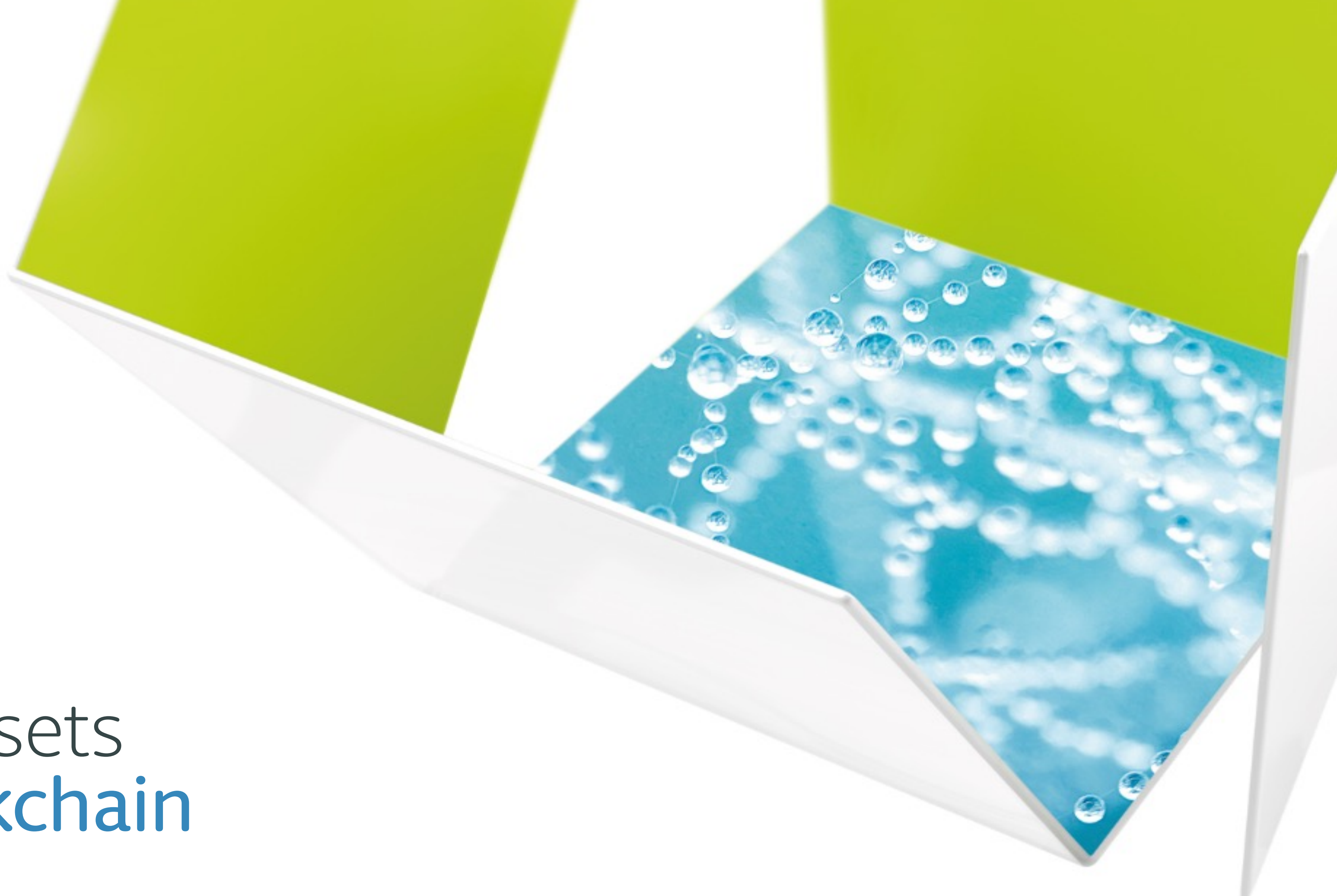
Hogan Lovells



Digital Assets and Blockchain

2022-23 Key Trends

Digital Assets and Blockchain Key Trends

2022 promises to be a defining year for digital assets and blockchain, as governments move from a watch and wait position to delivering regulatory frameworks and taking strides to harness the potential of the technology.

Whilst concerns still surround certain applications and how best to balance investor protection whilst stimulating growth, some clear trends have emerged as to what it is that policy makers, regulators, industry and practitioners need to look out for.

