AURA SOLUTION COMPANY LIMITED
ASSET & WEALTH MANAGEMENT COMPANY

The New FATF Rules for Crypto Exchanges and Custodians

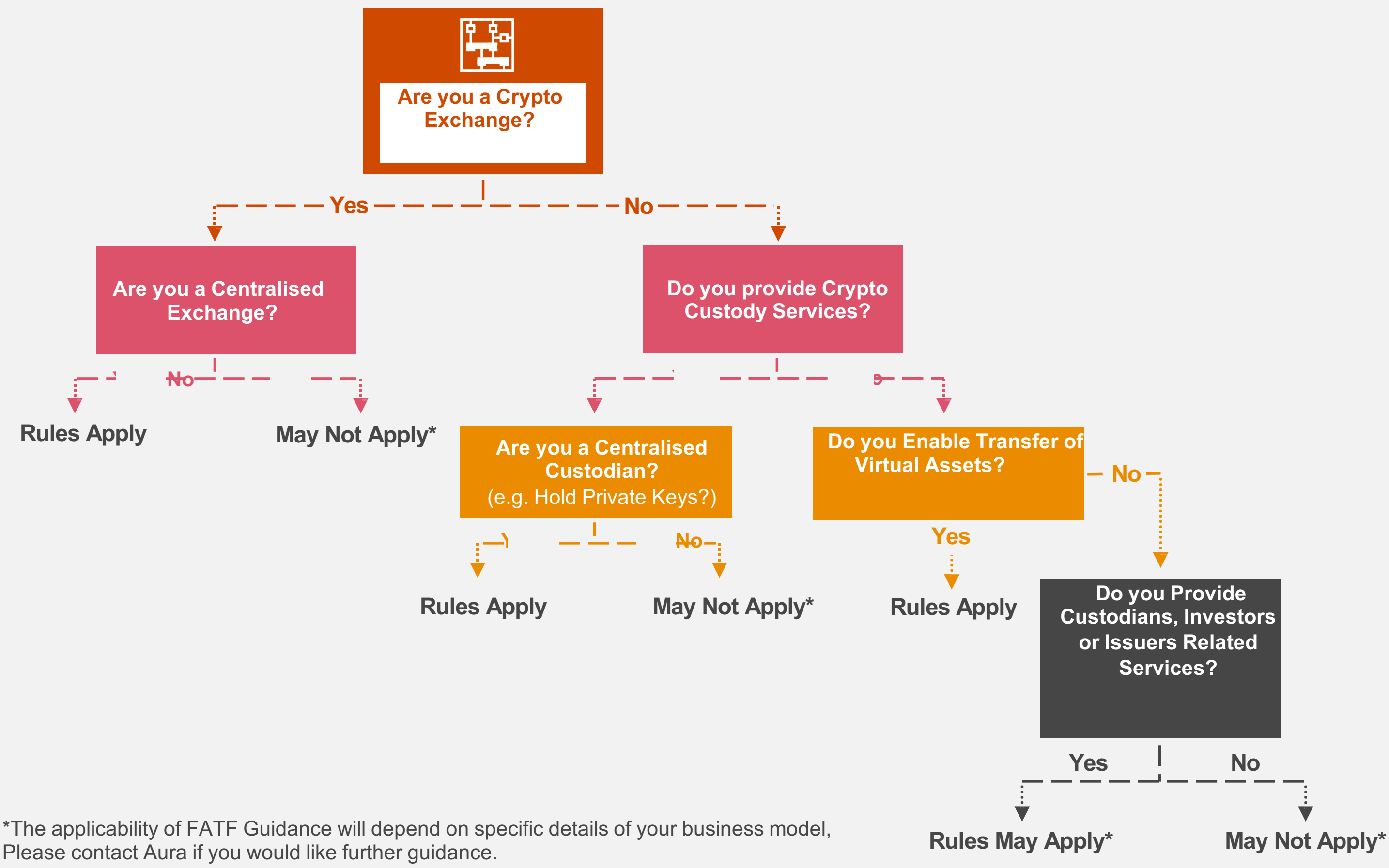
What are the new rules?

