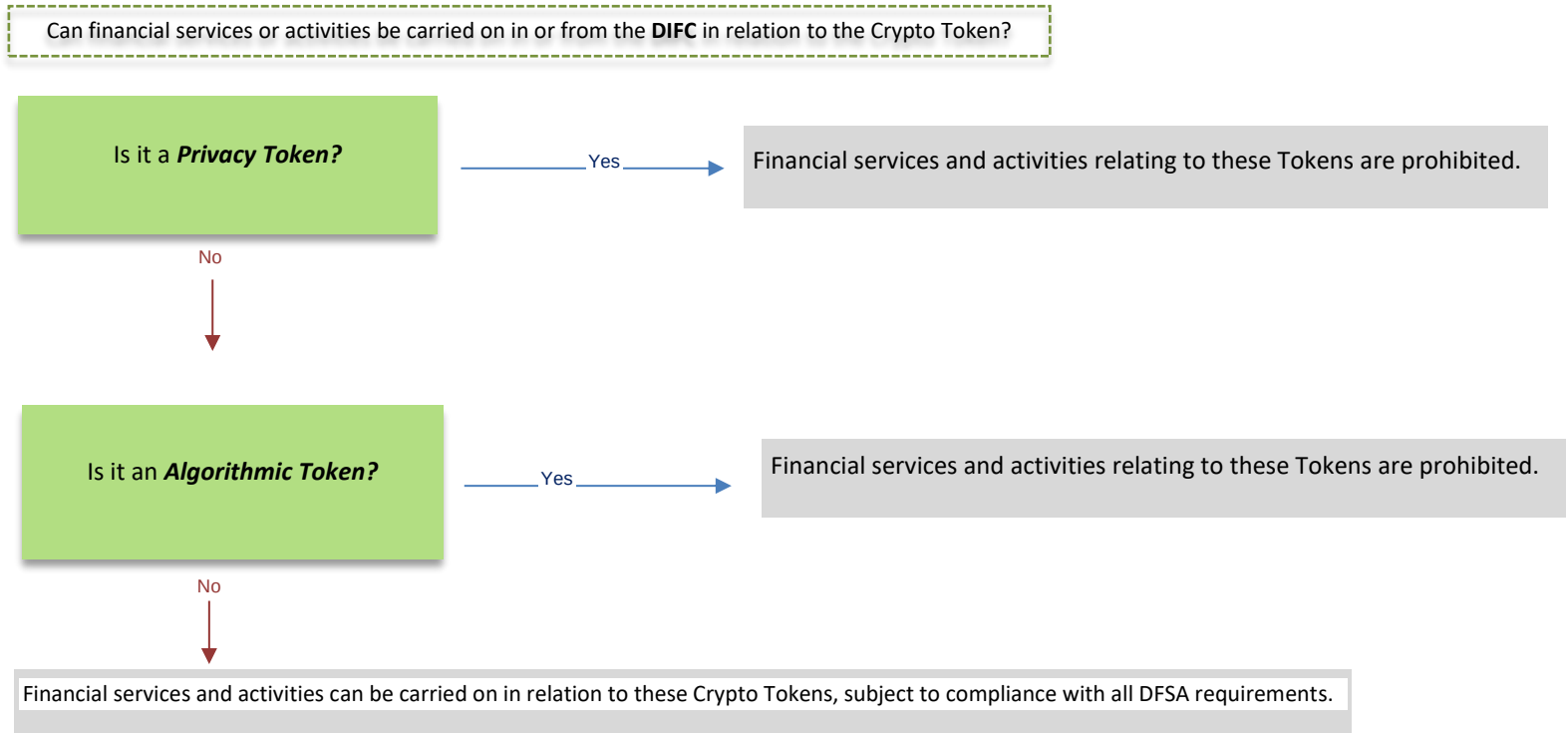
A Token is **a Crypto Token** if it (a) is used, or is intended to be used, as a medium of exchange or for payment or investment purposes, or (b) confers a right or interest in another Token that meets the requirements in (a).

A **CBDC** is a digital currency issued by any government, agency, central bank or other monetary authority. These are "**Excluded Tokens**" under the DFSA

A **NFT** is a Token that (a) is unique and non-fungible (b) relates to an identified asset and (c) is used to prove ownership or provenance of an asset. If all the above conditions are met, a NFT is an "**Excluded Token**" under the DFSA Rules.

A **Utility Token** is a Token that can be used only to pay for, or receive a discount on, or access, a product or service provided by the issuer or its group. If all the above conditions are




Can financial services or activities be carried on in or from the DIFC in relation to the Crypto Token?
A Privacy Token is a Crypto Token where the technology used has features to hide, anonymise, obscure or prevent the tracing of information on the identity of the holder, cryptographic keys, parties to and value of the transaction, or beneficial owners.
Is it a Privacy Token?
Yes
Financial services and activities relating to these Tokens are prohibited.
No
An Algorithmic Token is a Crypto Token which uses an algorithm to increase or decrease the supply in order to stabilise or reduce price volatility.
Is it an Algorithmic Token?
Yes
Financial services and activities relating to these Tokens are prohibited.
No
Financial services and activities can be carried on in relation to these Crypto Tokens, subject to compliance with all DFSA requirements.
A Crypto Token is recognised by the DFSA if (a) it is included on the one-off list of Crypto Tokens published by the DFSA or (b) it has been specifically recognised by the DFSA under Rule 3A.3.4.
Has it been recognised by the DFSA?
No
Financial services and activities relating to Unrecognised Tokens are prohibited (except for licensed custodians).