We have set out our top 10 digital assets and blockchain trends that we are seeing this year.

Below we set out the **top 10 digital assets and blockchain trends** we expect to see in 2022-23 and some thoughts on how businesses should prepare to respond to them.

1 AML and Sanctions	2 DeFi	3 ESG	4 NFTs	5 Security Tokens
6 Stablecoins / CBDCs	7 Financial promotions of crypto assets	8 Market surveillance	9 Interoperability	10 Tax

1

AML and Sanctions

TOOLKIT

Sanctions Navigator

Sanctions Navigator provides a practical and straightforward overview of the key international sanctions regimes. It allows you to assess key sanctions risks at a glance, evaluate the impact of sanctions on your business, keep abreast of the latest developments by receiving insights and analysis from the Hogan Lovells International Trade team.

You can find out more about the Sanctions Navigator here.

Blockchain faced an uphill battle when its first and most famous iteration, Bitcoin, looked to disrupt the financial services industry – one of the most heavily regulated sectors. High profile cases such as those involving the Silk Road darknet marketplace and ransomware demands in attacks by hacker groups REvil and DarkSide have both tarnished the reputation of digital currency and required a tightening of Anti Money Laundering (AML) controls to limit wrongdoers' access to the global financial system.

Whilst jurisdictions looked to put measures in place, global standards have been pushed for by the Financial Action Task Force (FATF), most recently publishing a targeted update on the implementation of the FATF standards on Virtual Assets and Virtual Asset Service Providers. These guidelines are seen as pivotal to preventing the misuse of crypto assets, requiring not just the implementation of legislation but also ensuring that authorities have the skills, resources and technology to regulate crypto assets effectively.

In light of the war in Ukraine, there has also been a growing focus on sanctions and the role that crypto assets play here. Initially, there was a misconception that crypto would be used to evade sanctions placed on Russia. However, putting aside the fact that the size and transparency of the crypto asset ecosystem made this highly unlikely, it was also clear that the enforcement of existing legislation was sufficient to address these concerns. Furthermore, technical solutions developed by industry have also enhanced the ability to detect and identify sanction evaders. Nevertheless, it is an area that will require constant monitoring and therefore it has come into sharp focus.

The strengthening of these requirements has been a clear priority for policy makers and regulators this year as they look to address concerns around the use of crypto and digital assets for illicit activity and going forward this is going to be imperative for the wide-scale adoption of this technology.

2

DeFi

TOOLKIT

Digital Assets and Blockchain Hub

Blockchain and distributed ledger technology could revolutionize supply chains, agreements, contracts, currencies and more.

Our Digital Assets and Blockchain Hub brings together our key digital assets knowledge, helping you take advantage of the technology's huge potential and disruptive impact, while avoiding falling foul of ever-developing legal and regulatory requirements. You can find out more about this toolkit here.

As the technology continues to evolve, so too do the applications that it manifests. Decentralized Finance (DeFi) has grown exponentially over the last three years with December 2021 seeing the Total Value Locked (TVL) reach an all time high of US$106.105 billion, grabbing the attention of policy makers and regulators worldwide.

DeFi promotes the proposition of completely removing intermediaries and in its place handing over control of the protocol to a Decentralized Autonomous Organisation (DAO), who issues governance tokens to participants of the DAO to make decisions on matters such as code application and maintenance. With the legal status of a DAO uncertain, it has posed a challenge for policy makers and regulators where existing financial services legislation is based on an accountable intermediary.

DeFi offers a great opportunity for financial markets with savings to be made through, faster, better, cheaper and more efficient financial services and as such has caught the attention for its use of institutional grade products, as well as for its use in unlocking capital for SME investment. However, there are hurdles to cross in the form of needing to garner trust through improving transparency and preventing illicit activity.

While no one has made significant progress to address DeFi to date, the EU has indicated that it plans to introduce rules on DeFi before the end of 2023. An indication of their approach has been published in the May report on "European Financial Stability and Integration Review 2022". The UK is also looking for solutions to tackle potential risks associated with DeFi, which has recently been highlighted in a report published by the Bank of England on "Financial Stability in Focus: crypto assets and decentralized finance". While these are only early stages, the rate of acceleration of the industry will certainly promote a strong response from governments across the globe.