In June 2020, the Financial Action Task Force (FATF) adopted an Interpretive Note to Recommendation 15 to further clarify how the FATF requirements should apply in relation to Virtual Assets and Virtual Asset Service Providers.

The Guidance from FATF addresses the application of a risk-based approach (RBA) to Virtual Asset activities or operations and Virtual Asset Service Providers. The guidance covers a range of topics including: supervision or monitoring of Virtual Asset Service Providers for anti-money laundering and terrorist financing (AML/CFT) purposes; licensing or registration; preventive measures, such as customer due diligence, recordkeeping, and suspicious transaction reporting, among others; sanctions and other enforcement measures; and international co-operation.

This updated Guidance expands on the 2015 Virtual Currency Guidance and further explains the application of the risk-based approach to AML/CFT measures for Virtual Assets; identifies the entities that conduct activities or operations relating to Virtual Assets —i.e., Virtual Asset Service Providers; and clarifies the application of the FATF Recommendations to Virtual Assets and Virtual Asset Service Providers.

Do The FATF Rules Apply To You?



*The applicability of FATF Guidance will depend on specific details of your business model, Please contact Aura if you would like further guidance.

To whom do they apply?

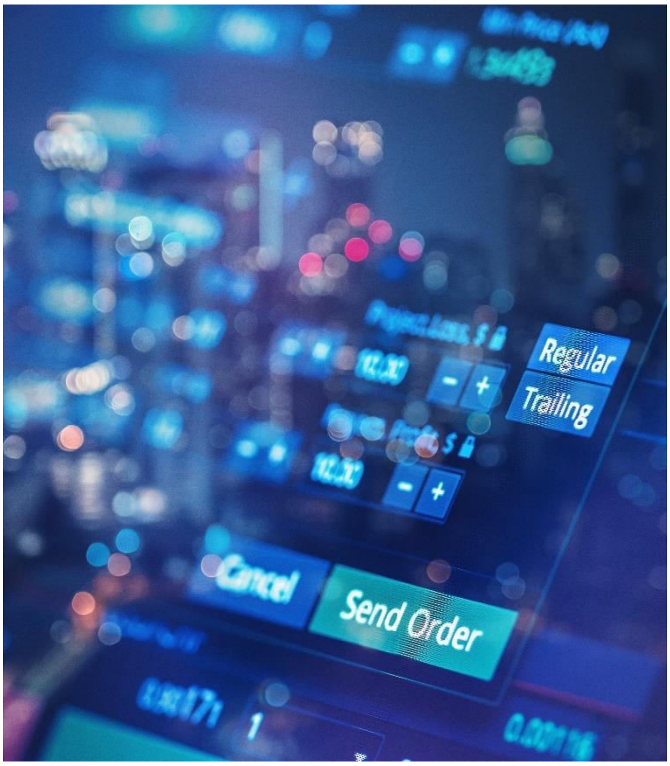
FATF Recommendations require all member jurisdictions to impose specified AML/CFT requirements on Virtual Asset Service Providers as well as traditional financial institutions and designated non-financial businesses and professions such as lawyers and accountants. Through membership in FATF or FATF-style regional bodies, more than 200 countries and territories are affected by the guidance.

FATF has defined a virtual asset and a virtual asset service provider in the following ways:

- "Virtual asset" as a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes. Virtual assets do not include digital representations of fiat currencies, securities, and other financial assets that are already covered elsewhere in the FATF Recommendations; and
- "Virtual asset service provider" as any natural or legal person who is not covered elsewhere under the Recommendations and as a business conducts one or more of the following activities or operations for or on behalf of another natural or legal person:
  - Exchange between virtual assets and fiat currencies; (e.g. Fiat-to-Crypto Exchanges)
  - Exchange between one or more forms of virtual assets; (e.g. Crypto-to-Crypto Exchanges)
  - Transfer of virtual assets; and Safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets; (e.g. Crypto Custodians)
  - Participation in and provision of financial services related to an issuer's offer and/or sale of a virtual asset.

