

FATF Guidance on AML Regulations Poses Significant Challenges to Crypto Industry

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On June 21, 2019, the Financial Action Task Force (“FATF”)¹ issued the Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers (the “2019 Guidance”). At the same time, the FATF adopted an Interpretive Note to Recommendation 15 on New Technologies (the “Interpretive Note R15”) setting out additional requirements for virtual assets and virtual asset service providers. The new FATF requirements expand the scope of rules on anti-money laundering and countering the financing of terrorism (“AML/CFT”) to virtual-to virtual transactions and to a broad range of providers of crypto-related products and services, including but not limited to custodians and exchanges. They aim at helping the national authorities in

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understanding and developing regulatory and supervisory responses to virtual assets activities as well as assisting the private virtual assets sector in understanding and complying with their AML/CFT obligations. The FATF expects the members to implement the new rules within the next 12 months.

The implementation of, and the compliance with, the new FATF rules may pose significant challenges to the crypto industry. In this Update we summarize evolution of the FATF approach to the regulation of virtual assets and virtual service providers and main provisions of 2019 Guidance and Interpretive Note R15.

2015 Initial Guidance on Virtual Currencies

In June 2015, the FATF provided for the initial guidelines for addressing money laundering and terrorist financing risks associated with virtual currencies in its

¹ The FATF is a Paris-based intergovernmental body initially established by the G7 in 1989 to set standards and establish policies for preventing money laundering and terrorism financing. The FATF currently has 39 members, comprising 37 jurisdictions, including the U.S., Germany and Russia as well as the EU Commission and the Gulf Cooperation Council. Over 200 jurisdictions around the world have committed to the FATF rules. Based on its mandate, the FATF formulated the International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation (the “FATF Recommendations”). The FATF Recommendations provide for 40 recommendations setting out comprehensive requirements for combating money laundering and terrorist financing and are complemented by their interpretive notes and a glossary of the applicable definitions.

Guidance For a Risk-Based Approach for Virtual Currencies (the “2015 Guidance”). The scope of the 2015 Guidance was limited to so-called “convertible virtual currency” and “convertible virtual currency exchangers.” The 2015 Guidance defines convertible (or open) virtual currency as a virtual currency that has an equivalent value in real currency and can be exchanged back and forth for real currency. Virtual currency exchangers were only subject to the FATF Recommendations if they facilitated exchange between convertible virtual currency and real currency. The FATF explained that its risk assessment “indicates that, at least in the near-term, only convertible virtual currencies, which can be used to move value into and out of fiat currencies and the regulated financial system, is likely to present money laundering and terrorist financing risks.”

2018 Amendments to FATF Recommendations

In October 2018, the FATF adopted amendments to the FATF Recommendations to explicitly clarify that the FATF Recommendations apply to financial activities involving virtual assets. A key amendment to the FATF Recommendations was the addition of definitions of “virtual assets” and “virtual asset service providers.”

“Virtual Asset” (“VA”)

“Virtual Asset” is defined as a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes. Virtual assets do not include digital representations of fiat currencies, securities and other financial assets that are already covered elsewhere in the FATF Recommendations.

“Virtual Asset Service Provider” (“VASP”)

“Virtual asset service provider” is defined as any natural or legal person who is not covered elsewhere under the Recommendations and, as a business, conducts one or more of the following activities or operations for or on behalf of another natural or legal person:

- exchange between virtual assets and fiat currencies;
- exchange between one or more forms of virtual assets;
- transfer of virtual assets;
- safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets; or

- participation in and provision of financial services related to an issuer's offer and/or sale of a virtual asset.

These broad definitions, including virtual-to-virtual activities, mark a substantial shift from the approach taken under the 2015 Guidance. The FATF recognized that not only virtual-to-fiat transactions, but also virtual-to-virtual transactions are likely to present money laundering and terrorist financing risks. These definitions are now also used in the 2019 Guidance and the Interpretive Note R15.

