

Financial Action Task Force
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To whom it may concern,

Response to public consultation on the Financial Action Task Force's draft Guidance on a risk-based approach to virtual assets and virtual asset service providers

We support the Financial Action Task Force's efforts to update its guidance to assist countries and the private sector in their adoption of the FATF Recommendations. As such, we are pleased to provide you with our feedback, which is based on our knowledge and expertise in policymaking and global regulation of virtual assets and virtual asset service providers.

About XReg Consulting Ltd (XReg)

XReg Consulting is a boutique policy and regulatory consultancy founded by former regulators that specialises in virtual assets. We are grateful for the opportunity to submit our comments in relation to the FATF's draft Guidance on a risk-based approach to virtual assets and virtual asset service providers.

Introduction

The FATF published its proposed revised Guidance on 19 March 2021 for consultation with private sector stakeholders. Following a review of the draft Guidance, and based on our experience in the public and private sectors, we believe that increased clarity is required in some areas to ensure the effective implementation of the FATF Standards.

Consultation Response

1. Does the revised Guidance on the definition of VASP (paragraphs 47-79) provide more clarity on which businesses are undertaking VASP activities and are subject to the FATF Standards?

We feel that the draft Guidance lacks clarity in certain areas, which may lead to regulatory arbitrage due to countries adopting different interpretations of the Guidance resulting in different implementations of the FATF Standards. Since ensuring a level-playing field is one of the 'key principles underlying the design and application of the FATF Recommendations', the prevention of regulatory arbitrage should be a key concern, and can be supported through clearer guidance.

Notably, the Guidance should provide further clarity on the application of the definition of a VASP to different types of entities and business models, particularly where they are decentralised or automated. In certain circumstances where it may be difficult to apply the VASP definition, more clarity and case study examples would support correct interpretation and implementation of the FATF Standards.

- **Is further guidance needed on how the FATF Standards apply to various business models, as stated in paragraphs 56-59? How should the Guidance further address the challenges in applying the definition of VASP to businesses which decentralize their operations across multiple parties?**

We feel the FATF could better support effective implementation of its Standards by giving more details and examples of how the definition of VASP could apply to different entities involved in decentralised business operations. In particular, further clarity could be given on the role of agents developing and managing decentralised or automated applications and services.

Notably, the VASP definition applies to the 'provision of financial services associated with that software application or platform, and not the writing or development of the software itself' (paragraph 68). The FATF draft Guidance equally suggests that a person that conducts business development for a DApp may be a VASP' (paragraph 57).

Countries may experience some uncertainty in applying the definition of a VASP to individuals or entities which have varying roles associated with the development, launch, and maintenance of decentralised or automated services. As such, we feel that further guidance on this aspect of the VASP definition would be valuable.

In particular, more detail could be given on how to isolate general development activities (either conducted voluntarily or on a commercial basis) from development activities associated with the launch and/or maintenance of a decentralised application, all of which may or may not be associated with VASP activities depending on the level of control exercised by the relevant developer. Similarly, guidance on commercial activities which may be understood as "business development" would be welcomed.

- **Is more guidance necessary on the phrase 'for or on behalf of another natural or legal person' in the FATF definition of VASP? What are the challenges associated with applying the business-customer relationship concept in the VASP context?**

The FATF's definition of a VASP differs slightly to that of a financial institution in that it applies to entities that conduct certain business activities 'for or on behalf of *another natural or legal person*', whereas the definition of a financial institution applies to activities conducted 'for or on behalf of a *customer*'. According to this definition of a VASP, entities may be considered VASPs if they provide VA services for or on behalf of natural or legal persons which are not their customers. However,

the draft Guidance highlights that a key consideration in determining whether a service provider is a VASP or not is 'who profits from the use of the service or asset' (paragraph 77). We believe that further clarity is required on the factors influencing whether an entity would be considered a VASP when providing services for or on behalf of natural or legal persons that are not customers, particularly if the entity in question does not profit from providing services, and where the entity's operation is partly or fully decentralised or automated.

