

A fragmented picture

Adrien Pierre and Michael Schweiger discuss the implications of divergent approaches to the regulation of virtual assets

Virtual or crypto-assets, and the entities dealing in them, present significant anti-money laundering / counter financing of terrorism (AML/CFT) challenges. The EU's AML/CFT framework is out of sync with the latest Financial Action Task Force (FATF) standards and Member States have adopted divergent approaches to regulating virtual asset service providers (VASPs). Change is on the horizon and VASPs must prepare.

Professionals in the compliance and legal community are currently grappling with a patchwork of regulation, with significant commercial pressure to exploit jurisdictional differences. But this approach is short-sighted and unsustainable. Instead, focus should be directed towards recent FATF and EU initiatives to comprehensively regulate this area and provide clear guidance.

Recognition of the AML/CFT risk

The FATF began highlighting the risks posed by virtual currencies in reports published in 2014 and 2015. In its 2014 report, it warned that *"virtual currencies provide a powerful new tool for criminals, terrorist financiers and other sanctions evaders to move and store illicit funds, out of the reach of law enforcement and other authorities."*¹ In its 2015 report on emerging terrorist financing risks, it suggested that virtual currencies such as bitcoin may pose a terrorist financing risk as they allow for anonymous international fund transfers.² Recent use cases, including the Silk Road platform – where purchases could be made only with bitcoin and which included a built-in tumbler system – or the financing of ISIL with the use of bitcoin, illustrate those concerns.³

The FATF's recognition of the risks culminated with the amendment to its Recommendation 15 in October 2018, which now states that *"to manage and mitigate the risks emerging from virtual assets, countries should ensure that virtual asset service providers are regulated for AML/CFT purposes, and licensed or registered and subject to effective systems for monitoring and ensuring compliance with the relevant measures called for in the FATF Recommendations."*⁴

This update also included the addition of the terms "virtual asset" (VA) and "virtual asset service provider". According to the FATF, a VA is a digital representation of value that can be digitally traded, or transferred, and can be used for payment or investment purposes. This definition was designed to be

broad enough to cover many different types of assets, and in particular to capture the growing variety of cryptocurrencies and tokens available on the market (noting, however, that the concept of VA does not capture the digital representation of fiat currencies, securities and other financial assets). The scope of the definition and the intended coverage were further clarified in the FATF's updated guidance for a risk-based approach relating to VAs and VASPs, published on 28 October 2021.⁵

A VASP is defined as any natural or legal person who is not covered elsewhere in the Recommendations conducting one or more of the following activities or operations as a business for or on behalf of another natural or legal person:

- exchange between VAs and fiat currencies
- exchange between one or more forms of VAs
- transfer of VAs
- safekeeping and/or administration of VAs or instruments enabling control over VAs
- participation in and provision of financial services related to an issuer's offer and/or sale of a VA.

As for VAs, the definition should be construed broadly and the FATF provides extensive interpretation assistance in its most recent guidance.⁶

The purpose of these amendments and new defined terms is to ensure the FATF Standards apply to a broad range of new products and services to limit as much as possible the opportunities for criminals to launder proceeds of crime or finance terrorism.⁷

The interpretive note to Recommendation 15⁸ provides additional guidance on how VASPs should be regulated, and notably requires countries to: identify, assess and understand the money laundering (ML) and terrorist financing (TF) risks emerging from VA activities and VASPs; ensure VASPs are licensed or registered and subject to AML/CFT supervision; ensure that supervisors have enforcement powers and the possibility of imposing sanctions; ensure that the occasional transactions threshold above which VASPs are

required to perform customer due diligence (CDD) is set at EUR/USD 1,000; ensure that VASPs collect appropriate originator and beneficiary information in the context of VA transfers; and ensure appropriate international cooperation.

Countries are expected to implement the FATF standards, and the requirements set out in the revised Recommendation 15 should gradually find their way into national AML/CFT frameworks.

VASPs and the current EU AML/CFT framework

The EU has also acted to regulate VASPs from an AML/CFT perspective. Although Directive (EU) 2015/849⁹ (AMLD4) did not include any content with respect to VA activities, Directive (EU) 2018/843¹⁰ (AMLD5) introduced certain measures to tackle the issue.