2019 Guidance and Interpretive Note R15

The 2019 Guidance and the Interpretive Note R15 provide more detailed advice on the application of the risk-based approach in relation to VAs and VASPs including examples of regulatory approaches in a number of countries. Key requirements of the 2019 Guidance and the Interpretive Note R15 include:

Initial Risk Assessment

The FATF requires the national authorities and the VASPs to conduct an initial risk assessment in order to properly assess and mitigate the risks associated with the VA activities and the provision of products and services by VASPs. The 2019 Guidance lists examples of risk indicators that should be considered in this context, including risks arising from the intersection of VA activities with the traditional financial system and the virtual system and with various jurisdictions, risks associated with centralized and decentralized business models as well as risks associated with anonymity-enhanced cryptocurrencies ("AECs") or services such as mixers or tumblers. Regarding the AECs, the FATF suggests refusing the listing of AECs if VASPs cannot mitigate such risks.

"Travel Rule": Obtaining and Transmitting Originator and Beneficiary Information

One of the most controversial requirements of the new FATF rules is the application of the so-called "travel rule" (Recommendation 16) to VASPs. Under the travel rule, traditional financial institutions are required to collect and transmit to each other information about the originator and the beneficiary of a wire transfer transaction. Applied to the VASPs, the travel rule requires the originating VASP to collect information on the originator and the beneficiary of a VA transfer transaction, such as the originator's name, wallet number and address or identifying information, and to transmit such information to the beneficiary VASP. Both VASPs must further retain such information and make it available to law enforcement on request. The 2019 Guidance clarifies that the transmission obligations do not apply in purely peer-to-peer

transactions or in the case of a VA transfer from/to a VASP-hosted wallet from/to a wallet that is not associated with a VASP. In the latter case, the involved VASP would still be under the obligation to collect and retain the information on its customer. The FATF further clarified that the national authorities may adopt a *de minimis* threshold for VA transfers of USD/EUR 1,000.

Registration and Licensing of VASPs

Particularly controversial is also the FATF requirement that all VASPs must be registered or licensed. At a minimum, the FATF expects a VASP to be registered in the country where it was created, i.e., incorporated or otherwise formalized under corporate laws or, in the case of a natural person, in the jurisdiction where such person's business is located. Other jurisdictions may adopt additional local licensing/registration requirements if a VASP makes its services available to residents of such jurisdiction. The FATF emphasizes, however, that the national authorities have flexibility to decide under which category of regulated activities VASPs should be regulated, e.g., as financial institutions, designated nonfinancial businesses and professions or as other, distinctive categories.

Regulation, Supervision and Monitoring of VASPs

The FATF requires the national authorities to subject the VASPs to an effective system of AML/CFT regulations and risk-based supervision and monitoring ensuring the implementation of the applicable FATF Recommendations. An important takeaway from the 2019 Guidance is that the FATF considers competent (national) authorities to be the only legitimate supervisory or monitoring bodies but not any self-regulatory bodies of the VA sector. Such national authorities should have adequate powers to ensure the compliance by VASPs with the FATF Recommendations including the powers to impose sanctions on the VASPs or to withdraw, restrict or suspend their license or registration.

Preventive Measures

The 2019 Guidance and the Interpretive Note R15 also clarify that the requirements of the FATF Recommendations on preventive measures (Recommendations 10 through 21) apply to both the national authorities and VASPs in the context of VA activities. Such preventive measures include customer due diligence (subject to a threshold for occasional transactions of USD/EUR 1,000), record-keeping (for at least five years) and suspicious transaction reporting. The FATF also clarifies that, as a general rule, all measures applicable to "property," "proceeds," "funds," "funds or assets" and other "corresponding value" under the FATF Recommendations also apply to VAs.

International Cooperation and National Coordination

Given the cross-border and mobile nature of the VASPs' activities, the FATF considers international cooperation to be critical. The FATF expects the countries to put in place tools enabling them to cooperate and to provide mutual legal assistance including regarding the identification, freeze or seizure of assets in the form of VAs. The FATF also urges the national authorities and market participants to closely cooperate with each other to ensure the compliance with the FATF Recommendations but also the compatibility of the AML/CFT requirements with other regulations including data protection and privacy rules.

