

Dubai Financial Services Authority Moves into the “Crypto” Space and Establishes Regulatory Framework for “Investment Tokens”

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On October 25, 2021, the Dubai Financial Services Authority (“**DFSA**”) updated its Rulebook for “crypto” based investments by launching a regulatory framework for “Investment Tokens”. This framework follows, on the whole, the approach proposed in the DFSA’s “Consultation Paper No. 138 - Regulation of Security Tokens”, published in March 2021 (the “**Consultation Paper**”).

Peter Smith, Managing Director, Head of Strategy, Policy and Risk at the DFSA has noted that: “*Creating an ecosystem for innovative firms to thrive in the UAE is a key priority for both the UAE and Dubai Governments, and the DFSA. Our consultation on Investment Tokens enabled us to understand what firms were looking for in a regulatory framework and introduce a regime that is relevant to the market. We look forward to receiving applications from interested firms and contributing to the ongoing growth of future-focused financial services in the DIFC.*”^[1]

What is an “Investment Token”?

An “Investment Token” is defined as either a “Security Token” or a “Derivative Token”^[2]. Broadly speaking, these are:

- a security (which includes, for example, a share, debenture or warrant) or derivative (an option or future) in the form of a cryptographically secured digital representation of rights and obligations that is issued, transferred and stored using Distributed Ledger Technology (“**DLT**”) or other similar technology; or
- a cryptographically secured digital representation of rights and obligations that is issued, transferred and stored using DLT or other similar technology and: (i) confers rights and obligations that are substantially similar in nature to those conferred by a security or derivative; or (ii) has a substantially similar purpose or effect to a security or derivative.

However, importantly, the definition of “Investment Token” will not capture virtual assets which do not either confer rights and obligations substantially similar in nature to those conferred by a security or derivative, or have a substantially similar purpose or effect to a security or derivative. This means that key cryptocurrencies such as Bitcoin and Ethereum, as well as stablecoins such as Tether, will remain unregulated under the Investment Tokens regime.

Scope of framework

This regulatory framework applies to persons interested in marketing, issuing, trading or

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holding Investment Tokens in or from the Dubai International Financial Centre (“DIFC”). It also applies with respect to DFSA authorised firms wishing to undertake “financial services” relating to Investment Tokens. Such financial services would include (amongst other things) dealing in, advising on, or arranging transactions relating to, Investment Tokens, or managing discretionary portfolios or collective investment funds investing in Investment Tokens.

Approach taken by the DFSA

The approach taken by the DFSA has been to, rather than establish an entirely separate regime for Investment Tokens, bring these instruments within scope of the existing regime for “Investments”, subject to certain changes. The Consultation Paper noted that *“in line with the approach adopted in the benchmarked jurisdictions, [the] aim is to ensure that the DFSA regime for regulating financial products and services will apply in an appropriate and robust manner to those tokens that [the DFSA considers] to be the same as, or sufficiently similar to, existing Investments to warrant regulation”*.

The Consultation Paper proposed to do this through four means: (i) by making use of the existing regime for “Investments” as far as possible, whilst addressing specific risks associated with the tokens, especially technology risks; (ii) by not being too restrictive, so that the DFSA can accommodate the evolving nature of the underlying technologies that might drive tokenization of traditional financial products and services; (iii) by addressing risks to investor/customer communication and market integrity, and systemic risks, should they arise, where new technologies are used in the provision of financial products or services in or from the DIFC; and (iv) remaining true to the underlying key characteristics and attributes of regulated financial products and services, as far as practicable.

As noted at (i) above, the changes brought about on October 25, 2021 necessarily involved the addition of new requirements to address specific issues related to Investment Tokens. For instance, added requirements are imposed on firms providing financial services relating to Investment Tokens in Chapter 14 of the Conduct of Business Module of the DFSA Rulebook.

