



**SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN**  
**Securities Market Division**

**November 6, 2020**

**Position Paper**  
**Regulation of Digital Asset Trading Platforms**

Digital assets also known as Virtual Assets, and Crypto Assets are the start of a new era of Digital Finance, and demand innovative regulatory measures and approaches by the regulators across the world. This could only be possible by initiation of a new era that re-invents regulatory regime/measures as they are known to the regulators globally today.

This position papers aims to provide the following key insights:

- Some basic definition, concepts and innerworkings of Digital Assets universe.
- Approach adopted by regulators towards digital assets globally.
- A definition to recognize digital assets in Pakistan.
- Mechanism for operation/regulation of digital assets in Pakistan.
- Way forward for designing and developing a robust regulatory regime at par with the World for regulating Digital Assets.
- Present policy proposals to industry participants and stakeholders

This consultation paper focuses exclusively on non-government or noncentral-bank-issued crypto assets and not on central bank digital currencies,

**A. Basic Definition and Concepts**

A global consensus has not yet emerged in relation to giving a unanimous definition to Digital Assets. This is because Digital assets have been treated differently by regulators across the World, some giving prime importance to operational perspective of digital assets while others have taken an approach to define them to be able to make the regulations robust to minimize Anti-Money Laundering, terrorist financing and tax evasion reservations for their respective jurisdictions. The problem is significant: even though the full scale of misuse of virtual currencies is unknown, its market value has been reported to exceed EUR 7 billion worldwide.<sup>1</sup>

In June, 2019 the Financial Action Task Force (FATF) updated its Recommendations and defined the term Virtual Assets as follows:

*“A virtual asset is 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”.*

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<sup>1</sup> COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT Accompanying the document “Proposal for a Directive of the European Parliament and the Council amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC”, SWD/2016/0223 final, <https://eurlex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016SC0223&from=EN>.



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Although there is still no consensus over the definition of Digital Assets but the shared commonality between all of them are:

- i. Digital/Crypto currencies
- ii. Digital Tokens/Assets
  - a. Utility Tokens
  - b. Security Tokens – either backed by real assets or cryptographic Distribute Ledger Technology.

### **Utility Token:**

These tokens are designed to be used for a particular purpose, usually within the application/platform for which they are developed. The most common use of a utility token is as a payment option for purchases within the platform.

For instance, Medipedia Platform-A blockchain based healthcare startup aimed for Medical Tourists. The platform has issued utility tokens i.e. MEP tokens can be used for payment of healthcare services within the Medipedia platform.

### **Security Token:**

Token issued with some investment dimension through an initial security offering are classified as Security tokens. Such tokens bear more similarity to financial instruments than to cash. Security tokens should be thought of as assets providing rights such as ownership, right to share in future profits or cash flows or payment of a specific sum of money (e.g. dividends).

The asset tokenization of real assets on distributed ledgers or the issuance of traditional assets classes in tokenized form with application of smart contracts has the potential to deliver a number of advantages over the traditional system. These include:

- Transparency i.e. near to impossible duplication/cheating avenues inherent in the system;
- Improved liquidity potential i.e. enabling tradability of illiquid assets;
- Efficiency gains due to disintermediation and automation.
- Comparatively efficient clearing and settlement mechanisms.

Beside the above-mentioned advantages, a rather revolutionary impact of security tokens lies in its inherent potential to democratize the financial systems i.e. by enabling fractional ownership of assets which will further cause:

- Lowering of barriers to investment.
- Inclusive access to retail investors to previously unaffordable or insufficiently divisive asset classes.



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Nevertheless, for the financial systems to be able to reap the astounding benefits of DLT security tokens, scalability is termed as one of the biggest challenges to overcome. To make it a system to permeate deep into the existing financial systems or replace the existing one eventually, a significant throughput would be required to match the scale of financial markets.

### **Points of Divergence between Security Tokens and Dematerialized securities, Assets backed Securities, REIT Certificates.**

It is pertinent to classify and define security tokens in comparison with other asset classes in order to highlight the points of divergence between them, because of surrounding confusion with these frequently overlapped concepts.

#### **B. Jurisdictional Analysis – Digital Assets/Security Tokens.**

##### **i. Malaysia:**

- Regulated by: Securities Commission Malaysia
- Defined in CAPITAL MARKETS AND SERVICES (PRESCRIPTION OF SECURITIES) (DIGITAL CURRENCY AND DIGITAL TOKEN) ORDER 2019
- Definition:
  - “digital token” means a digital representation which is recorded on a distributed digital ledger whether cryptographically-secured or otherwise.
  - A digital token which represents a right or interest of a person in any arrangement made for the purpose of, or having the effect of, providing facilities for the person, where—
    - (a) the person receives the digital token in exchange for a consideration;
    - (b) the consideration or contribution from the person, and the income or returns, are pooled;
    - (c) the income or returns of the arrangement are generated from the acquisition, holding, management or disposal of any property or assets or business activities;
    - (d) the person expects a return in any form from the trading, conversion or redemption of the digital token or the appreciation in the value of the digital token;
    - (e) the person does not have day-to-day control over the management of the property, assets or business of the arrangement; and
    - (f) the digital token is not issued or guaranteed by any government body or central banks as may be specified by the Commission, is prescribed as securities for the purposes of the securities laws.
- The mechanism proposed by Malaysian Regulator, for the offer of digital Tokens is divided into primary and secondary digital markets.



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- For primary market, IEO operators are introduced by the Malaysian regulator as registered electronic Platform Operators under digital assets Guidelines.
- For secondary trading of digital assets a separate operator and platform are introduced along with their guidelines; termed as DAX (Digital Asset Exchange) operator and DAX platform respectively.
- Can be pitched to all investors.

