

Digital Assets and Blockchain

2023 Key Trends



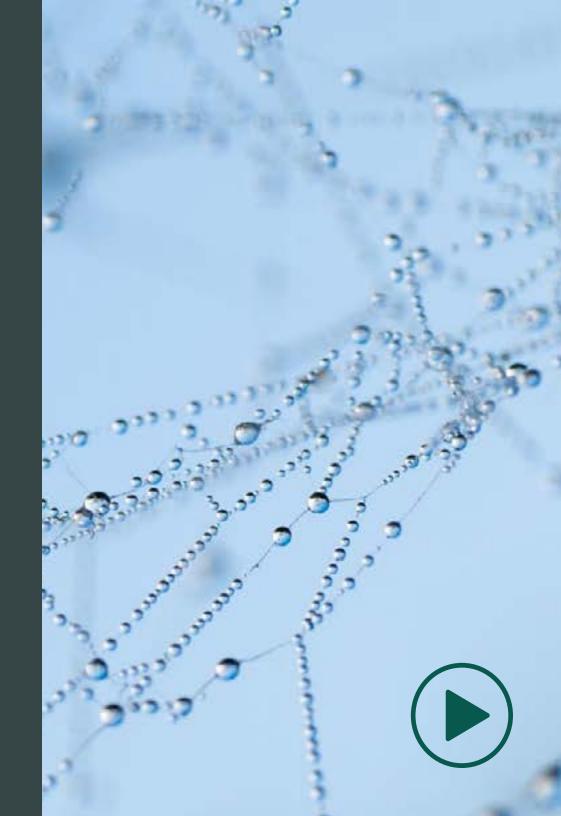
Introduction

2023 has been a defining year for digital assets and blockchain, with a number of jurisdictions publishing new regulatory frameworks, cementing the importance of digital assets and blockchain into legislation.

As the digital assets and blockchain industry moves into a new phase, following the turmoil we have seen over the last year, we are seeing a consolidation of the market with an influx of traditional finance firms entering into the fold.

Whilst many of the regulatory discussions from last year have carried on into this year, focussing on investor protection and stimulating growth, there have been some new trends that policy makers, regulators, industry and practitioners need to look out for.

One such trend, is digital trust – a topic of keen interest for our Digital Assets and Blockchain Practice. It is a trend that we see come up in a number of conversations and one that we think is imperative to achieving widespread adoption of digital assets and blockchain. We have not listed it as a topic in itself, as it applies across a number of trends, for example: custody, financial market infrastructure and market surveillance to name a few. But we are sure that 2023 will see the discussion in digital trust grow in its own right.



We have set out our top 10 digital assets and blockchain trends that we are seeing this year below, and we would love to continue the conversation with you.







Custody of digital assets TOOLKIT Digital Assets Custody Paper Hogan Lovells and Zodia Custody have worked together to produce a paper that seeks to demystify digital asset custody by comparing the custody of digital assets with that of more traditional assets, as well as highlighting key considerations and questions for institutions and corporations to consider when exploring projects in this field. Read more here.

The custody of digital assets has arguably been the most in vogue theme this year and we see it being an increasingly important topic going forward. In the wake of FTX and the fallout from its unravelling, there has been a sharper focus on digital asset custody and what this actually means.

On the one side there is greater scrutiny being put into how third-party custodians hold client funds with discussions around the benefits of cold and hot storage. However, there is also a trend towards self-custody of digital assets with large amounts of investment going into developing suitable solutions. At an institutional level, institutional grade custody is also gaining prominence. Despite high barriers to entry and stringent standards requirements, financial institutions are increasingly working on how to develop this service offering and be able to take client funds on in a safe and secure way. We discuss this more in our <u>custody paper that we put</u> together with Zodia.