3

ESG

KNOWHOW
ESG Academy

To help our clients navigate the complex and rapidly-evolving world of ESG issues, we've created the Hogan Lovells ESG Academy, a video and podcast series that quickly and concisely breaks down key issues behind critical ESG topics that impact every organization.

In brief episodes, our leading lawyers from across geographies, sectors, and practices deliver powerful content that empowers in-house counsel to understand and communicate key legal and commercial issues. You can find out more about the academy here.

With growing concerns on climate change, Environmental, Social and Governance ("ESG") is an important measure assessing companies' sustainable practices. In this context, crypto assets face a strong critique associated with their environmental impact. In particular, questions have been raised around the energy consumption of certain consensus mechanisms, particularly proof-of-work. While blockchain has perhaps been called out unfairly, whilst other industries and practices go unmentioned, it is an area which the industry have themselves looked to improve upon.

Governments are adopting climate goals and aiming to significantly reduce fossil fuel emissions and non-environmentally friendly practices. Examples of this are the EU Taxonomy Regulation, or UK's goals of "carbon net zero" by 2050, which will soon bring in new legislative regimes. At present, there is not a dedicated set of rules that have been put in place to address the energy consumption of mining crypto assets; however, the incoming Markets in Crypto Assets (MiCA) regulation does have a set of disclosure requirements for issuers of crypto assets. In the United States, the White House has released a framework for responsible development of digital assets, which acknowledged that opportunities exist to align the development of digital assets with transitioning to a net-zero emissions economy and improving environmental justice"

Irrespective of regulations, there is growing pressure on companies to consider the ESG criteria when making investments. As a result, crypto assets will also have the same expectations placed on them going forward. As this importance grows, so too will the need for crypto and digital assets to have cleaner and greener practices.

4

NFTs

Non-Fungible Tokens (NFTs) have exploded onto the scene with sales such as the Beeple NFT fetching US$69 million and catching the attention of people across the world. NFTs are increasingly seen as a new digital ownership framework that creates opportunities for new business models.

Artists, creators or musicians can attach stipulations to an NFT that ensures they receive some of the proceeds when it gets sold – benefitting if their work increases in value. Similar to DeFi, the blockchain technology adds a layer of security to the trading of NFTs. Smart contracts ensure that assets change hands automatically and the algorithms ensure that both parties honor their agreements.

At present, the legal status of NFTs is uncertain. Nevertheless, its rise in popularity and high value transactions have resulted in jurisdictions taking steps to try to identify what / if any regulatory approach should be taken towards the use of NFTs.

At present, there is not a specific regulatory initiative aimed at NFTs, but some regulations capture certain NFTs. For example, in the UK, certain NFTs may fall under the classification of "security tokens" or "e-money tokens" and thus would fall under the Financial Services and Market Act 2000 or Electronic Money Regulations 2011; however, the reality is that most fall outside of this scope. The EU recently discussed the inclusion of NFTs within the remit of the Markets in Crypto Assets (MiCA) regulation; however the extent to this is yet to be seen. As the NFT market continues to expand, so too will the regulatory focus on this application. Similarly, the regulatory discussion in the U.S. is centered around whether NFTs, or perhaps fractional NFTs, are considered securities. U.S. regulators are also studying whether NFTs could be used as a means of transferring or storing proceeds of illicit activity.

5

Security Tokens

Security Tokens often refers to two things. The first is a tokenized security i.e. the tokenization of existing securities that exist outside of the blockchain and the second is a security token, which is a security that is blockchain native such as a collateralized crypto loan. Both operate on leveraging the benefits from the efficiencies that blockchain technology gives, mainly the ability to have 24/7 trading, atomic settlement, truly globalized markets, increased transparency through a single source of information, and of course, cheaper fees.

Operating in a highly regulated market is always going to create difficulties, however even more so when considering that the definition of a security varies across jurisdictions and therefore the classification of security tokens will also vary, making this quite difficult for companies to gain regulatory approvals.

In Europe, the Malta Digital Innovation Authority Act adopts an all-encompassing legislative framework for issuing security tokens, whereas in Switzerland, security tokens are overseen by the Swiss Financial Market Supervisory Authority which supports security token offering projects, reviews token proposals and confirms the designation of the offering. Lithuania has created detailed security token regulations that provide institutional support for security token offerings, as well as free consultation from financial market supervisors. We expect others to ramp up efforts in this area too, acknowledging the huge potential that this area has.

