**ADMISSIBILITY FRAMEWORK FOR DIGITAL CURRENCIES**

## 1.0 Introduction

1.1 Digital currencies have emerged as a new investment class that offers both substantial opportunities and considerable risks for investors.

1.2 Since 2018, there has been significant growth in the digital currency transactions undertaken within Labuan International Business and Financial Centre (IBFC). While digital currencies have yet to pose a material risk to financial stability, general consensus among regulatory authorities is that they could compromise investor interests. As such, there is a need to set requirements to govern the trading of digital currencies and regulatory stance on privacy coins.

1.3 The *Admissibility Framework for Digital Currencies* (referred to as "the Guidelines") provides the regulatory expectation on the trading of digital currencies. This includes the identification of the inherent risks for various types of digital currencies as well as the corresponding risk control measures that need to be instituted by the Labuan financial institutions (LFIs).

1.4 Labuan FSA is expecting LFIs not to undertake the trading of digital currencies other than those scoped in within the Guidelines until Labuan FSA develops regulatory requirements to govern such activities.

## 2.0 Applicability

2.1 The Guidelines are applicable to LFIs which provide financial services related to the trading and exchanging of digital currencies as permitted under the applicable law, as follows:

(i) Labuan banks and Labuan investment banks licensed under Part VI of the Labuan Financial Services and Securities Act 2010 (LFSSA);

(ii) Labuan Islamic banks and Labuan Islamic investment banks licensed under Part VI of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and

(iii) Labuan money-broking business and Labuan Islamic money-broking business licensed under Part VI of the LFSSA and Part VI of the LIFSSA, respectively.

For the purpose of the Guidelines, digital currencies include central bank digital currencies (CBDCs) and digital assets covered under paragraph 6.0 i.e. stablecoins, non-backed digital currencies and privacy coins.

2.2 Notwithstanding paragraph 2.1, Labuan FSA reserves the right to modify the scope to include other LFIs to observe the requirements of the Guidelines which may be specified from time to time.

2.3 The Guidelines are to be read together with the requirements under relevant guidelines issued by Labuan FSA as set out in **Appendix I**.

## 3.0 Legal Provision

3.1 The Guidelines are issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) for the purpose of specifying the requirements to be implemented by LFIs.

3.2 Any person who fails to comply with the Guidelines may be subject to enforcement actions which include an administrative penalty under Section 36G of the LFSAA and/or any other enforcement action provided under the LFSAA, or other applicable laws governed by Labuan FSA.

## 4.0 Effective Date

4.1 The Guidelines shall come into effect on **1 January 2025**, and would remain effective and applicable unless amended or revoked.

4.2 As a transitional measure, existing LFIs are granted a one-year period to comply with the Guidelines by **1 January 2026**. During the transition period, existing LFIs are expected to ensure that:

(i) no new transactions involving privacy coins and algorithmic stablecoins are carried out; and

(ii) all existing trading in privacy coins and algorithmic stablecoins (if any) by their clients are properly unwind within the stipulated timeline.

LFIs that wish to adopt the Guidelines' requirements earlier are permitted to do so before the effective date.

## 5.0 Definitions

| | |
|---|---|
| **Central Bank Digital Currency** | A digital representation of fiat currency issued by a sovereign government or central bank. A central bank digital currency is considered as a new form of central bank money. |

| | |
|---|---|
| **Digital Asset** | A digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes but does not include a digital representation of fiat currencies. |
| **Digital Currency** | A digital representation of value which is issued/transferred using a distributed ledger technology (DLT) or blockchain technology. It can be digitally traded and functions as medium of exchange or store of value. |
| **Hard Fork** | A hard fork is a major update to a blockchain's protocol that is incompatible with the previous version, resulting in a permanent split into two separate networks. This creates a new blockchain and digital currency, requiring all nodes to upgrade to the new software and typically grants holders of the original digital currencies equivalent digital currencies on the new chain. |
| **Privacy Coin** | Digital currency that preserves the anonymity and obscure the flow of transaction details across the networks. |
| **Pseudonymous** | The transaction details are public, but user identities are concealed. Having said that, the information about the sender or recipient of digital currencies can be inferred from analysing transaction data and patterns. |
| **Stablecoin** | Digital currency issued by private entity that aims to maintain stable value relative to a specified financial asset or a basket of financial assets. |
| **Non-backed Digital Currency** | Digital currency that is neither central bank digital currency nor stablecoin. It is issued by private entity and has no formal backing or underlying asset. |

## 6.0 Type of Digital Currencies

6.1 The Guidelines cover the following categories of digital currencies:

(i) CBDC;

(ii) Stablecoin;

(iii) Non-backed digital currency; and

(iv) Privacy coin.

