Consultation Paper

AFSA-P-CE-2023-0001

Consultation paper on Policy on the Enhancement of the AIFC Digital Asset Trading Facility Framework

Unrestricted

January 27, 2023

Introduction

Why are we issuing this Consultation Paper (CP)?

1. The Astana Financial Services Authority (AFSA) has issued this Consultation Paper to seek suggestions from the market on the Policy paper on the Enhancements to the Digital Asset Trading Facility Framework.

Who should read this CP?

2. The proposals in this paper will be of interest to current and potential AIFC participants dealing with digital assets as well as the market and other stakeholders.

Terminology

3. Defined terms have the initial letter of the word capitalised, or of each word in a phrase. Definitions are set out in the Glossary Rules (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

What are the next steps?

4. We invite comments from interested stakeholders on the proposed framework. All comments should be in writing and sent to the address or email specified below. If sending your comments by email, please use “Consultation Paper AFSA-P-CE-2023-0001” in the subject line. You may, if relevant, identify the organisation you represent when providing your comments. The AFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise. Comments supported by reasoning and evidence will be given more weight by the AFSA.

5. The deadline for providing comments on the proposed framework is **25 February 2023**. Once we receive your comments, we shall consider if any refinements are required to this proposal.

6. AFSA prefers to receive comments by email at consultation@afsa.kz or posted to:
   Policy and Strategy Division
   Astana Financial Services Authority (AFSA)
   55/17 Mangilik El, building C3.2, Kazakhstan

Structure of this CP

Part I – Status Quo;
Part II – Issues;
Part III – Best Practice;
Part III – Proposals;
Part IV – Public Consultation Questions;
Part V – Outcomes;
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POLICY PAPER ON

ENHANCEMENTS TO DIGITAL ASSETS TRADING FACILITY FRAMEWORK

January 2023

Status quo

AIFC Digital Asset Trading Facility Framework

In 2018, a regulatory framework for Operators of Digital Asset Trading Facilities focussing on cryptoexchanges was first implemented in AIFC. This framework was amended subsequently to introduce certain enhancements, for example a change in the definition of "Private E-currency" to "Digital Asset" and setting limits related to Retail Clients.

Operating a Digital Asset Trading Facility ("DATF") is currently a Market Activity and members admitted to trading on such facilities must comply with the Conduct of Business Rules and the Authorised Market Institution Rules.

In this regard, the activity of the cryptoexchanges is subject to both:

a) general requirements applicable to all financial institutions (e.g., fitness and propriety, appointing of Approved and Designated Individuals under General Rules, know your client, appointment of a Money-Laundering Reporting Officer under Anti-Money Laundering Rules), and
b) tailored rules under the AIFC Authorised Market Institutions Rules (e.g., admission of Digital Assets to trading on a cryptoexchange and applicable investment limits) and Conduct of Business Rules (e.g., disclosures of risks relating to Digital Assets).

The AIFC cryptoexchange framework is spread across multiple AIFC rules and regulations – Financial Services Framework Regulations, Authorised Market Institution Rules, Conduct of Business Rules, General Rules, Anti-Money Laundering and Counter Terrorist Financing Rules, Glossary, and Fintech Rules.

Where a company intends to conduct activities with Digital Assets other than conducting a cryptoexchange, e.g., custody, brokerage or advising, they need to obtain regular licenses from the AFSA for respective types of activities. These licensed companies are subject to compliance with requirements specific to their License type, and in addition, with Digital Assets specific requirements (under Conduct of Business Rules (Part 17) and Fintech Rules).

Digital Asset in the AIFC is a type of Investment (along with a Security, Unit, and Derivative) and is defined in the AIFC Glossary as:

a digital representation of value that

(1) can be digitally traded and functions as (a) a medium of exchange; or (b) a unit of account; or (c) a store of value; and
(2) can be exchanged back-and-forth for Fiat Currency, but is neither issued nor guaranteed by the government of any jurisdiction: and
(3) fulfils the above functions only by agreement within the community of users of the Digital Asset; and accordingly
(4) is to be distinguished from Fiat Currency and E-money.