6

Stablecoins / CBDCs

Beginning with the advent of Libra (as it was then known) and more recently following the turmoil in the crypto assets market and the crash of a stablecoin (Luna), more attention has been brought to regulating stablecoins.

In the EU, the Markets in Crypto Assets (MiCA) Regulation addresses this through requirements bestowed upon issuers and service providers to ensure that the impact of these events are mitigated. The UK is also set to introduce new rules for stablecoins – initially expanding the scope of Electronic Money Regulations to include stable tokens that reference fiat currency and plans for a wider framework to cover all other crypto assets later in the year. In the U.S. capital or collateralization requirements exist for holders of a New York Bitlicense and are under consideration at the federal level, as well. Pursuant to the White House's September framework for development of digital assets, the Treasury Department is actively considering the benefits and risks associated with a CBDC for either retail or wholesale use. In contrast, Japan has at the beginning of June 2021 passed a bill that aimed at curbing financial system risks of stablecoins to strengthen the protection of investors.

The benefits of stablecoins include lower costs of financial services, real-time and more competitive payments compared to what consumers and businesses have on offer now. Businesses could benefit from their use as they would allow for quicker and cheaper payments. Moreover, thanks to their accessibility, stablecoins technology could bring more people into the market – those unbanked or underbanked segments of population.

6

Stablecoins / CBDCs (cont'd)

Central Bank Digital Currencies (CBDCs) are digital tokens that are issued by a Central Bank representing its own fiat currency on a 1:1 basis. A CBDC is issued, regulated and backed by a nation's monetary authority or Central Bank. As such, they are supported by the national authority and influenced by the country's monetary policies, CBDC'S are therefore seen as more secure and less volatile.

Many Central Banks have introduced pilot programs and research projects to determine the potential use of CBDC'S usability in their economy. In the European Union, in June 2022, the President of the European Central Bank has expressed plans to evaluate a potential implementation of a digital Euro. Sweden's Riksbank recently began developing an electronic version of the e-krona. The Bank of England is in the process of investigating integrating CBDC into its financial system. In the United States, President Biden has recently directed federal agencies to evaluate the infrastructure needed to issue a US-wide CBDC. In India, the Central Bank has announced that it will introduce a digital rupee by the end of 2023. Finally, some smaller jurisdictions have already launched CBDCs, among others: The Bahamas, Dominica, Nigeria or Grenada, whereas 80 other countries worldwide are adopting projects with the aim to develop their own CBDCs.

There are many reasons why a Central Bank may opt to issue a CBDC and the reason behind this will vary from jurisdiction to jurisdiction. While for some it may be to bank the unbanked or to facilitate faster, cheaper and more efficient financial services. For others, it may be to develop resilience through an additional payments rail or to enable programmable payments.

7

Financial promotions of crypto assets

2022 began with a strong focus on how to deal with financial promotions, following increasing concerns of misleading adverts. Financial promotion regimes regarding crypto assets are aimed at ensuring customer protection, stabilizing market volatility and ensuring that the services offered to the public are fair, clear and not misleading.

At present, the lack of clarity over the classification of certain crypto assets and the fact that several of them fall outside of the remit of existing legislation has led to uncertainty over the obligations surrounding their promotion. Jurisdictions are now moving to bring them within scope.

In the European Union, Markets in Crypto Assets (MiCA) Regulation has provided a comprehensive framework on the use of crypto assets that outlines how companies can legally adopt and promote their use. Spain has implemented its own, more specific rules on the matter, requiring advanced notice of crypto assets promotions to be submitted to regulators prior to any mass advertising campaigns. In the United Kingdom, HM Treasury consulted on broadening the scope of the financial promotions regime to bring crypto assets within the remit; this is now subject to Parliament approving the relevant legislation to bring qualifying crypto assets within the financial promotions regime. Finally, in Singapore, Digital Payment Token (DPT) service providers who facilitate the exchange of crypto assets, as well as banks, payment providers and other financial institutions, face a ban on promoting their DPT services to the general public.