The Directive:

- added a definition of "virtual currencies" to the EU framework
- added two additional obliged entities – providers engaged in exchange services between virtual currencies and fiat currencies (not defined), and custodian wallet providers (defined as entities which provide services to safeguard private cryptographic keys on behalf of customers, to hold, store and transfer virtual currencies)
- introduced a requirement for these new obliged entities to be registered.

As a result, providers engaged in exchange services between virtual currencies and fiat currencies and custodian wallet providers are subject to the AML/CFT professional obligations, including the obligation to perform a risk assessment, to conduct CDD, to have an appropriate internal organisation, to cooperate with authorities and report to financial intelligence units, and to keep appropriate records. AMLD5 does not provide any details on the registration requirement and Member States are therefore free to set up their own processes in this respect.

Discrepancy in scope

Although it does cover additional market players in the virtual asset space, AMLD5 does not equal compliance with

the FATF Recommendations, primarily because the FATF definition of VASP targets a broader population of entities than the two new obliged entities in the EU framework. AMLD5 was adopted in May 2018, whereas the FATF amended its Recommendation 15 in October 2018, which explains this discrepancy in scope.

This discrepancy has led to fragmented AML/CFT regulation. Certain Member States, such as the Netherlands, have opted for a mere transposition of AMLD5. Others, including Luxembourg, went beyond the scope of AMLD5 and used the transposition exercise to also implement the revised FATF requirements. Luxembourg did not introduce the concepts of "providers engaged in exchange services between virtual currencies and fiat currencies" and "custodian wallet providers" into its legal framework, but used the concept of "virtual asset service provider", the definition of which aligns with the FATF definition.¹¹ As a result, the Luxembourg framework notably covers VA-to-VA (or crypto-to-crypto) exchanges, whereas the Dutch framework does not.

No level playing field for VA-to-VA exchanges

One illustration of the consequences of this legislative choice is the occurrence of regulatory arbitrage between Member States having chosen to align with the FATF and Member States having transposed AMLD5 without extending its scope.

The discrepancy between Member States has led to certain market players transferring their business to a different jurisdiction to avoid the full extent of the AML/CFT professional obligations, notably the detailed CDD requirements, which are at odds with the anonymous functioning of certain platforms. These platforms may be technically able to collect certain data, perform certain checks or impose limits on transactions. For instance, they can detect a customer's country of origin based on the IP address, detect the use of virtual private networks (VPNs), analyse the origin and destination wallet addresses, include a monetary limit per operation, or generate risk scores based on the type and quantity of ►

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VA exchanged. These measures, however, fall short of the detailed requirements imposed by AML/CFT frameworks which require the collection of names, place and date of birth, nationalities, full addresses, etc. In practice, certain market players prefer to maintain the anonymity of their service to safeguard their business model rather than asking their customers for detailed information.

Short-term vision and fragmentation

Such jurisdiction transfers are short-term solutions given that most countries are expected to ensure compliance with the revised FATF standards and national frameworks in the EU and elsewhere will be amended accordingly. It is also interesting to note that the FATF considers such jurisdiction hopping to be an ML/TF risk indicator.

Where market players decide to switch jurisdictions to reduce their AML/CFT burden, they should be attentive to the registration requirement introduced by AMLD5; the registration requirement in one country may capture entities established in another country. Although AMLD5 does not expand on the registration requirement¹², the Interpretive Note to FATF Recommendation 15 states that VASPs should be required to be licensed or registered at least in the jurisdiction where they are created, and that a jurisdiction may require the licensing or registration of VASPs that are established abroad but offer products and/or services in that jurisdiction.¹³ As an example, Luxembourg's AML Law requires registration for VASPs established in Luxembourg, but also for VASPs providing services in Luxembourg.¹⁴ Providers choosing to leave to avoid the registration requirement should factor in that they may still be caught by the requirement if they provide services in Luxembourg or to Luxembourg clients.

The freedom left to Member States regarding the registration requirement also creates a fragmented approach in terms of requirements for the establishment of VASPs across the EU. For instance, Luxembourg requires registration followed by the payment of an annual fee of EUR 15,000; France requires mandatory registration for certain services and optional licensing for others, with either a one-time fee of EUR 1,000 or an annual fee of EUR 2,000 for the license; and Malta proposes different classes of licenses which require payment of an initial application fee of EUR 6,000 to EUR 24,000 and a variable annual supervisory fee which can exceed EUR 50,000.