Although this definition follows the Financial Action Task Force ("FATF") recommendations and translates what digital assets are and what they are not, (1) it is mostly directed to cover unbacked digital assets (or so-called exchange tokens or crypto tokens such as Bitcoin or Ethereum) and utility tokens that have features of Investments, and (2) may not be fully sufficient to cover other types of digital assets being developed (e.g., security tokens (offerings), derivative tokens, or stablecoins.).

Current Global and Domestic Crypto Market

Global trends

The global cryptoasset market is volatile, with periods of growth and decline in value in relatively short periods. The capitalisation of the cryptocurrencies grew by 3.5 times in 2021 and reached $2.6 – 3 trillion but fell by two thirds of its value hitting below $1 trillion in May 2022 and further to $800B as of end of 2022[1].

Despite volatility, the digital asset markets attract significant capital. Recent events and failures of cyptoassets related businesses have shown that provision of financial services related to the digital assets industry lack credibility and fail to address many regulatory concerns, including those regarding consumer protection, financial stability, and illicit activities financing. Given the current economic and geo-political environment, global regulators are moving to bring digital assets, in particular cryptoassets, into a regulated space under comprehensive and clear regulatory frameworks.

Notable recent developments in the global regulatory agenda include the following:

- 17 November 2022 - Launch of Abu Dhabi Crypto Hub, a web-based interactive platform providing users access to information and connecting with the financial centre's existing virtual asset firms.
- 11 November 2022 – In the wake of the FTX Trading Ltd. Bankruptcy, public and media calls for more regulation of the crypto industry, with tighter restrictions on access and governance controls.
- 1 November 2022 - New regime for the regulation of Crypto Tokens came into force in Dubai International Financial Centre (DIFC) that provides that:
    - Only Recognised Crypto Tokens to be used in the DIFC;
    - Use of Privacy Tokens/Devices and Algorithmic Tokens is prohibited;
    - Mixing regulated and unregulated business related to Utility Tokens or non fiat Tokens is generally prohibited;
    - Money Services Providers restricted to Fiat Crypto Tokens;
    - Authorised crowdfunding operators may not facilitate investment in Crypto Tokens through their platforms;
    - Authorised representative offices may not market Crypto Tokens or financial services related to Crypto Tokens;
    - Authorised Firm applicants must generally be DIFC companies and not branches;
    - Provision of information on Crypto Tokens to clients - an authorised firm must not provide a financial service related to a Crypto Token to a person unless it has given the person a "key features document";
    - An "appropriateness test" was introduced in relation to a retail client.
- 7 October 2022 – The European Council approved the Markets in Crypto-Assets (MiCA) Regulation, one of the first attempts at a comprehensive cross-border regulatory initiative regarding the cryptoasset markets.
- 2022 – US Securities and Exchange Commission's (SEC) lawsuit against crypto firm Ripple and subsequent court battles over the SEC allegations that the company sold a cryptocurrency to investors without first registering it as a security.
- 25 October 2022 - Australian Securities and Investments Commission launched the first case to test crypto regulation powers as it sees a need to protect consumers (cryptoassets are one of the areas of ASIC's focus for 2023)
- 13 October 2022 – Financial Conduct Authority announced it would make 15 hires to power crypto regulation catch-up.

The AFSA's aim in this policy paper is to set a foundation for a framework regarding digital assets, that is informed of both market and regulatory developments globally.

Kazakhstan and AIFC

Except for the territory of the AIFC, the trading (i.e., buying, selling, exchanging) of unbacked Digital Assets such as Bitcoin and Ethereum is prohibited under the national legislation of the Republic of Kazakhstan. In addition, the term "digital asset" is defined and qualified as a "property" under the Civil Code of Kazakhstan.

Importantly, cryptomining activity is legally permitted under the laws of Kazakhstan. The legal regime, state support, low electricity prices, favourable cold climate for cryptomining process and ban of mining

[1] www.coinmarketcap.com

in China in 2020 encouraged the development of Kazakhstan as the 2nd largest cryptomining industry in the world.