8

Market surveillance

KNOWHOW

Engage

Engage is the Hogan Lovells online thought leadership platform available exclusively for our clients. Engage brings together our latest legal,market and regulatory news, industry insights and analysis from across our global network. We also offer a range of cutting-edge digital tools that are available by subscription on Engage Premium. You can sign up to Engage here.

As more forms of crypto assets enter the financial markets and gain popularity, the need for market surveillance and risk management systems rises.

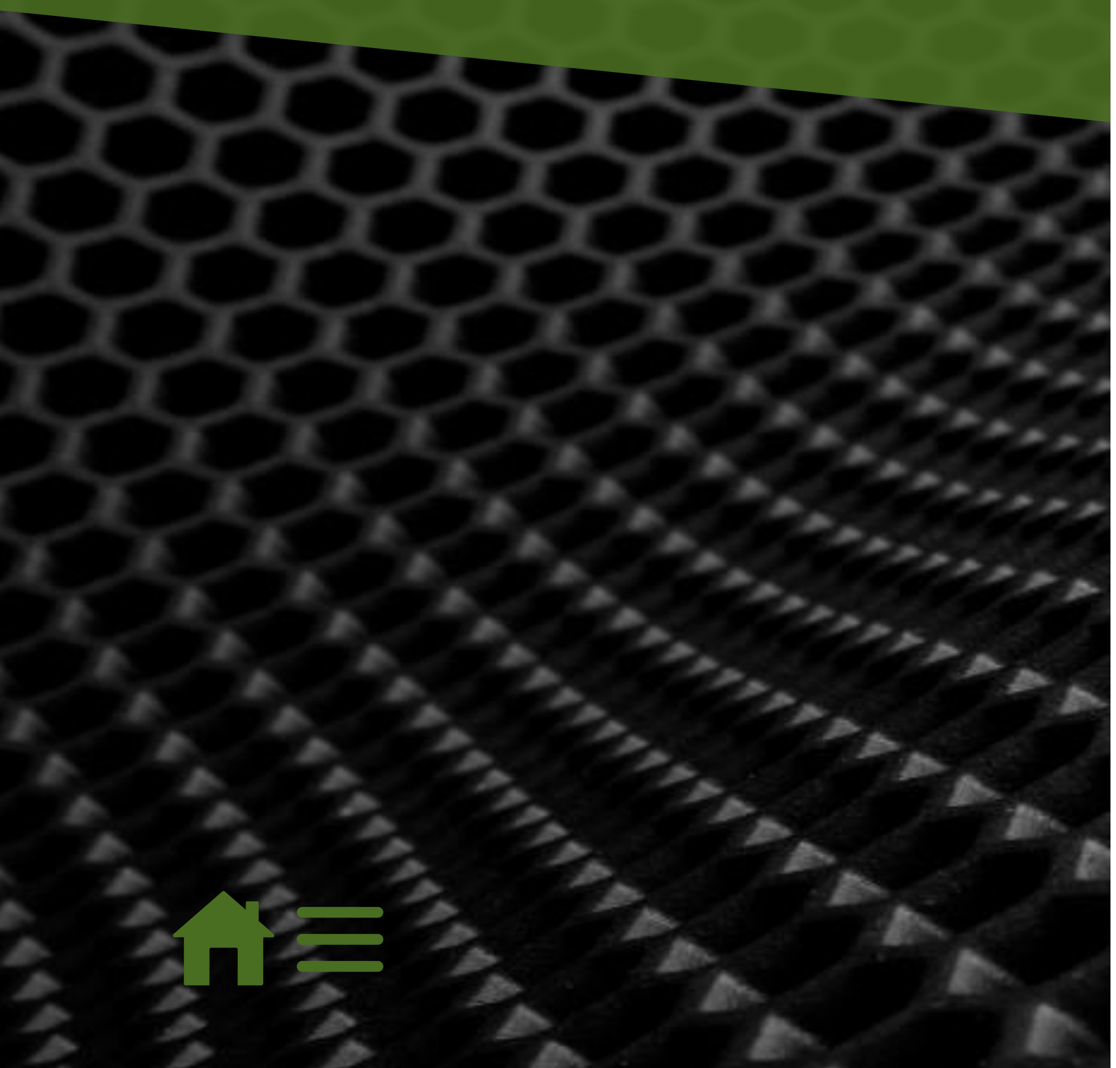
Crypto trade surveillance measures adopted by crypto assets service providers or by public institutions are needed to ensure that markets are more transparent and credible, preventing forms of market manipulation and abusive trading behaviours. Market surveillance's aim is to empower demonstrably healthy crypto trading ecosystems, mitigating the risks linked to bad actors and market manipulation to enable significant growth.