This sets out (amongst other things):

- technology and governance requirements for firms operating facilities (trading venues) for Investment Tokens – for instance, they must: (i) ensure that any DLT application used by the facility operates on the basis of permissioned access, so that the operator is able to maintain adequate control of persons granted access; and (ii) have regard to industry best practices in developing their technology design and technology governance relating to DLT that is used by the facility;
- rules relating to operators of facilities for Investment Tokens which permit direct access – for example, the operator must ensure that its operating rules clearly articulate: (i) the duties owed by the operator to the direct access member; (ii) the duties owed by the direct access member to the operator; and (iii) appropriate investor redress mechanisms available. The operator must also make certain risk disclosures and have in place adequate systems and controls to address market integrity, anti-money laundering and other investor protection risks;
- requirements for firms providing custody of Investment Tokens (termed “digital wallet service providers”) – for example: (i) any DLT application used in providing custody of the Investment Tokens must be resilient, reliable and compatible with any relevant facility on which the Investment Tokens are traded or cleared; and (ii) the technology used and its associated procedures must have adequate security measures (including cyber security) to enable the safe storage and transmission of data relating to the Investment Tokens; and
- a requirement that firms carrying on one or more financial services with respect to Investment Tokens (such as dealing in investments as principal/agent, arranging

deals in investments, advising on financial products and managing assets), provide the client with a “key features document” in good time before the service is provided. This must contain, amongst other things: (i) the risks associated with, and the essential characteristics of, the Investment Token; (ii) whether the Investment Token is, or will be, admitted to trading (and, if so, the details of its admission); (iii) how the client may exercise any rights conferred by the Investment Tokens (such as voting); and (iv) any other information relevant to the particular Investment Token that would reasonably assist the client to understand the product and technology better and to make informed decisions in respect of it.

Comment

In taking the approach to Investment Tokens outlined in this alert, the DFSA has aligned with the approach taken by certain key jurisdictions. It is similar to that taken by the U.K. Financial Conduct Authority, for example, which has issued guidance to the effect that tokens with specific characteristics that mean they provide rights and obligations akin to specified investments, like a share or a debt instrument (the U.K. version of Investment Tokens) be treated as specified investments and, therefore, be considered within the existing regulatory framework^[3].

The DFSA's regime has baked-in flexibility, particularly as a consequence of the fairly high level, principles-based approach. This will likely prove helpful, given the evolving nature of the virtual assets world. However, the exclusion of key cryptocurrencies from the scope of this regime may limit the attractiveness of the regime, particularly to cryptocurrency exchanges seeking to offer spot trading. However, this may be offset to some extent by the DFSA regime's willingness to allow operators of facilities for Investment Tokens to provide direct access to retail clients, subject to those clients meeting certain requirements (such as having sufficient competence and experience). This is in contrast to the approach proposed by the Hong Kong Financial Services and the Treasury Bureau, which has proposed restricting access to cryptocurrency trading to professional investors only.^[4]

Next steps

As noted above, the Investment Tokens regime does not cover many key virtual assets. However, we understand that the DFSA is drafting proposals for tokens not covered by the Investment Tokens regulatory framework. These proposals are expected to cover exchange tokens, utility tokens and certain asset-backed tokens (stablecoins). The DFSA intends to issue a second consultation paper later in Q4 of this year.^[5]

[1] <https://www.dfsa.ae/news/dfs-a-introduces-regulatory-framework-investment-tokens>

[2] DFSA Rulebook: General Module, A.2.1.1

[3] FCA Policy Statement (PS 19/22), Guidance on Cryptoassets (July 2019)

[4] See our previous alert on the proposed Hong Kong regime:
<https://www.gibsondunn.com/licensing-regime-for-virtual-asset-services-providers-in-hong-kong/>

[5] <https://www.dfsa.ae/news/dfs-a-introduces-regulatory-framework-investment-tokens>

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn's Crypto Taskforce (cryptotaskforce@gibsondunn.com) on the Global Financial Regulatory team, or the following authors:

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