Despite maintaining a framework that covers the fundamental aspects of cryptoexchanges, the AFSA generally only allows Digital Asset Service Providers (“DASP”), including cryptoexchanges, under its Fintech Lab (Sandbox) regime where they are required to meet certain limits. Today 6 out of 17 companies operating in a testing environment of the Sandbox are DATFs (cryptoexchanges).

Going forward, AFSA expects more companies to obtain Fintech Lab Licenses. As of August 2022, Fintech Lab had 37 certificate holders (i.e., companies that were pre-selected and in the process of obtaining in-principle or full license), 22 of which were DASPs.

Pilot Project

In June 2022, Kazakhstani government agencies in cooperation with the AIFC officially launched a Pilot Project on the cooperation of cryptoexchanges with Kazakhstani banks to accelerate the enablement of the cryptoasset industry in Kazakhstan.

The Project aims to ensure that cryptoexchanges are able to exchange fiat to digital assets under the regulated environment. Prior to the start of the Pilot Project, cryptoexchanges were allowed to open bank accounts at second-tier banks of Kazakhstan. This Project opens the opportunity:

(1) for cryptoexchanges to provide services to the Kazakhstani market where transactions with Digital Assets are prohibited;
(2) for residents of Kazakhstan to invest in cryptoassets with certain investor protections; and
(3) for cryptominers of Kazakhstan to sell mined Digital Assets under transparent supervision of state regulators of Kazakhstan and the AFSA. The Project ran until the end of 2022.

Notably, some of the outcomes of the Pilot Project such as pre-funded trading, mandatory IT audit and appointment of Chief Technology Officer translated into the proposals of this Policy Paper. However, given that the Project has been finalised only by the mid-2023, AFSA expects to initiate further enhancements to the DATF framework based on the outcomes of the Project.

Mapping of the digital assets market participants in the AIFC and Kazakhstan

In the short term the key players of the crypto ecosystem in AIFC and Kazakhstan will include:

DATFs, mainly cryptoexchanges and cryptobrokers, including non-residents

(1) **Cryptoexchanges** will play the primary role by facilitating the trade of Digital Assets. Cryptoexchanges are typically also licensed for providing custody services with Digital Assets and fiat as per crypto industry practice.
(2) **Digital wallet providers**. The storage of Digital Assets in hot wallets (DA storage platform connected to the Internet) is risky, therefore, under the AIFC Fintech Rules the DATFs may store only 10% of all Clients’ funds or assets on hot digital wallets (i.e., offline on physical device).
(3) In the absence of the central clearing counterparty, the settlement risk is mainly mitigated by the **pre-funding requiremen**t of fiat and Digital Assets of investors requested by cryptoexchange’s internal rules in accordance with the market practice.
(4) Additionally, at the nascent stage of cryptoexchanges’ development, AFSA expects that **market making** by cryptoexchanges would be important to ensure liquidity on the platform.
(5) **Cryptobrokers** can act as agents for Clients (both Retail and Professional), who may lack proper expertise in investing in highly volatile instruments, and provide additional services such as custody and advisory.

Investors, both residents and non-residents of Kazakhstan

(1) Under the Pilot Project residents of Kazakhstan that are legal persons are banned from trading digital assets (except for miners). Non-residents, including AIFC Authorised Firms, in turn, may participate in trading. Due to the ability to use fiat held on bank accounts for purchasing digital

assets (on-ramp) and withdrawing fiat obtained from selling digital assets on cryptoexchange (off-ramps), investors can avoid complex and expensive transfer and conversion schemes.
(2) Cryptoexchanges are typically available to Retail Clients, both residents and non-residents of Kazakhstan. This disintermediated business model entails that cryptoexchanges become the critical "gateways" for screening the Customers for AML/CTF and client classification purposes.
(3) The investors' journey will typically unfold as follows:
- account registration on the platform;
- non-face-to-face know your client (KYC), know your transaction (KYT) and customer due diligence (CDD) procedures;
- client classification;
- depositing fiat from the investor's bank account to virtual bank account of cryptoexchange or depositing Digital Asset from e.g., self-custodied wallet to digital wallet opened on cryptoexchange; and
- trading.