As the crypto asset industry grows so too does the importance of the integrity of the market and the need for higher standards of risk monitoring, consumer protection and compliance to ensure the fair and orderly operation of the crypto asset industry.

Key regulators in the U.S., including the New York Department of Financial Services (NYDFS), have articulated that crypto licensees are to maintain transaction monitoring and sanctions screening programs that are reasonably designed, based upon the risk assessment of the entity, to ensure the monitoring of the entity's transactions for potential AML violations and suspicious activity reporting and to interdict transactions that are prohibited by the U.S. Treasury Department's Office of Financial Asset Control (OFAC). NYDFS guidance that requires Virtual Asset Service Providers (VASPs) to use blockchain analytics further clarifies this expectation.

9

Interoperability



Blockchain interoperability refers to a broad range of techniques that allow different blockchain protocols to actively communicate and collaborate with each other. Currently, the main cases of interoperability are transmissions of a crypto asset's liquidity from one blockchain to another, allowing users to trade assets between different chains and borrowing assets on one chain, by posting tokens as collateral on another chain. Blockchain interoperability has become an increasingly important feature of Web3.

Until now the topic of blockchain interoperability has not been directly addressed by any jurisdiction. Nevertheless, the World Bank, in January 2021, released a report on blockchain interoperability which outlined legal considerations connected to the topic. It highlights the challenges that will follow if countries do not coordinate their regulatory approaches. As blockchain interoperability's goal is to ensure a better cooperation between different chains, jurisdictions which introduce conflicting frameworks might significantly stifle its development and their potential interconnectivity.

Effective blockchain interoperability is an important path of development for the industry, as it would allow for an easier exchange of information, improve the overall ecosystem's processing efficiency and self-sovereignty, cultivate financial inclusion and lead to further innovation in the crypto assets market.

10

Tax

With the rise in popularity of the crypto assets markets, and increased volumes of transactions and value, many countries have sought to clarify their approach to the taxation of crypto assets.

In the European Union, the Commission is looking to amend the Directive on Administrative Cooperation (DAC) to ensure that EU rules stay in line with the evolving economy and include areas such as crypto assets. For now, some countries in Europe (Germany and Portugal) have exempted crypto transaction from VAT. Outside of the EU, in the United Kingdom, HM Revenue & Customs have issued a manual for the regulation of crypto taxation, with a Call for Evidence on how DeFi lending should be treated. In Singapore and Malaysia, companies holding crypto for long-term investment are not taxed. Nevertheless, in Singapore, as a business makes transactions through crypto, its profits get taxed in the form of income tax.

Taxing crypto assets is an important step in assuring that the digital assets market is considered as legitimate and is seen to be contributing to public interests.

Key contacts

John Salmon
Partner and Global Head of Blockchain and Digital Assets, London
T: +44 20 7296 5071
john.salmon@hoganlovells.com

Sharon Lewis
Partner and Global Head of Finance, Insurance & Investment, Paris/London
T: +33 (1) 53 67 47 04 / +44 20 7296 2474
sharon.lewis@hoganlovells.com

Andrew McGinty
Partner, Hong Kong
T: +852 284 050 04
andrew.mcginty@hoganlovells.com

Elizabeth Boison
Partner, Washington D.C.
T: +1 202 6375624
elizabeth.boison@hoganlovells.com

Leopold von Gerlach
Partner, Hamburg
T: +49 40 41993 175
leopold.vongerlach@hoganlovells.com

Luke Grubb
Consultant, London
T: +44 20 7296 2912
luke.grubb@hoganlovells.com

Lavan Thasrathakumar
Crypto Policy Consultant, London
T: +44 20 7296 2278
lavan.thasarathakumar@hoganlovells.com

Ranked in the **top ten most innovative law firms Europe** for six consecutive years by the *Financial Times*

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dublin
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Riyadh*
Rome
San Francisco
Sao Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.
Zagreb*

*Our associated offices
Legal Services Centre: Berlin

www.hoganlovells.com