Notably, the scope of the FATF definition includes both Crypto-to-Crypto and Fiat-to-Crypto transactions or financial activities or operations.

Depending on their particular financial activities, Virtual Asset Service Providers include Virtual Asset exchanges and transfer services; some Virtual Asset wallet providers, such as those that host wallets or maintain custody or control over another natural or legal person's Virtual Assets, wallet(s), and/or private key(s); providers of financial services relating to the issuance, offer, or sale of a Virtual Asset (such as in an ICO); and other possible business models.



When do they need to be implemented?

FATF will conduct a 12-month review in

June 2020

The FATF guidance is designed to be implemented by local regulatory authorities and FATF has explicitly stated that self-regulation will not be acceptable.

The FATF will monitor implementation of the new requirements by jurisdictions and service providers, and will conduct a 12-month review in June 2020. Jurisdictions are expected to have made reasonable and rapid progress towards compliance by this time; however, the exact timing of when regulations come into force will vary from jurisdiction to jurisdiction.

What do you need to do?

Local regulations are required to include all applicable FATF Recommendations. This includes obligations on governments and regulators, as well as market participants. Virtual Asset Service Providers will be required to develop end-to-end AML/CFT control frameworks, which include amongst others:

FATF Recommendation 10

- Virtual Asset Service Providers should design Customer Due Diligence (CDD) processes to help them in assessing the AML/CFT risks associated with covered Virtual Asset activities and customers.
- CDD must be performed in the context of establishing a business relationship or while carrying out occasional transactions for non-customers with a value greater than USD 1,000 or EUR 1,000.
- CDD comprises identifying the customer and applying a risk-based approach to verifying the customer's identity using reliable and independent information, data or documentation. Where the customer is not a natural person, the customer's beneficial ownership must be determined. The CDD process also includes understanding the purpose and intended nature of the business relationship, where relevant, and obtaining further information in higher risk situations.
- Ongoing due diligence of the customer relationship must be performed and transactions must be scrutinised.

FATF Recommendation 16

- When a Virtual Asset Service Provider conducts a transfer of Virtual Assets on behalf of a customer, it is required to:
  1. Obtain and hold accurate (i.e. verified for accuracy) originator information, including customer name and wallet address, as well as other data such as physical address, date of birth or other specified alternatives;
  2. Obtain and hold beneficiary information, specifically the customer name and wallet address; and
  3. Transmit the originator and beneficiary information to a receiving Virtual Asset Service Provider (or other obliged entity, such as a financial institution), if any. This requirement, which banks already adhere to, is known as the Travel Rule.
- Originator and beneficiary information must be screened to ensure that transactions with designated persons and entities (e.g. those subject to financial sanctions) are identified, reported to competent authorities and subject to freezing measures.

What does this mean for your business?

If you are a Virtual Asset Service Provider you need to start exploring how you will comply with such requirements. However certain elements of the FATF requirements present challenges given today's Virtual Asset infrastructure, especially the Travel Rule. New solutions are required and these may take time.

2020 3Q · 01 · 02 · 2020 4Q · 03 · 04 · 05 · 06 · 2020 2Q · 07 · 08 · 2020 3Q

1.Determine AML Governance Structure
Determine who will be responsible for AML and sanctions matters, and whether you need to build out a team

2.Assess Existing AML Framework
Identify existing AML and KYC controls, processes and documentation on hand

3.Determine High-Level AML Framework
Consider the desired future state of your AML framework, and where gaps may exist in existing framework

4.Update AML Policies & Operating Procedures
Based on FATF and local requirements, update or draft AML policies and procedures

5.Remediate identified Deficiencies
Take steps to address gaps that arise from your newly updated policy requirements, including KYC

6.Evaluate Travel Rule Solution Options
Begin formal evaluation of travel rule solutions, systems and/or vendors

7.Select Travel Rule Solution
Select the travel rule solution most suited to your business and operations, begin implementation process

8.Progress towards Licensing
Finalise preparations for licensing, including obtaining supplemental legal advice and conducting independent assessments of your systems and controls

Whilst the crypto ecosystem continues to make considerable progress in building out its infrastructure and 'institutionalising' the space, many crypto players are facing challenges due to a broad range of issues, from a fall in cryptoasset prices to more regular start-up challenges. This is forcing many well-intentioned crypto firms into financially distressed situations with the need to urgently restructure their operations or redefine their business strategy in order to stay afloat.