Also, more detail should be given on the evaluation of factors influencing the determination of VASP status, such as governance mechanisms including those which accord voting rights to token holders. While the list in paragraph 77 is non-exhaustive, as many examples and as much detail as possible should be given on factors determining whether a particular entity is a VASP. Additionally, the Guidance states that a provider that 'runs the functioning of the VA ecosystem itself' would be considered a VASP (paragraph 62), and we feel this is a broad notion which requires further clarification. Equally, the Guidance should clarify what constitutes '[f]inancial services related to an issuer's offer and/or sale', as well as other services which may qualify service providers as a VASP.

Further, the VASP definition's reference to 'for or on behalf of' potentially implies the existence of a principal-agent relationship, yet VA issuers may be deemed VASPs under the Guidance despite them not acting as an agent of a principal. Moreover, issuers of traditional securities are not subject to AML/CFT requirements. As such, the circumstances in which VA issuers could be considered VASPs and subject to AML/CFT requirements should be clarified.

- **Do the clarifications on the 'expansive' approach to the definition of VASP in identifying and policing the 'regulatory perimeter' for VASPs provide countries and the private sector with enough guidance? What additional clarity can be given to make the perimeter clearer?**

The updated Guidance aims to 'clarify the definitions of VA and VASP to make clear that these definitions are expansive and there should not be a case where a relevant financial asset is not covered by the FATF Standards (either as a VA or as a traditional financial asset)' (paragraph 8). We believe that the Guidance requires further clarification on various definitions including of VA and VASP, so that any limits (or lack thereof) to expansive definitions are well understood. If these definitions are too open-ended, they may be interpreted and applied differently, resulting in opportunities for regulatory arbitrage due to differing implementation of the FATF Standards in different jurisdictions.

The FATF's definition of a VA excludes 'financial assets that are already covered elsewhere in the FATF Recommendations', yet the term 'financial asset' is not defined in the Guidance or Recommendations. While the Guidance appears to indicate in some places (e.g. paragraph 39 and Box 2) that the definition of a financial asset depends on each country and their national law, the Guidance should either explicitly specify this or offer a definition of a financial asset within the Guidance which would serve to clarify the definition of a VA and the scope of the FATF Standards.

As for the term 'traditional financial asset', the Guidance states in non-exhaustive fashion that this includes 'securities, commodities, derivatives or fiat currency', but further clarification on the distinction between 'financial asset' and 'traditional financial asset' should be given. Reference is made to certain tokens which may fall entirely outside the FATF Standards, but this should be made clearer and more consistent in the Guidance. For example, Box 2 of the draft Guidance specifies that if a 'new digital token' meets neither the definition of a traditional financial asset under national law, nor the FATF's definition of a VA, 'the token is not covered by the FATF Standards'.

Whereas Box 2 implies that a non-traditional financial asset which does not qualify as a VA would not be covered by the FATF Standards, the Guidance also states that ‘there should not be a case where a relevant financial asset is not covered by the FATF Standards’. Therefore, these two statements may be contradictory depending on the distinction (if any) between the definitions of ‘financial asset’ and ‘traditional financial asset’; as such, these definitions should be specified in the Guidance in order to clarify the scope of application of the FATF Standards. Additionally, certain phrases such as in paragraphs 40 and 45 reference ‘asset’ rather than ‘financial asset’, which could lead to broader interpretations of the Guidance than is intended. As such, we believe paragraphs 40 and 45 should be amended to refer to ‘financial asset’ in order to specify their focus.

Either the definition of VA or the Guidance should also be clarified to indicate whether Non-Fungible Tokens (NFTs) could qualify as VAs. An NFT can be defined as a unique token representing ownership rights of a digital asset such as a digital work of art. Although many NFTs have value, it is unclear whether they can be considered as a ‘digital representation of value’, which forms part of the FATF’s definition of a VA. In discussing which digital assets could qualify as a VA, the draft Guidance states: ‘The key question in this context is whether the VA has inherent value to be traded or transferred and used for payment or investment or, rather, is simply a means of recording or representing ownership of something else’. While NFTs can be traded or transferred and can be used for investment, it is unclear whether they have inherent value or only subjective value, and NFTs essentially are ‘simply a means of recording or representing ownership of something else’.