The cryptomining community of Kazakhstan

Cryptominers may also benefit from selling the mined asset under the AIFC's regulated environment for fiat. Under the Pilot Project Rules cryptominers have to sell 80% of their mined Digital Assets via AFSA authorised cryptoexchanges.

Commercial banks

Banks will serve as a crucial component that ensures fiat influx to and outflow from the cryptoecosystem. Banks are also subject to robust AML screening of both DATFs and the investors. Currently, only those cryptoexchanges that express willingness and comply with Pilot Project Rules may have access to fiat rails. Otherwise, cryptoexchanges may only conduct trading of crypto-to-crypto trading pairs.

The Pilot Project will continue till approximately mid-2023. The AFSA will incorporate any additional lessons learned from the Project into the framework drafting.

Issues

Regulatory authorities globally are examining the issues surrounding trading of digital assets. International Organization of Securities Commissions' ("IOSCO") in its March 2022 Decentralized Finance Report have raised concerns about key risks including market integrity, illicit activity and operational and technological risks. There are also other issues such as safekeeping and segregation of client assets, liquidity (or insolvency) risk, lack of disclosure and skills (experience, culture) on market surveillance function, risk of improper investor assessment, business continuity risk (prudential risk), pre- and post-trade processes, risk of arbitrage and inefficient price formation which regulators seek to address. The AFSA also examined its legal and regulatory framework based on risks and issues that were raised by jurisdictions around the world.

Based on our analysis, it is believed that the below factors require further enhancements of the framework:

(1) Market specifics and consequential risks; and
(2) Concerns of the current DATF framework structure.

Market specifics and consequential risks

There is a number of market factors that influence the level of risks originating from DATFs:

- Market capitalisation hit 2.6 trln. USD (2021) with subsequent fall to one third of value (to approximately one 1 trln. USD);
- A large number of Retail Investors (e.g., 6.2% of British citizens own cryptoassets);

- Increasing level of adoption of cryptocurrencies by traditional finance intermediaries. Many online retailers and some brick-and-mortar stores accept payment in crypto through payment service gateways and providers.
- Collapse of Luna and Terra (USD pegged algorithmic stablecoin) in Q2 2022, demonstrating the high volatility of the asset class.

The above factors demonstrate the risks for consumer protection and ffinancial stability from illicit activities, cyber threats and market abuse. These risks are only partially addressed by the existing mitigants or lack the appropriate and adequate measures, including

(1) money laundering and terrorist financing risks;
(2) risk of operational failure and cyber risk;
(3) conflict of interest risk;
(4) market abuse risk (market manipulation, misleading or other fraudulent and deceptive conduct);
(5) insufficient information available to the investors on trading rules;
(6) lack of information describing all relevant types of Digital Assets;
(7) insufficient knowledge by DATFs;
(8) counterparty risk and settlement finality risk;
(9) problems within DATF framework, i.e., inefficient structure of the framework, inefficient provisions, deficiencies revealed as a result of day-to-day supervision processes;
(10) structural issues with the DATF framework.

In addition, the need for strengthening of the framework is also driven by the findings of the Pilot Project. The Project was primarily designed to identify the gaps and inefficiencies hampering the effective regulation of DATFs. So far it has stressed the importance of setting clear conditions for DATFs and banks for the feasibility of cryptoexchanges.

Concerns of current DATF framework's structure

The ongoing supervision of cryptoexchanges revealed contradictions, inefficient provisions, and uncertain definitions within the regime. The AIFC DATF regime does not address all required risks that would be caused if/when FinTech Lab cryptoexchanges start operating under full authorisation regime. Another deficiency of the framework is its form, where DATF related rules are spread across various AIFC rules. This is known to be inconvenient to technology driven cryptoexchanges that do not have a regulatory compliance skillset and culture and prefer to have all requirements in one place.