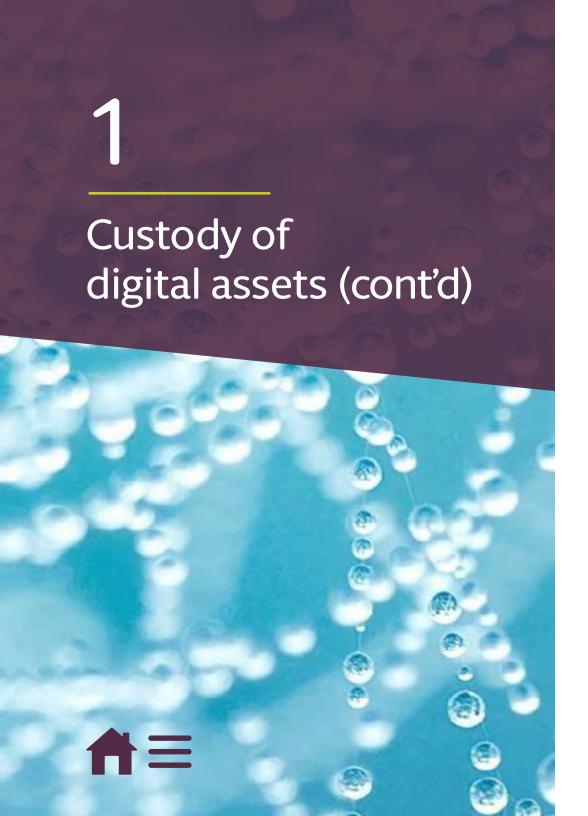
The high profile collapse of FTX and enhanced focus on the space overall has translated into increased regulatory and policy discussion on the topic. On a global level, the Financial Stability Board (FSB) published a paper which identifies the main risks related to wallets and custody services and proposes foundational recommendations for digital asset regulation.

In the European Union, the Markets in Crypto Assets Regulation (MiCA) lays down rules for crypto-assets service providers (CASPs), which includes firms providing custodial services. CASPs are required to obtain a license to perform this activity and MiCA determines that those offering custody have liability for loss of client's assets in the event of malfunction or cyber-attacks.

In the United Kingdom, HM Treasury consulted on a Future Financial Services Framework for Cryptoassets where it noted the need for a clear regulatory framework for custody that is tailored to the nuance of how cryptoassets are held.







Work is currently also underway by the Law Commission to review which aspects of the law of England and Wales need to be adapted to accommodate digital assets and this will certainly impact the future framework. The Government has stated that a proportionate approach to custody arrangements and associated legal obligations is preferred, and that contrary to the position laid out in MiCA, there may not be full liability on the custodian where customer losses arise from a hack or malfunction that was not in the control of the custodian.

In the United States, the SEC published amendments to the Custody Rule titled 'Safeguarding Advisory Client Assets', which expands the scope to, among other things, include cryptoassets. This amendment results in registered investment advisors needing to hold cryptoassets with a qualified custodian. In addition, the newly proposed rules for those wishing to become a "qualified custodian" include increased transparency measures, obligations regarding the proper segregation of digital assets, and additional audits from public accountants.

In Germany, new licensing requirements were put in place for crypto custody businesses defined as providing, custody, administration and safeguarding of cryptoassets. Should a firm conduct any of these activities, they will be required to licence themselves as a crypto custody business. These requirements sit subsidiary to any provisions that are required for custodying certain cryptoassets which, for example, may qualify as a financial instrument, in which case for example, a banking license may be required.

Two jurisdictions that are also of interest are Hong Kong and Japan. Hong Kong with its new licensing regime which went live as of 1 June and Japan with its amendments to the Payment Services Act both have restrictions on what percentage of custodied funds must be held in cold wallets ie. stored offline for security purposes. Japan put a requirement of 95%, whereas Hong Kong's new regime puts a requirement of 98% with private keys also required to be held on shore. These requirements are examples of custody rules which take into consideration the nuanced differences that the custody of digital assets bring and we expect other jurisdictions to follow suit.