As such, it appears that NFTs might not qualify as VAs according to the draft Guidance, but further clarification is necessary to ensure correct interpretation. On this basis, and since NFTs would be unlikely to qualify as traditional financial assets, it appears that NFTs may fall entirely outside the FATF Standards. However, the scope for NFTs to be used to transfer value digitally may give rise to ML/TF risks. Indeed, the draft updated Guidance removes a statement in the previous Guidance that ‘the VA and VASP definitions are intended to capture ... assets that are fungible’, and this deletion may signify the FATF’s intention that non-fungible assets could qualify as VAs. If the FATF intended for NFTs and other non-fungible assets to be captured within the definition of VA, this should be clarified in the Guidance.

2. What are the most effective ways to mitigate the money laundering and terrorist financing (ML/TF) risks relating to peer-to-peer transactions (i.e., VA transfers conducted without the use or involvement of a VASP or other obliged entity, such as VA transfers between two unhosted wallets) (see paragraphs 34-35 and 91-93)?

- **How are peer-to-peer transactions being used for ML/TF purposes and what options are available to identify how peer-to-peer transactions are being used? What role and implications (e.g., benefits) do peer-to-peer transactions and unhosted wallets have in VA ecosystems?**

Peer-to-peer (P2P) transactions may facilitate ML/TF as they can be conducted in the absence of regulatory restrictions and monitoring. Nonetheless, P2P transactions can be identified and analysed through blockchain analytics, which are available as a service from a range of providers. According to a perhaps cautious approach, P2P transactions could be defined as any transactions not involving an identified, regulated VASP, though this classification depends heavily on the availability of up-to-date and accurate data on VASPs across the globe.

P2P transactions and unhosted (i.e. self-hosted/private) wallets are fundamentally important to the VA industry, as they enable users to retain control of their VAs and so avoid the risks associated

with custodial service providers which may lose the VAs held in custody. Also, P2P transactions and unhosted wallets may play an important role in promoting financial inclusion in VA ecosystems, as they would likely be cheaper to use than VASP services which may charge fees to cover costs of compliance and operations.

- **What specific options are available to countries and VASPs to mitigate the ML/TF risks posed by peer-to-peer transactions?**

The use of blockchain analytics should be strongly encouraged in the Guidance, as this helps to identify and mitigate ML/TF risks, and supports the application of other risk controls according to a targeted, risk-based approach. Countless successful investigations into illicit VA activity attest to the strength of blockchain analytics in tackling ML/TF, which can offer even greater visibility into transaction activity than is possible when investigating transactions involving the traditional financial system. In support of this perspective, a recently published report by Michael Morell, previously the acting and deputy director of the US Central Intelligence Agency (CIA), emphasised the strength of blockchain analytics as a 'highly effective crime fighting and intelligence gathering tool', and affirmed that the majority of illicit activity remains within the traditional banking system.¹

Also, ML/TF risks of P2P transactions can be mitigated through the application of enhanced regulatory requirements on VASP activities involving unhosted wallets and customers which have conducted P2P transactions. While there may be some residual risks, we believe that effective control of VA activity between obliged entities and non-obliged entities could mitigate the ML/TF risks associated with P2P transactions and unhosted wallets (paragraph 91). In the future, alternative measures may emerge as effective means of mitigating ML/TF risks, such as blockchain-based digital identity solutions which are currently in early phases of technological development.

- **Are the risk mitigation measures proposed in the Guidance in paragraphs 91-93 appropriate, sufficient and feasible?**

Options outlined under paragraphs 91-93 would likely support the mitigation of ML/TF risks posed by P2P transactions and unhosted wallets. Although de-risking is alluded to in the revised Guidance (paragraphs 91 and 94) and may be appropriate where ML/TF risks are unacceptable or cannot otherwise be managed, more emphasis should be given that de-risking should only be used as a last resort. In most cases, implementation of enhanced regulatory requirements should be feasible and may be sufficient to manage these risks.