Best Practice

The AIFC's legal framework was assessed against the issues and risks specified in the IOSCO's Final Report *"Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms"*. Guidance of other global standard setting bodies (e.g., the FATF and Financial Stability Board) has also been taken into account, and relevant suggestions / recommendations have been developed based on such guidance and best international practice. The Policy Paper mainly focuses on the analysis of regimes in such financial centres and jurisdictions as the Abu-Dhabi Global Market ("ADGM"), Dubai International Financial Centre ("DIFC"), and Bahrain that have comprehensive cryptoexchange regulatory frameworks. In addition, in some instances, references to best practices of other jurisdictions (Malaysia, the European Union, United States, and Japan) have been given.

Primarily, the legal framework of the ADGM is selected as a primary benchmark due to various common features such as:

(1) Similar status of international financial centre with risk-based regulation;

(2) Regulatory framework is generally based on the UK financial legal framework, principles and rules;
(3) Comprehensive regulatory framework for DATFs embracing many aspects of their activities (e.g., authorisation, fitness and propriety, conduct of business, anti-money laundering, prudential requirements and guidance);
(4) Previously AIFC followed the ADGM approach for DATF and DA regulations;
(5) Relatively mature DATFs regulatory framework that was implemented in 2018 and was subject to revisions;
(6) Relatively developed cryptomarket (multiple DATFs have been licenced by the ADGM's Financial Services Regulatory Authority);

The other two benchmark jurisdictions are the DIFC and Bahrain. The DIFC introduced its Investment Token framework recently in October 2022 and its Crypto Token Framework in November 2022. The Bahraini framework has also the common financial center feature and is based on the UK financial legal framework. Bahrain adopted its DASPs and DA regulatory framework in 2019. Bahrain established a standalone crypto framework that is comprehensive, convenient in terms of navigation, has some commonalities with ADGM, but at the same time provides for many specific and tailored measures that address the risks of the DASP-related activities.

Unlike AIFC, where DATF is treated as an Authorised Market Institution, cryptoexchanges provide services under the Multilateral Trading Facility regime in the ADGM.

Proposals

1. Risk mitigation measures

1.1. Governance

Digital Asset Service Providers should have internal controls in place with a view to establish risk management across its operations, departments, branches, and subsidiaries, both domestically and where relevant abroad. Those internal controls should include appropriate governance arrangements to establish clear responsibilities for the management of risks. These arrangements are scalable depending on the nature and size of the business, but for a cryptoexchange or large broker should include a board of directors, board committees and an executive team with a Chief Executive Officer, Chief Financial Officer, Chief Compliance Officer, Chief Risk Officer, Chief Technology Officer, and external/internal independent audit function. Some of these requirements are already set by the AIFC General Rules.

1.2. Risk of illicit activity

The AIFC AML framework addresses some key money laundering and terrorist financing risks originating from DATFs operations and compliant with some FATF recommendations on DATFs and Digital Assets. Specifically, the DATFs are subject to licensing, the definition of Digital Asset is provided, and the activities of decentralized and P2P platforms are prohibited. However, the analysis revealed that AIFC AML regime has to be strengthened by a Travel Rule requirement and Guidance on AML aspects of DATF operations (e.g., setting criteria for Digital Assets admission to trading).

The rule, formally known as FATF Recommendation #16, requires DASPs to obtain, hold, and submit required originator and beneficiary information associated with Digital Asset transfers in order to identify and report suspicious transactions, take freezing actions, and prohibit transactions with designated persons and entities.

1.3. Operational resilience and cyber security

Overall, the regulatory measures under the AIFC Rules are aimed at ensuring basic standards for technology governance to prevent operational disruptions and cyber threats within cryptoexchanges (systems and controls, outsourcing requirements, requirements for testing etc.). However, given the high cyber risks in the cryptosphere, the regulatory protections have some deficiencies. Therefore, the following measures are suggested:

(1) impose mandatory independent third-party audit of technology governance and IT systems of all DASPs;
(2) requirement to make a mandatory appointment of Chief Information Technology Officer for all DASPs;
(3) regulate the types of wallet solutions (hot vs cold wallet) for Digital Asset custody through a guidance; the Paper suggests setting expectations under the Guidance for storage of DAs in cold wallet or using other alternative solutions that ensure high standards of security and resilience.
(4) extend the COB Chapter 4 on Client agreement and Key Information on DATF regime;
(5) impose additional obligations for providing DA custody services (e.g., informing client on confirmation of successful transfer of DA, on final fees and charges, set out in Client agreement the legal grounds for cryptoexchange to stop and restrict client access to its services).