DLT financial markets infrastructure / **Digital Bonds**

DLT Financial Markets Infrastructure comes off the back of a flurry of activity in the use of digital bonds. The European Investment Bank has been the most prominent in this area earlier this year issuing the first ever sterling bond – its third digital bond transaction. It has provided valuable insight into the use of DLT for such transactions including the efficiencies it can bring as well as the hurdles that need to be overcome. In general to date, these transaction have been carried out in jurisdictions that offer codified 'dematerialisation of securities' laws including France and Luxembourg. We are seeing interest in such transactions steadily grow.

DLT FMI is required to underpin these offering and in particular to enable secondary market liquidity and trading. Recent progress has been made in this area. The EU DLT pilot regime has recently entered into force allowing operators to test DLT solutions in the issuance, trading and settlement of tokenised financial instruments. In March 2023, the European Securities and Markets Authority (ESMA) published guidelines on standard forms, formats and templates to apply for permission to operate a DLT market infrastructure. The guidelines introduce specific permissions and obligations for applicants to operate DLT market infrastructures including the DLT Multilateral Trading Facility, the DLT Settlement System and the DLT Trading and Settlement System.

In fact, there have been several advancements across Europe on this matter. Luxembourg recently implemented Blockchain Law III which brought clarity and legal certainty on how financial instruments are to be treated. This, read alongside Blockchain law II, allows for the possibility of EU credit institutions and investment firms acting as central account keepers.



DLT financial markets infrastructure / Digital Bonds (cont'd)

In France, Blockchain Law II was implemented to comply with the EU DLT pilot regime and allows both listed and unlisted securities to be issued, transferred and delivered through DLT market infrastructure governed by the regime.

In Germany, a new law was introduced called the Electronic Securities Act, which makes it possible to issue bearer bonds, mortgage bonds and certain funds in a purely electronic format. The new law allows issuers to issue securities by way of certificate or electronically therefore allowing for the development of dematerialised DLT products and infrastructure offerings in Germany.

In the UK the Financial Services and Markets Bill 2022 has proposed to grant HM Treasury the power to create sandboxes which would allow developers of financial market infrastructures to test and adopt new technologies and practices which will improve effectiveness and efficiencies. This could see a range of solutions tested in the UK with HMT given the powers to amend, disapply and create rules within these sandboxes. Also of note is the Electronic Trading Documents Bill, which is in its final reading. Once passed, it will enable dematerialisation of trading documents under English law, replacing certain aspects of old legislation such as the Bill's of Exchange Act 1882, which is significantly outdated in the modern technology-enabled age. This is important for international trade and will open up a number of new opportunities for DLT infrastructures to evolve in support of these markets.



3

Tokenisation / Security Tokens



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.