3. Does the revised Guidance in relation to the travel rule need further clarity (paragraphs 152-180 and 256-267)?

- **Are there issues relating to the travel rule where further guidance is needed? If so, where? Please provide any concrete proposals.**

Further clarification of the requirement that originator and beneficiary information be transferred 'securely' would be instructive. Notably, reference should be made to any standards against which security of data transmission should be measured.

- **Does the description of counterparty VASP due diligence clarify expectations, while remaining technology neutral and not prescribing how VASPs must undertake this process (see paragraphs 172-177 and 261-265)?**

¹ Michael Morell, Josh Kirshner and Thomas Schoenberger, 'An Analysis of Bitcoin's Use in Illicit Finance' (2021) <https://cryptoforinnovation.org/resources/Analysis_of_Bitcoin_in_Illicit_Finance.pdf>.

Yes, though identification and mitigation of ML/TF risks associated with counterparty VASPs is likely to be most effective when due diligence takes into account the specific risks and characteristics of the VA industry. As such, the Guidance could recommend that countries take steps to support effective counterparty VASP due diligence, such as providing tailored guidance on conducting counterparty due diligence in light of the specific risks and characteristics of the VA industry.

4. Does the revised Guidance provide clear instruction on how FATF Standards apply to so-called stablecoins and related entities (see Boxes 1 and 4 and paragraphs 72-73, 122 and 224)?

- **Is the revised Guidance sufficient to mitigate the potential risks of so-called stablecoins, including the risks relating to peer-to-peer transactions?**

Further clarification is needed of the specific factors influencing the determination that entities involved in a stablecoin arrangement are likely to be considered VASPs, especially where these entities are not centralised or identifiable. Also, the Guidance should include more detail on how stabilisation mechanisms should be considered in the VASP licensing or registration procedure, particularly on differences between asset-backed stablecoins and algorithmic stablecoins.

Risk mitigation around stablecoins and P2P transactions could be supported by enhanced guidance on the circumstances where stablecoins may pose higher risks which warrant the application of enhanced regulatory requirements.

5. Are there any further comments and specific proposals to make the revised Guidance more useful to promote the effective implementation of FATF Standards?

Overall, we feel that the revised Guidance requires increased clarity to support effective implementation of the FATF Standards. Notably, more detail on the boundaries of the expansive outlines of VASPs and the regulatory perimeter would help prevent the blind application of regulatory requirements to all activities involving VAs. In particular, further clarification of how the FATF Standards apply to decentralised business models and stablecoins would be beneficial, alongside more specific suggestions for managing the associated ML/TF risks.

Serious consideration should also be given to FATF's parallel consultation on mitigating the unintended consequences of the FATF Standards, especially of de-risking and financial exclusion. Indeed, clarity in the FATF's Guidance supports correct interpretation and implementation of its Standards, which mitigates the risks of unintended consequences associated with implementation of the Standards. Although de-risking is an option for addressing ML/TF risks which cannot be managed or are deemed to be unacceptably high (paragraphs 91 and 94), this restricts the growth of the VA sector and may also restrict financial inclusion. While we recognise that de-risking is necessary as a last resort, we feel the Guidance should clarify the FATF's expectations of the (limited) circumstances in which this approach is justified.

For example, more detail should be given on the steps which should be taken prior to the consideration of de-risking, such as an 'appropriately-targeted risk assessment' as described in paragraph 21. Without clarity in this area, there may be increased de-risking to the detriment of financial inclusion, growth, competition, and innovation in the VA sector. Indeed, where de-risking is unjustified, it runs contrary to the FATF Standards' endorsement of a risk-based approach, as well as the FATF Guidance on risk-based supervision.

We would like to thank you for the opportunity to submit this response and would be happy to expand upon any of our comments or answer any questions the FATF may have.