In July 2021, the FATF issued its second 12-month review findings¹⁵ and highlighted that not all jurisdictions were moving quickly enough, with arbitrage increasing as a result of the fragmentation.¹⁶ Presumably, the EU's efforts to harmonise will advance progress and relegate those market participants who do not wish to comply with adequate standards to less stable countries, creating other business risks. Those risks may ultimately be more important than perceived flexibility when it comes to AML/CFT controls.

The market should prepare for this new reality and ensure business models are adapted

Towards alignment

In its January 2019 report on crypto-assets,¹⁷ the European Banking Authority (EBA) considered the need to address crypto-asset businesses from a regulatory perspective and also identified divergent approaches between Member States.¹⁸ On the topic of AML/CFT specifically, it

recommended that *"the European Commission have regard to the latest FATF recommendations and any further standards or guidance issued by the FATF as part of a holistic review of the need, if any, for action at the EU level to address issues relating to crypto-assets."*¹⁹

The EBA report was followed by a Joint Opinion of the European Supervisory Authorities (ESAs) on the risks of ML and TF affecting the EU's financial sector.²⁰ The Joint Opinion lists a number of ML/TF risks linked to FinTechs and virtual currencies, such as the quality of information gathered during CDD processes, the lack of understanding of applicable obligations, remote onboarding without proper safeguards, and an increase in online transaction processing with limited customer identification and verification. The ESAs also recognise that the EU framework is no longer aligned with FATF standards and that the divergence between Member State frameworks as a result of different transpositions of the AML Directives poses increased ML/TF risks. As a result, they consider that further action would be appropriate to strengthen the AML/CFT framework.²¹

The EU took action. On 20 July 2021, the Commission published a new AML/CFT Package, which includes: (i) a proposal for a new AML/CFT regulation, (ii) a proposal for a 6th AML/CFT Directive, and (iii) a proposal for a revised regulation on transfers of funds.²² "Providers engaged in exchange services between virtual currencies and fiat currencies" and "custodian wallet providers" are replaced. The new AML/CFT regulation includes "crypto-asset service providers" (CASPs) as obliged entities.

CASPs are defined by reference to a proposal for a regulation on markets in crypto-assets (MiCA)²³, which forms part of the Digital Finance Package published by the Commission on 24 September 2020.²⁴ The aim of ►

MiCA is to introduce a comprehensive regulatory framework for crypto-asset businesses. It defines CASPs as persons whose occupation or business is the provision of one or more crypto-asset services to third parties on a professional basis, which include:

- the custody and administration of crypto-assets on behalf of third parties
- the operation of a trading platform for crypto-assets
- the exchange of crypto-assets for fiat currency that is legal tender
- the exchange of crypto-assets for other crypto-assets
- the execution of orders for crypto-assets on behalf of third parties
- the placing of crypto-assets
- the reception and transmission of orders for crypto-assets on behalf of third parties
- the provision of advice on crypto-assets.

The list of services that lead to a qualification as CASP is much more detailed than the list provided in the FATF's definition of VASP, signalling the EU's commitment to meet and exceed the FATF Recommendations to ensure entities involved in crypto-assets are comprehensively covered by the AML/CFT framework.

In addition, these two EU legislative packages also remedy the fragmentation across the EU. The registration requirement currently included in Article 47(1) of Directive (EU) 2015/849 will disappear as CASPs will have to be authorised under MiCA.²⁵ The anonymous functioning of certain platforms – one of the drivers for jurisdiction transfers – will also be addressed by prohibiting CASPs from keeping anonymous accounts or anonymous crypto-asset wallets and clarifying that owners and beneficiaries of such accounts and crypto-asset wallets must be subject to CDD measures.²⁶

Although these legislative proposals have yet to be discussed, adopted, and implemented in the national frameworks of EU Member States, the market should prepare for this new reality and ensure business models are adapted. A consistent framework covering 27 Member States (many of which are hubs for virtual assets and innovation) will provide the stability and credibility which VAs are keen to obtain as they position themselves as real competitors to traditional financial sector. ●



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6. FATF (2021), op. cit., p. 24-31, para. 55-79.
7. FATF (2021), op. cit., p. 7, para. 1 and p. 8, para. 5.
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