Crypto Insolvency

Ten things every director of a crypto firm needs to know when things start to go wrong

February 2020

We set out below ten things that any director or senior executive of a crypto entity needs to know:

1.When am I considered insolvent?

In many jurisdictions, an insolvency test involving a cash flow and / or balance sheet assessment is used to determine a company's financial status:

a. Cash flow test – does your company have the ability to service its debts as and when they fall due?

b. Balance sheet test – are your company's assets greater than its liabilities?

Should your company's finances fail to meet one or both of these tests, your company may be deemed to be insolvent.

2.How is it different with cryptoassets?

As for any other volatile asset class, cryptoassets with their wide swings in value require extra care when assessing your company's financial viability. Further, the lack of clarity on the accounting treatment of cryptoassets and as of yet, no broad consensus on taxonomy in the crypto world or how to accurately value cryptoassets, means that ambiguity may arise when evaluating the solvency status of your crypto firm.

Given these complexities, we highly recommend that you seek advice from legal and financial professionals if you are in doubt about your crypto firm's solvency status. This recent publication from Aura on the valuation of cryptoassets could be a useful tool for you as well.

3.Can someone in senior management be held responsible for a crypto company's insolvency even if they are not a director?

The short answer is yes, subject to the legislation of the jurisdiction you are operating in.

Even if you are not formally appointed as a director, if you are a member of senior management you may be caught within the responsibilities and obligations of a director if you typically take on roles associated with a director. Whilst this will be assessed on a case by case basis, if you are deemed to be a shadow or de facto director, then the statutory duties of a director apply to you too.

Typically directors are expected to exercise reasonable care, skill and diligence. There is also a duty of loyalty to act in the company's best interests and not for personal benefit. As a director or de facto director, you are expected to be aware of relevant statutory and regulatory rules including corporate governance and anti-money laundering legislation. A breach of such rules may lead to disciplinary procedures including private reprimands, public censure and criticism.

4.When does my fiduciary duty shift from serving my shareholders to serving my creditors?

As a director of a company in good financial standing, you owe a duty to act in good faith and in the best interests of all its shareholders. However, when a company is in financial distress or becomes insolvent, the onus shifts and the interests of the company's creditors are paramount. You must act in a way to minimise the potential loss to them.

The reason for this is that, if your company is insolvent and goes into liquidation, creditors have priority for repayment before shareholders. Failure to consider the interests of creditors when your company is in financial distress can lead to legal proceedings being brought against you and potentially disqualification from taking on other director appointments in the future.

5.What can I do if I know that my company may be insolvent?

Time is of the essence to make informed choices when a company is facing financial distress and insolvency. If appropriate actions are not taken there is always a risk that you may lose control of your company if creditors take enforcement actions against it.

If you still have good relationships with your major creditors, you may be able to agree some breathing space (a so-called informal standstill or moratorium against taking action) with them. This period of time could allow you to come up with a restructuring plan and / or to sell non-core assets to satisfy outstanding debts.

However, if relationships with key creditors have deteriorated to a point where there is a lack of trust and open communication, a disgruntled creditor may take enforcement action to initiate formal insolvency proceedings against your company (a 'compulsory liquidation' process) and to appoint a liquidator.

Note that in many jurisdictions, directors and shareholders may have the option to initiate the insolvency proceeding themselves and to place their company into liquidation (a 'voluntary liquidation' process). And don't be put off by the term 'liquidation'. In some jurisdictions companies can be placed into a 'soft touch' liquidation where management can remain in place in order to put forth a restructuring plan.