1.4. Safekeeping and segregation of client assets

There is a high risk of co-mingling of cryptoexchanges' DAs with those of their clients and there are concerns with proper record-keeping procedures in cryptoexchanges. Overall, the existing regime partially covers DATFs segregation, frequent reconciliation and ensuring accurate accounting requirements, however, there are several areas that could benefit from further enhancement:

(1) application of COB 8 Client investment rules on DATF (proposal considered when a problem of treatment of cryptoexchanges as Regulated or Market activity is analyzed below);
(2) "Digital Asset Depository" definition; and
(3) daily and weekly reconciliation requirements and lack of guidance on custody arrangements.

Therefore, it is proposed to:

(1) substitute the term "Digital Asset Depository" with the term "Digital Asset Custodian" or "Providing (Digital Asset) Custody" services; and
(2) consider whether in certain cases only weekly reconciliation requirement may be used;

1.5. Conflict of interests

Existing cryptoexchanges' business models that combine custody, market making, settling and clearing services are highly exposed to conflicts of interest risk. The current regulatory measures against this risk are not efficient since conflict of interests rules under COB are not applicable to DATF activity. Hence, this review proposes to extend existing conflicts of interests Rules under COB on DATF.

Additionally, AFSA will consider not to ban proprietary trading for DATF on its own platform. Proprietary trading by cryptoexchanges is a prevailing practice in many markets abroad, used for creating liquidity on its own platform. Given that the AIFC cryptoexchange market is at the early stage of development, this approach may have positive effects such as decreased price volatility and attraction of investors.

1.6. Market Abuse

Trading on cryptoexchanges globally has attracted various market abuse practices, whereas the measures are generic and lack the clarity on applicability of the separate and comprehensive rules against market abuse on DATF and Digital Assets. Thus, the clarifying amendments are needed (on applicability of Market Abuse provisions under AIFC Market Rules to DATF and Digital Assets). Additional mitigants concern imposing requirement on DATF to monitor its own forums to avoid market manipulation.

1.7. Disclosures to investors

The process of admission to trading would require the DATF to prepare a report on Digital Asset in the form of a white paper but additionally with non-technical details for AFSA's approval.

In regard to the lack of specific rules on disclosures of data on specific features of Digital Assets (e.g., hacking vulnerabilities, traceability of Digital Assets), that can be mitigated by imposing a requirement on DASPs to disclose a Key Features Document (KFD or "Digital Asset Prospectus") prior to providing services to clients. KFD may provide data on key issuers, design team of the Digital Assets, underlying technology, valuation of the Digital Assets, volatility, fraud, hacking risks, and other relevant topics.

We propose to seek public comments on on-going disclosure requirements regarding the Digital Assets on cryptoexchanges.

1.8. Pre- and post-trade processes

In addition to the existing requirements on cryptoexchanges to disclose trade data prior to and after the trades, it is proposed that DATFs have to disclose additional pre-trade data, in the form of volume of bid and offer, and the depth of trading interest shown at the prices and volumes advertised to participants.

Further, there might be some benefits to permitting exemption from pre-trade transparency for participants that intend to enter into large trades (e.g., large orders of institutional investors that do not wish such orders to be displayed). Different market response scenarios will be taken into account in this regard.

1.9. Settlement risk

The DATF framework lacks a key measure to address the settlement risk. In the absence of clearing houses in cryptosphere globally, the settlement risk is mitigated by the market practice of pre-funding of fiat and digital assets prior to clearing and settlement. Therefore, this Paper suggests transforming the current business practice of pre-funded trading into a regulatory requirement.

The risk of settling one leg of a transaction before the other should be addressed by settling on a “delivery versus payment” (or DvP) basis. This means that one leg of the transaction settles if and only if the other one does. The point of settlement should be clearly defined and occur immediately or before the end of the trade day. AFSA invites relevant firms to propose technical implementation of this requirement for both crypto to fiat, and crypto to crypto scenarios.