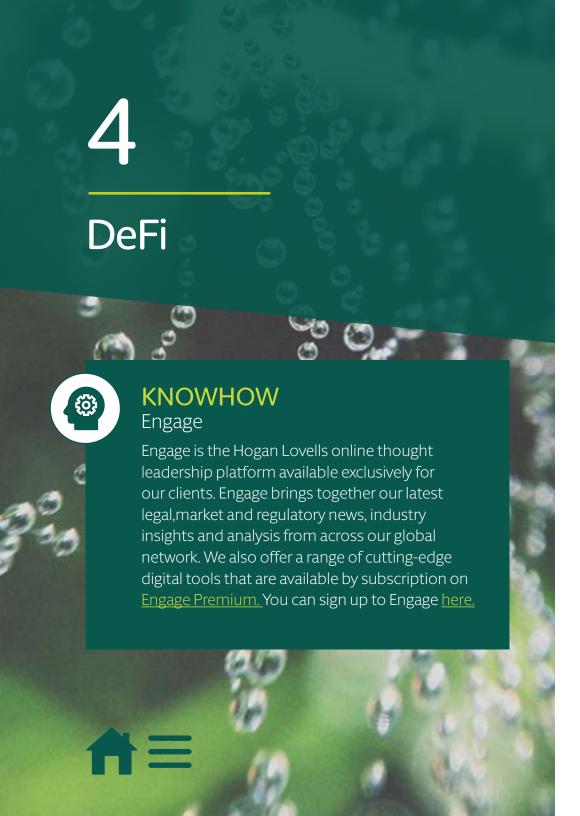


The tokenisation of assets allows for a digital representation of real-world assets on blockchain - converting something from the real world into an ownership value in the form of a digital token.

Using the characteristics of blockchain, tokenisation can offer liquidity in otherwise illiquid assets amongst other features like fractionalisation and settlement improvements including instant delivery vs payment functionality. Examples of this are the tokenisation of commodities and metals, art and collectibles, intellectual property, sports teams and athlete contracts as well as carbon credits, real estate and investment funds. Tokenisation may also enable a wider base of investors to participate due to decreasing the barriers to entry, thereby bringing liquidity and also increasing the levels of investment.

Different jurisdictions have adopted varied approaches to regulating tokenisation - either by applying existing financial regulations to tokenised assets or by introducing tailor-made regulatory frameworks. In January 2021, the OECD issued a report on the Regulatory Approaches to the Tokenisation of Assets which provides conceptual clarity on the adopted approaches. In Germany, a proposal was recently put forward that will enable corporations to issue electronic shares which can be registered in a central register or on blockchain. This in practice allows for the tokenisation of shares. The focus for regulatory frameworks is on investor protection, ensuring compliance with securities laws, Anti-Money Laundering (AML) and Know Your Customer (KYC) regulations.





As the technology continues to evolve, so too do the applications that it manifests. Decentralised 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), which 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 given that typical existing financial services legislation is based on an accountable intermediary. DeFi offers a significant opportunity for financial markets due to the available efficiencies and as such has caught the attention in terms of use cases for institutional grade products, as well as potential for 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 jurisdiction has made significant progress to address DeFi to date, the final text of MiCA puts a commitment within 18 months after the date of entry into force to present a report on the latest developments on decentralised finance and assess whether there is a need to regulate it. The UK has also moved forward in this dialogue, putting within the call for evidence part of the Future Financial Services Regulatory Regime for Cryptoassets Consultation Paper, a section on decentralised finance and how this should be addressed. Whilst early days, it is clear that the UK wants to leave this to be dealt with on an international level and then look to follow suit in a uniform manner. IOSCO has also set up a separate workstream looking at this area and addressing how it will move forward.



5

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 which underpins the Bitcoin Blockchain. While blockchain has perhaps been called out unfairly, whilst other industries and practices go unmentioned, energy consumption and ESG credentials more broadly are areas in which the industry has sought to improve. Governments are adopting climate goals and aiming to significantly reduce fossil fuel emissions, as well as promoting other environmentally friendly practices. Examples of this are the EU Taxonomy Regulation, and the UK's adoption of mandatory climate related financial disclosure requirements. Other concerns in this area such as biodiversity, the sustainability of supply chains and increasing social pressures arising from challenges such as the cost of living crisis will soon bring in new legislative regimes. Specifically regarding digital assets and crypto, the incoming Markets in Crypto Assets (MiCA) regulation does have a set of ESG disclosure requirements for issuers of crypto assets. The UK also included a section on ESG considerations in the call for evidence section of their recent consultation.

In Dubai, the Virtual Asset Regulatory Authority published its full market product regulations within which it introduces ESG disclosure requirements which will vary based on number of staff, turnover and business model but operates on a voluntary, compliance and mandatory level, with VASPs which mine or stake required to disclose the use of renewable energy and initiatives they have towards emission reduction and decarbonisation.