6. What is a liquidator and do I need one?

A liquidator is a person appointed who has the duty to manage the affairs of a company in liquidation. Their main responsibilities are to collect in the assets of the company in order to settle its outstanding debts, but also to investigate the conduct of the directors and eventually dissolve the company. Upon the appointment of a liquidator, the powers of the directors cease but not the duties.

In the case of a compulsory liquidation, a disgruntled creditor will have made the decision to appoint a liquidator through a Court process. Whilst you may be able to put forth a choice of liquidator, there is no guarantee that your named individual will be appointed – in the usual course, the creditors, and or the Court will make that decision.

It is also worth noting that regardless of whether a liquidator was nominated by you or another party, a liquidator in a compulsory liquidation is an officer of the Court and their powers and conduct are governed by the legislatory framework of the jurisdiction in which they have been appointed. Their primary duty is to the Court and to the creditors of the company, not to you.

Note that in most jurisdictions, the liquidator is a personal appointment and not the firm for whom he or she works for.

7. I operate in many jurisdictions. What rules apply?

Most crypto firms operate in several jurisdictions. In an insolvency scenario, the Centre of Main Interest ('COMI') becomes relevant when considering which jurisdiction's laws take precedence if insolvency proceedings have commenced in different jurisdictions.

Assessment of COMI includes the place where the company conducts the administration of its business on a regular basis. In the absence of proof to the contrary, the COMI may be presumed to be the place where its registered office is located. Insolvency proceedings in the COMI will be deemed as being the 'main' proceedings.

Certain jurisdictions are viewed as being either more 'debtor friendly' or 'creditor friendly'. This distinction enables forum shopping to take place whereby proceedings can be commenced in the most appropriate jurisdiction subject to connectivity to that jurisdiction. Typically, the U.S. is perceived to be debtor friendly due to its Chapter 11 reorganisation regime in which a company's management remains in control of its business operations subject to oversight and jurisdiction of the court.

In contrast, the United Kingdom and Hong Kong are viewed as being creditor friendly as directors typically lose their powers and a liquidator assumes operation and control of the company. Some offshore jurisdictions such as Bermuda and Cayman Islands offer something in between: a liquidator is appointed but does not assume control of the company rather he assumes an oversight role over management who stay in place – 'soft touch'.

Experienced legal and financial advisers can provide you with guidance on how to navigate COMI issues should your crypto firm be heading towards insolvency.

8. What is my liability and what do I need to do?

If a disgruntled creditor takes enforcement action to appoint a liquidator, you lose control of the process. There will be a scrutiny of your actions; in particular if and how quickly you took action to preserve value and prevent further losses prior to the appointment of the liquidator.

You will be held to account for both what you did and what you failed to do. Failure to act appropriately and in the interests of creditors and shareholders may expose you to legal proceedings.

It is important to realise that when an external liquidator is appointed, they have a statutory duty to investigate the actions of directors. This may lead to civil and criminal proceedings (rare) against you including fines, imprisonment (very rare), disqualification and exposure to personal liability.

In particular, you run the risk that a wrongful or fraudulent trading claim, also known as deepening insolvency, may be brought against you. Whilst the definitions and thresholds for such claims vary between jurisdictions, essentially the claim is that you knowingly allowed further debts to accrue without a reasonable expectation of payment and hence the threat of personal liability.

9. Can I choose which creditors I want to pay off first?

If in the months prior to liquidation you were paying off creditors merely on the basis of who was shouting the loudest prior to the liquidation, such payments may be deemed to be preferential payments and the payments themselves will be voidable.

Simply put, a liquidator may challenge any payments made before their appointment on the basis that a creditor was preferred above others - this so-called lookback period varies between jurisdictions and may depend on the parties involved. If proven to be an unfair preference, then the Court may order a return of the payment by the preferred creditor and directors may be liable for misfeasance.

Note that a liquidator is generally paid from the assets of the company. Such liquidation costs are an expense of the process and rank above creditors for payment.

10.Is there insurance coverage to protect me?