Further, the recent collapse of FTX Trading Ltd., the world’s second largest cryptoexchange, has raised concerns regarding the safety and segregation of client assets. While this risk can be managed by cryptocustodians and trusts over cryptoassets, AFSA invites additional proposals on potential ways to safeguard client assets.

It is also considered to avoid imposing requirements on periodic on-chain settlement of transactions. In the decentralized cryptosphere all Digital Asset transactions are processed and recorded on certain blockchains (e.g., Ethereum, Bitcoin, Solana) and each transaction is subject to fees. However, the business model of centralized cryptoexchanges is based on recording of transactions mainly off-chain, i.e., traditionally on the books or ledgers of the platform. Off-chain records allow to avoid paying blockchain fees by clients and time-consuming blockchain processing.

2. Further enhancement of the existing DATF framework

During our analysis, several policy matters were identified that are suggested to be changed.

2.1. Regulated vs Market activity

The fundamental aspect of the regulatory regime is treatment of the cryptoexchange either as a market or regulated activity. Currently, cryptoexchanges are considered an Authorised Market Institution, however direct access of investors to a cryptoexchange without traditional brokers weakens its market infrastructure features. The business practices of cryptoexchanges require them to combine additional custody and proprietary trading services (meaning direct interaction with clients), therefore, qualifying the cryptoexchange as a regulated firm may be more appropriate.

2.2. Net asset test

It is proposed to allow investors to provide evidence of owning Digital Assets as part of their net assets for the professional investor eligibility test. Specifically, it is proposed to recognise Approved Digital

Assets in the net asset test with 70% haircut for unbacked Digital Assets (e.g., Bitcoin) or without a haircut for regulated fiat-backed stablecoins (e.g., USD Coin or Tether).

2.3. "Green list"

The existing DATF regulatory regime requires the approval of Digital Assets for trading on cryptoexchange by the AFSA. To increase efficiency in the course of assessment, the Paper proposes a criteria-based process that leads to the inclusion of DA on a "green list". These criteria may include maturity / market capitalisation, security, traceability of the Digital Asset, support of Digital Assets by other cryptoexchnages, security and usability of distributed ledger technology, innovation / efficiency, and practical application/functionality. AFSA may publish the so-called green list of the Approved Digital Assets on its website, and regularly review it.

This Paper proposes to impose a requirement on DATFs to notify the AFSA 10 days before admission of a Digital Asset to trading and confirm that it has available tools to trace the specific Digital Asset transaction on its underlying blockchain. In addition, the Paper proposes to impose a requirement on DATFs to notify the AFSA if DATFs become aware of significant developments that may result in the Digital Asset no longer qualifying as an Approved Digital Asset (e.g., cyber risks, or privacy features making the Digital Asset transaction non-traceable or fully-anonymous).

2.4. Considering DATF framework restructuring

Analysis suggested three options for the restructuring of the existing DAFT Framework:

Option 1 – Keeping the existing framework form

One of the suggested deficiencies of the framework is its form, where DATF related rules are spread across various AIFC Rules. This is known to be inconvenient to technology driven cryptoexchanges that do not have a high-level regulatory compliance skillset and culture and prefer to have all requirements in one place. In addition, removing the cryptoexchange regime from the list of Market Activities to Regulated Activities would result in considerable changes to the framework.

Option 1 is considered to require the least amount of restructuring, as it does not evolve major reforms. In addition, the existing framework has not yet gone through extensive practical use.

Option 2 – Developing Standalone DATF framework

There are two sub-options to Option 2:

2a - Comprehensive approach (following the Bahraini model), where a single Rulebook brings together all provisions from other rulebooks with necessary adjustments for Digital Asset and DATF activity. Although it could be the most user-friendly option, this approach will be against the general legal framework structuring model adopted in the AIFC.