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 economy and improving environmental justice" Irrespective of regulations, there is growing pressure on companies to consider ESG criteria when making investments. As a result, crypto businesses and digital assets will have the same expectations placed on them going forward. On the flipside of this, there is much anticipation about the climate and ESG solutions that digital assets and blockchain may enable. This includes in relation to monitoring, reporting and verifying ESG credentials as well as offerings in the regenerative finance and financial inclusion areas.



6

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.

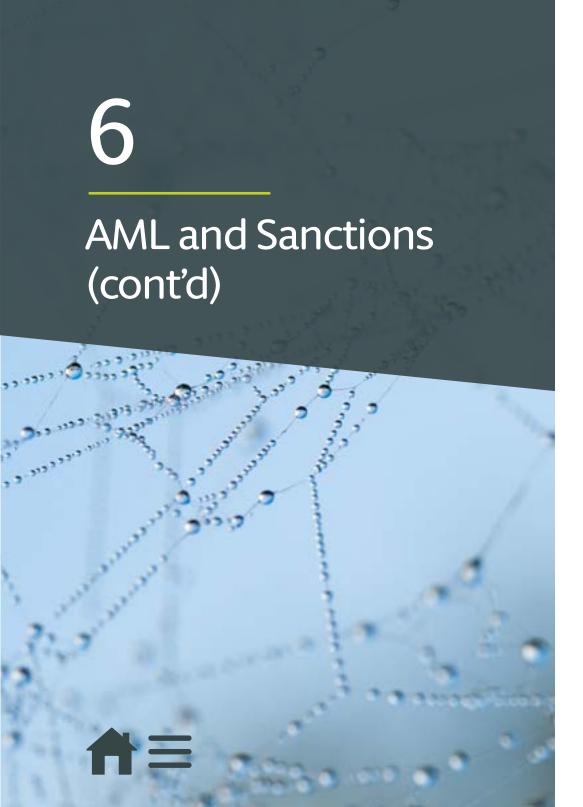
You can find out more about the Sanctions Navigator <u>here.</u>

AML continues to be a key trend for the digital asset and blockchain industry. As mentioned in the <u>previous edition of the Hogan Lovells key trends report</u>, 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.

A number of jurisdictions have continued to implement AML / CFT rules and bring rules in line with global standards that have been pushed for by the Financial Action Task Force (FATF). The FATF 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. The EU's new AML package is an example of this, with a successful conclusion of interinstitutional negotiations (trilogues) standing in between a comprehensive set of measures being entered into the official journals. The AML package introduces a new single rulebook, an Anti-Money Laundering Authority and the digital asset equivalent of the Travel Rule. The ambition is to improve the detection of suspicious transactions and activities and close loopholes used by criminals to launder illicit proceeds or finance terrorist activities through the financial system.







In light of the war in Ukraine, there has also been a growing focus on sanctions and the role that crypto assets play here. Technical solutions have continued to be developed by industry, enhancing the ability to detect and identify sanction evaders, putting forward a strong case for public private partnerships with policymakers and regulators – a theme picked up by the UN Security Council Counter Terrorism Committee, who are due to publish non-binding guidelines this year.

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.





Beginning with the advent of Libra (as it was then known) and more recently following the turmoil in the crypto assets market, the crash of Luna (a stablecoin) and after that turmoil in the traditional banking market that led to the de-pegging of USDC (Circle's stablecoin), more attention has been brought to regulating these instruments.

In the EU, the recently concluded Markets in Crypto Assets (MiCA) Regulation addresses this through requirements bestowed upon issuers and service providers to ensure that the impact of destabilising events are mitigated. This part of the Regulation will come into force in the next 12 months. 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 via the Financial Services and Markets Bill and a consultation paper has been published which addresses the wider use of digital assets which we are expecting to be laid before parliament in early 2024. In the U.S. capital or collateralisation requirements exist for holders of a New York Bitlicense and are under consideration at the federal level, as well. Japan also has passed a bill in 2021 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 the services that 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, stablecoin technology could bring more people into the market, including from a financial inclusion perspective the unbanked or underbanked segments of population.