### ii. **Hong Kong:**

- Regulated by: Hong Kong's Securities and Futures Commission (SFC)
- Defined in Securities and Futures Ordinance
- Definition:
  - "Virtual Assets" means digital representations of value which may be in the form of digital tokens (such as digital currencies, utility tokens or security or asset-backed tokens), any other virtual commodities, crypto assets or other assets of essentially the same nature, irrespective of whether they amount to "securities" or "futures contracts" as defined under the SFO
- The framework is essentially an opt-in to regulation.
- A crypto exchange, upon becoming licensed, will be a "licensed corporation" and must comply with the relevant legal and regulatory provisions applicable to other licensed corporations (e.g. Securities and Futures Ordinance and its subsidiary legislation, Code of Conduct and guidelines, circulars and FAQ published by the SFC)
- In addition to these existing requirements, the SFC has included additional requirements, called the "Licensing Conditions and Terms and Conditions for Virtual Asset Trading Platform Operators" (**Terms and Conditions**) which are drafted to address the unique features of digital assets and blockchain/DLT technology.
- Can be pitched to: Professional Investors

### iii. **USA:**

- Regulated by: U.S. Securities and Exchange Commission
- Defined in Securities Exchange Act of 1934. SEC has provided guidance in its Framework for "Investment Contract" Analysis of Digital Assets.
- Definition
  - An investment contract is (i) an investment of money; (ii) in a common enterprise (iii) with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

### iv. **Other Countries – where framework for digital assets exist/regulated**

- Australia
- Singapore



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- Canada
- Japan
- Thailand

### **C. Problem Statement**

The need to develop a policy and regulatory response to Digital Assets in Pakistan is driven by the following:

- Digital assets are a form of innovation that may impact the financial sector of the country:
- Digital assets do not fit within the current regulatory framework:
- Digital assets may create conditions for regulatory arbitrage while posing risks; and
- Increasing interest, investment and participation in Digital Assets.

### **D. Digital Assets/Tokens - Pakistan:**

SECP intends to study and evaluate the effects of the distributed ledger, digital assets and other innovative technologies and encourages market participants to get engaged with the regulator. While ensuring that investors and markets are protected, SECP aims to encourage innovative and beneficial ways to raise capital.

With all the major regulators worldwide rapidly realizing the potential of digital assets as well as the uncertainty revolving around them, it has become incumbent upon them to start assessing the risk associated with digital assets as well as the innovation it can bring to financial sector and hence design regulatory frameworks to protect investors and make larger financial inclusion a possibility.

#### **i. Approaches available to regulate digital assets**

First can be regulating and restricting new products according to existing regulations, and may in some instances even entail outright banning. Under this approach, innovators are obliged to adapt to the prevailing regulatory environment.

Second is based on the conjecture of 'let-things-happen' approach, described by the Commodity Futures Trading Commission (CFTC) as the 'do-not-harm' approach (Giancarlo, 2018), where the financial sector is considered as dynamic and the associated need to innovate is strongly emphasised. The do-not-harm approach is highly cognizant of not letting overregulation stifle innovation, and supports finding the optimal balance between innovation, the concomitant risks and the wider safety of the financial system (He et al., 2016).



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This position paper is mainly prepared based on second approach.

### ii. Wider objective of the regulatory framework

- Support financial inclusion efforts and the advancement of technological innovation in a responsible and balanced manner.
- Ensure the safety and efficiency of capital market and its institutions.
- Ensure consumer and investor protection.
- Minimise opportunities for regulatory arbitrage.
- Combat the circumvention of exchange control rules and regulations; illicit financial flows, money laundering and the financing of terrorism.

### iii. Defining “Digital Asset/Token”

Digital Assets to deliberate further can be classified as

- Asset backed Digital Assets/Token
- Distributed Ledger Technology based Digital Assets/Tokens

The question arises

- What assets/type of assets can be classified in both the above categories;
- Product dynamics, its custodian and settlement mechanism
- Risks involved both from the prospective of the issuer and the investor

### iv. Primary Token Offering:

An option would be registering the Initial Exchange operators (IEO's), who shall perform the due diligence to allow public offering through capital market by mode of issuing security tokens.

Probable process can be:

- An issuer to submit its application including a white paper to an IEO operator for approval.
- The IEO operator will then assess the issuer and white paper and, if approved, facilitate the offering of the tokens to investors.
- SECP will be working with the IEO operator in assessing the IEO issuer.
- Once approved, the public may then invest in the issuer's tokens from the IEO platform.

This would require designing regulations to register Initial exchange operators (IEO's) as well as prescribe a criterion to operate as such by the Commission. Resultantly, the IEO's can only be offered by registered operators meeting the suitability criteria



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### v. **Secondary Trading:**

- An option would be to allow IEO's for secondary trading as Decentralized Exchange Platforms (i.e performing the services of trading; settlement and custodian)
- Second option could be to separately register Digital Assets Trading (DAT) operators, DAT operator shall be providing the services of trading settlement and custodian services.
- Third Option could be allowing secondary trading through Pakistan Stock Exchange, and traditional mechanism of settlement and custody be followed.

### The question arises

- What would be the most efficient way for primary offerings and secondary trading
- Whether intermediaries be required to participate in the process and what will be their role
- How settlement and custody would be different from traditional class of securities
- What kind of risk would each form result in.

### E. **Way Forward:**

In order to assess the above, SECP intends to hold multiple discussion session and welcomes any input/comments.

Comments/input/queries can be emailed at the following address: [Feedback@secp.gov.pk](mailto:Feedback@secp.gov.pk)

Information about discussion sessions shall be posted on SECP's webpage and social media.