2b – This is a hybrid of Options 1 and 2, where a separate rulebook is created to include all applicable references to applicable provisions of the AIFC rules and regulations. **2b is recommended by the AFSA.**

Option 3 – Treatment of cryptoexchanges as an MTF

Treatment of cryptoexchanges as MTF is considered to resolve several fundamental issues, by treating the cryptoexchanges as a Regulated Activity and applying relevant rules of the MTF regime. The MTF regime is a newly established regime in the AIFC that has also not yet been tested. Any future amendments to MTF for the purposes of commodity instruments implementation may cause subsequent unintended outcomes for cryptoexchange regulation.

It is proposed to publicly consult on options 1-3 and conduct targeted discussions with potential and existing DATFs.

Public consultation questions

In the course of public consultation, existing and potential market participants will be invited to comment on the following questions:

1) AFSA invites comments on the policy positions set out above.
2) AFSA invites comments on the risk mitigation measures.
3) AFSA invites proposals that would reduce the principal risk, discussed above.
4) AFSA invites additional proposals on measures to ensure safety of client assets.
5) AFSA invites comments on the DATF rulebook restructuring options set out above.
6) AFSA invites comments on the illustrative regulatory framework.

Outcomes

It is expected that the implementation of the Policy Paper proposals by the AFSA will help:

1) address and mitigate risks originating from cryptoexchanges' operations and cryptoasset industry in general;

2) address contradictions, inefficient requirements, unclear provisions of the existing framework;

3) create favorable regime for cryptoexchange business in the AIFC, encouraging innovation in digital assets and contributing to the development of crypto-asset ecosystem in Kazakhstan.

This will collectively help to create more a clear, convenient, efficient, detailed and balanced AIFC DATF framework with high standards for consumer protection, without hindering development of cryptoexchanges.

Despite the proposed measures, the potential risks especially emanating from cyber threats may still hold. There is also a possibility that proprietary trading by cryptoexchanges may be harmful to the investors' interests, which will be taken into account (together with public comments) in the course of further drafting.

Finally, despite its innovative features and benefits, the cryptoassets industry is criticized for its negative impact on the climate as a result of significant carbon footprint of mining. Given that two most energy hungry digital assets – Bitcoin and Ethereum - account for 40-50 % of trading activity out of all 15,000 existing digital assets, the issues are significant despite the emergence of more environmentally friendly digital assets. In Kazakhstan, excessive use of electricity for cryptomining not only has a negative climate impact, but also leads to deterioration of power grid. Therefore, the government plans to increase the tax levies for the electricity consumption from 1 tenge per Kw/h to 10 tenge (1000% growth).

At the same time there are number of trends taking place globally and locally that to some extent mitigate the risk. In September 2022, Ethereum switched from a Proof-of-Work (PoW) to a Proof-of Stake (PoS) mechanism. Previously, the Ethereum blockchain relied on PoW, a consensus mechanism that requires a lot of computational effort from all the decentralized nodes participating in the blockchain. The PoS mechanism radically changes how the Ethereum blockchain works. It eliminates the need for mining new blocks, reducing Ethereum's energy consumption by 99.95%.

Notably, the EU that is the main driver of ESG standards, in its recent draft version of the Markets in Crypto-Assets Regulation revised its plans to completely ban the PoW, that will take effect from 2023 and 2024. The ban of PoW may have significant adverse impact to the industry with subsequent loss of the most popular assets. While the change of Bitcoin consensus mechanism from PoW to PoS is considered as highly difficult in the absence of the centralized governing body as the miners may not be willing to make such amendments against their own interests, unlike Ethereum where the founder has a large impact on the ecosystem.

Overall, the regulatory framework is at the early stages of the development and there is a need to observe how the measures of the DATF framework will work in practice. The operation of the DATFs under sandbox regime and Pilot Project will help AFSA to react immediately and set certain conditions and requirements under the license notice of particular cryptoexchanges.

Strategic Relevance

The review of the DATF framework is in line with the “AFSA’s Strategy for 2022”, where the development of “Digital Assets framework: Cryptoexchanges, STO and DASP” is one of three key regulation development objectives. The Kazakhstan government has a significant interest in the development of digital asset ecosystem in Kazakhstan: in June 2022 President Tokayev at the meeting of the AIFC Management Council stressed the importance of creation of favorable regulatory framework for comprehensive development of the digital assets’ ecosystem.

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