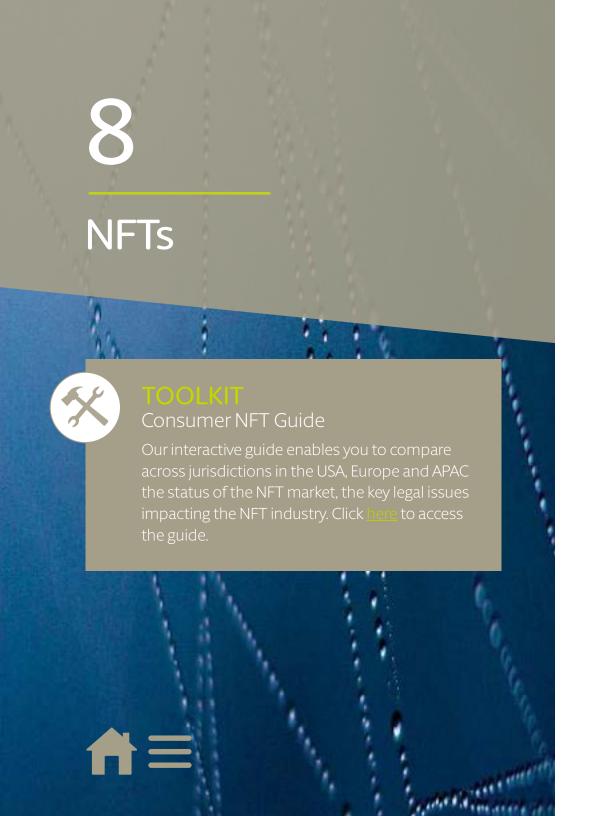




Stablecoins / CBDCs (cont'd)

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 than privately issued tokens. Many Central Banks have introduced pilot programs and research projects to determine the potential use of CBDC in their economy. In the European Union, in June 2022, the President of the European Central Bank expressed plans to evaluate a potential implementation of a digital Euro. We anticipate the enabling legislation for the Digital Euro will be published soon as per the Commission's commitment late last year. 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, with a recent consultation paper highlighting plans to move from the research and exploration phase into the design phase which outlines what a Digital Pound looks like and how it will operate. In the United States, President Biden has directed federal agencies to evaluate the infrastructure needed to issue a US-wide CBDC. 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 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 enable better resilience through an additional payments rail or to enable programmable payments.





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 honour their agreements. At present, the legal status of NFTs is uncertain. Nevertheless, their 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 no 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. There has been further discussion on NFTs through the consultation on the future financial services framework for cryptoassets and the financial promotions order, however both have excluded this from scope. The EU's Markets in Crypto Assets (MiCA) regulation, excludes NFTs from the scope of the Regulation, however does qualify this by stating that an NFT that is part of a large series or collection may constitute fungibility and therefore not be categorised as an NFT. As with DeFi, the Commission intends to produce a report on the necessity and feasibility of regulating NFTs. 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.





Market surveillance

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. This has also been something that has been addressed in the recent UK HMT consultation, where strong obligations are put on trading venues to detect and mitigate against these risks.





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 Council has agreed a general approach to the Directive on Administrative Cooperation (DAC 8) to ensure that EU rules stay in line with the evolving economy and include areas such as crypto assets.

We now wait for the European Parliament to reach an agreed position before entering into trilogues. 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 consultation paper on Defi lending and staking. 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. In the US, concerns have been raised around the need to implement tax rules for cryptoassets, noting that the Treasury Inspector General for Tax Administration found that the lack of reporting is making it difficult for the IRS to identify those who owe tax. This is coupled with what seems to be a stalled attempt to initiate a 30% digital asset mining energy tax on cryptoasset miners – we may see more on this later in the year.





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