If you are a company director or officer you are able to purchase some protection, namely an insurance product known as Directors & Officers Insurance cover (D&O Cover). This can provide you with financial protection against the consequences of actual or alleged wrongful acts when acting in the scope of your managerial duties, i.e. covering defence costs when legal fees can add up. You should be aware however, that commonly D&O does not cover fraudulent, criminal or intentional non- compliant acts nor does it cover you if you obtained illegal remuneration or acted for personal profit. It is also worth bearing in mind that D&O Cover premiums can be hefty.

D&O cover purchased after distress (not possible after formal liquidation) will be expensive and cover will be limited.

It is important for directors to take sensible steps to mitigate the risk of liability, seek appropriate advice and review the company's options and record justifications for your decisions at each stage.

The Rise of Central Bank Digital Currencies (CBDCs)

What you need to know

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The Rise of Central Bank Digital Currencies (CBDCs)

There has been renewed conversation and debate recently about Central Bank Digital Currencies (CBDCs). Whilst central banks have been researching this topic for some time, recent media articles about certain central banks potentially issuing their own CBDC have brought this topic to the forefront of the related policy debate. Here are essential aspects of CBDCs that you need to know!

What is a CBDC?

Prompted by technology advances and a decline in cash usage around the world, many central banks are exploring whether it would be possible to issue a CBDC complement to cash. A CBDC is a digital payment token which is issued and fully backed by a central bank and is legal tender.

Blockchain or Distributed-Ledger-Technology (DLT) is one technology that can facilitate a CBDC and it is a key feature that CBDCs share with other cryptoassets, such as Bitcoin. However, unlike decentralised cryptocurrencies which operate on a permissionless or public blockchain and where no one person, corporation or central bank has control over the network, it is expected that central banks will initially issue their CBDC on a permissioned or private blockchain network. This means that access and control to the blockchain is limited to a select group of approved participants, permitting the central bank to retain control of the overall money supply.

CBDCs are also 'programmable money', meaning that payment tokens or digital fiat can now have specific design features and attributes built into the token itself. Broadly speaking, the common policy debates contemplate two types of CBDCs, 'wholesale central bank digital currencies', which would facilitate more efficient central bank clearing operations between the central bank and its members banks, and 'retail central bank digital currencies' which would be available for use by the public at large and would effectively be the equivalent of a bank note, albeit in digital form.

For example, the token could pay the token holder interest directly into their wallet and there are endless possibilities for the design of the tokens, as well as the overall network. Each central bank could design a currency according to their own monetary policy and economic objectives.

What are the potential benefits of a CBDC?

There are many potential benefits for the issuing central bank. Digital currency could provide a real-time picture of economic activity in a country or region as well as provide more accurate and timely economic data for GDP estimates than are available today.

For citizens and businesses, transactions would be more efficient with near instantaneous settlement at potentially a fraction of the cost.

CBDCs can also help in the fight against corruption and money laundering, as authorities would be able to trace transactions far more effectively than is possible today.

What are potential policy areas of interest?

Depending on how the system supporting a CBDC is designed, a new blockchain enabled CBDC may give rise to some complex questions which need to be considered.

Many central banks are concerned, for example, that introducing a CBDC could potentially disintermediate the commercial banking sector. If citizens, particularly in times of economic stress, pull their savings from commercial banks and place them in risk-free accounts directly with the central bank, this may trigger a bank run and place intense stress on the commercial banking sector. This risk was discussed by the European Central Bank (ECB) in a recent policy paper[1], noting that "by potentially providing an alternative to some types of bank deposit, CBDC could induce its holders to withdraw a substantial amount of liquidity from the banking system, thereby influencing its ability to finance economic activity in normal times". It is for this reason that many central banks are unlikely to implement retail CBDCs as a first step or, in any event, do so without using existing financial intermediaries.

Data privacy, and compliance with applicable consumer data protection and data privacy laws is another potential area of focus. If transactions are immutable, how will the 'right to be forgotten', which is a core tenet of the General Data Protection Regulation (GDPR) law in the European Union (EU), be addressed by affected central banks? Ironically, the ECB noted recently[1] that traditional cash could continue to be a favoured transaction medium for those wishing to have anonymity or privacy.