No De-Risking of VASPs

The FATF finally makes clear that it does not support the current practices of financial institutions to generally refuse or terminate business relationships with the VASP sector in order to avoid the risks associated with them. In the view of the FATF, such situation is neither desirable nor sustainable. The FATF suggests that financial institutions should manage such risks in line with the FATF Recommendations rather than just avoid them.

Issues and Challenges

Broad Definition of VAs

One of the frequent points of criticism of the new FATF requirements is the broad definition of "virtual assets" which entirely disregards the distinction among payment token, investment token and asset token. In the 2019 Guidance, the FATF responds that it intentionally did not provide for any exemption for specific assets based on terms such as "utility token." In FATF's view, such terms may lack a common understanding across jurisdictions or even in the industry. The FATF further argues that, given that the technology is still rapidly evolving, and the nature of a token is not always clear on its face, the guidance must remain technology neutral and be based on the activity rather than industry terms in order to maintain flexibility.

Activity-Based Definition of VASPs

Similarly, the new FATF requirements will apply to a very broad range of service providers in the VA sector. The definition of VASPs includes VA exchange platforms (fiat-to-crypto and crypto-to-crypto) and other VA transfer service providers, custodial wallet providers, VA escrow service providers, service providers in connection with ICOs, brokerage service or order-book service providers. In some cases, the application may be less obvious. For instance, providers of peer-to-peer trading platforms, decentralized exchanges (DEXs) or applications (Dapps) may fall within the definition

of VASPs if they facilitate or conduct exchange or transfer of VAs. The same applies to developers or sellers of applications or platforms.

Technological Limitations

During the consultation process, market participants advised that certain requirements of the 2019 Guidance and the Interpretive Note R15 may require technological solutions that are not available yet. This is the case in particular with the requirements under the “travel rule.” The current blockchain infrastructure’s ability to transmit additional information, such as originator and beneficiary information, between VASPs is limited. This may require a new (possibly off-chain) infrastructure which would need to comply with certain security requirements. The VASPs may also face the problem that they are not able to verify whether a wallet is associated with another VASP or not.

Costs of Implementation

The compliance with the FATF Recommendations will certainly be costly with respect to both the technological and the licensing requirements. This could put too much of a strain on the capabilities and resources of start-ups. This issue may emphasize the importance of availability of regulatory sand-boxes.

Unintended Consequences

Some market participants voice the concern that the new strict FATF rules may drive users to peer-to-peer transactions or decentralized exchanges. This may lead to less transparency in the VA sector.

OUTLOOK

Although the FATF Recommendations are not binding, they will definitely be broadly implemented. It remains to be seen how the FATF members will interpret and implement the rules in detail, in particular, what licensing or registration requirements will be introduced.

The 12 months’ time frame for implementation of the 2019 Guidance might appear ambitious, but some countries already started the implementation. For instance, the U.S. FinCEN recently issued its interpretive guidance² which is similar to the FATF approach in many respects. The German Government also indicates in its recently proposed draft

² See FinCEN Guidance “Application of FinCEN’s Regulations to Certain Business Models Involving Convertible Virtual Currencies” of May 9, 2019:
<https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf>.

law³ implementing the 5th AML Directive that the draft law intentionally goes beyond the scope of the 5th AML Directive in order to incorporate the new FATF requirements. Also, the State Duma of the Russian Federation announced plans for a proposal for a regulation of cryptocurrencies that incorporates the new recommendations of the FATF.⁴

The market participants may want to start evaluating their existing systems, in particular with respect to the compliance with the travel rule and the preventive measures. The positive aspect of the new FATF rules for the VA industry might be that it finally gives the industry more certainty about the AML/CFT obligations on a global level that the industry was for long time craving. In addition, the compliance of the VA industry with these requirements may facilitate the mainstream adoption of the VAs and increase their acceptance by traditional financial institutions.

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Please do not hesitate to contact us with any questions.

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³ See: https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_VII/19_Legislaturperiode/2019-05-24-Gesetz-4-EU-Geldwaescherichtlinie/0-Gesetz.html.

⁴ See: <https://tass.ru/ekonomika/6469565>.