Regulation around DLTs and digital assets can also be inconsistent and may vary widely across different jurisdictions. As regulators begin to formulate more mature approaches and react to new developments, there may be rapid changes to the regulatory landscape.

Additionally, there is an inherent risk that the private keys which provide access to digital assets could be stolen by hackers. Security is paramount for the wallets which store the private keys that are necessary to transact (e.g., buy/sell/transfer) digital assets on the blockchain.

How widespread is the exploration of CBDCs?

Many central banks have been researching this technology since 2013 and a recent Bank for International Settlement (BIS) study[2] shows that seventy percent of central banks surveyed are engaged in some type of CBDC exploration[3]. In fact, the IMF published a paper in November 2017 encouraging central banks to experiment with CBDCs[4]. The First Deputy Governor of the Bank of France also stated at the Official Monetary and Financial Institutions Forum (OMFIF) meeting in October 2020 that central banks should not refrain from experimenting with different forms of CBDC, with a higher potential from his perspective, for wholesale CBDCs[5].

Examples of pilots abound, such as 'Project Jasper' where the Bank of Canada is conducting a collaborative research initiative between the public and private sectors to understand how DLT could transform the wholesale payments system[6]. In Singapore, 'Project Ubin' is a collaborative project with the banking sector, exploring the use of DLT for clearing and settlement of payments and securities, as well as new methods of conducting cross-border payments using CBDCs[7]. In February 2018, the Republic of the Marshall Islands issued the Sovereign Currency Act of 2018[8] which introduced a new blockchain based currency called the Sovereign ('SOV'). The recent announcement from Facebook launching the Libra Association was a major catalyst in bringing this topic to the top of the agenda of many policy makers around the world.

These examples have also prompted many other central banks to look more closely at CBDCs. For example, the Bank of England's Governor Mark Carney raised the idea of a Global Digital Currency, backed by numerous central banks at the annual Jackson Hole gathering of central bankers.

What are the characteristics of China's CBDC?

At HK FinTech Week, Mr. Mu Changchun, Director-General of the Institute of Digital Currency of the People's Bank of China (PBoC), announced details regarding the PBoC's plans to release China's version of a CBDC, the Digital Currency Electronic Payment (DCEP) coin.

Mr. Mu noted that the DCEP coin will be targeted specifically at the retail sector only, and not at institutional and wholesale payments. The PBoC plans to enable commercial banks and certain other institutions to distribute the DCEP coins to the general public. The PBoC does not plan on issuing DCEP coins to the public directly, rather allowing the existing financial ecosystem to bring the coins to the public.
DCEP coins will be designed to be used as the equivalent of existing fiat currency (i.e. paper notes and coins). However, users will need to open a digital wallet to send, receive, and hold DCEP coins (this can be done without any linkage to a bank account). No interest will be paid for holding DCEP, and there also should be no implications for inflation and no impact on central bank monetary policy.

How will businesses have to adapt?

Blockchain and cryptocurrencies are emerging technologies that are continuously evolving and being applied to new use cases. This subject matter is complex and technical, requiring sufficient expertise to navigate. Senior management should consider having a strategy in place which outlines the potential impact of CBDCs on their businesses and consider implementing a strategy in order to respond to the changing landscape.
Management and digital asset teams will need to collectively build the appropriate competence and capabilities to perform business operations, as well as to understand and effectively manage the related risks.

Organisations will potentially need new policies and procedures to govern how they will interact with and manage digital assets. Digital asset activities will impact not just policies and controls surrounding the new technology, but also resources and whether they are properly suited and have the right expertise to perform their jobs. Distributed ledger technology protocols may have different governance, organisational, or technological approaches, which may necessitate a redesign of traditional control frameworks.

Businesses can consider whether to focus on in-house development or work with a third party for services related to digital assets. Similar to traditional business processes, there might be functions related to digital assets that would be more efficient if outsourced to a third party. The maturity of internal capabilities and the level of complexity in a business model will dictate whether third party service providers could be an effective solution.