**Central Bank Digital Currency**

6.2 The value of CBDC is backed by a sovereign government or central bank. This includes CBDCs with regional usability features similar to the Euro for European Union member countries.

6.3 In view that CBDC may function as digital equivalent of fiat currency, it may be exchanged and traded similarly as foreign exchange of fiat currencies.

**Stablecoin**

6.4 A stablecoin has value stabilisation mechanism and may be less volatile as compared to non-backed digital currencies. Notwithstanding this, its stability would depend on the way in which it is pegged, the type and volatility of reserve assets (if any) as well as the governance structure that underpins the backing and redemption mechanism.

6.5 For the purpose of the Guidelines, the relevant types of stablecoins include:

(i) **Fiat-backed stablecoin**

The value is backed by one or more fiat currencies such as US Dollar and Euro which is held by regulated financial institution typically in a 1: 1 ratio to the reserve fiat currency e.g. USD Coin (USDC) and Euro Coin (EURC).

(ii) **Digital currency-backed stablecoin**

The value is backed by another digital currency or a portfolio of digital currencies e.g. Dai (DAI) and Wrapped Bitcoin (WBTC). This type of stablecoin functions similarly to fiat-backed stablecoin, but the peg is executed on-chain through smart contracts. Given the high volatility of the underlying digital currencies, these stablecoins usually require over-collateralisation to mitigate the associated risks.

(iii) **Algorithmic stablecoin**

The value is controlled by pre-programmed protocols or algorithms that dynamically adjust the stablecoin's supply in response to changes in demand e.g. TerraUSD (UST) and Ampleforth (AMPL). It is not backed by reserves of assets such as fiat currencies or other digital currencies.

**Non-backed Digital Currency**

6.6 The value is subject to market forces and speculation, resulting in significant price volatility e.g. Bitcoin (BTC) and Ethereum (ETH).

**Privacy Coin**

6.7 A digital currency with anonymous features to obscure transaction details would be deemed as privacy coin e.g. Monero (XMR), Zcash (ZEC) and Dash (DASH).

6.8 A privacy coin employs advanced privacy technologies such as ring signatures, stealth addresses, or zero knowledge proofs to hide transaction information which include the amount and identities of transaction parties.

## 7.0 Digital Currency Risk Profiles

7.1 The relative riskiness of various types of digital currency from least to most risky is as follows:

(i) CBDC;

(ii) Stablecoin;

(iii) Non-backed digital currency; and

(iv) Privacy coin.

7.2 A CBDC is considered the least risky as it represents a direct claim on a sovereign government or central bank, which provides a high level of safety.

7.3 A stablecoin is generally less risky than a non-backed digital currency provided that its value stabilisation mechanism such as the financial assets backing it functions effectively.

7.4 Based on the categories of stablecoins, the relative level of riskiness is ranked as below:

(i) *Fiat-backed stablecoin* is the least risky as it is supported by fiat currencies held in regulated financial institutions.

(ii) *Digital currency-backed stablecoin* is riskier than fiat-backed stablecoin as it is subject to the volatility of the underlying digital currency.

(iii) *Algorithmic stablecoin* is the riskiest due to concerns on its algorithms' transparency and effectiveness especially during high-stress periods.

7.5 *A non-backed digital currency* is inherently volatile due to the absence of a value stabilisation mechanism, making it highly susceptible to market speculation.

7.6 *Privacy coin* poses the highest risks related to money laundering (ML), terrorism financing (TF) and proliferation financing (PF). Its advanced privacy features with typically high opacity can complicate efforts to detect and prevent illicit financial activities. As such, it is highly probable that such digital currency would not fulfil the requirements of the *Guidelines on Travel Rule for Labuan Digital Financial Services*.

7.7 The risk matrix used to assess the risk profiles of varying types of digital currencies are provided under **Appendix II**.

7.8 As the digital landscape is evolving rapidly, the risk profile of digital currencies outlined in the Guidelines reflects the current risk environment. These risks may change as the digital currency ecosystem evolves.

## 8.0 Risk Control Measures

8.1 Based on the risk-profiling of digital currencies under paragraph 7.0, LFIs are required to adopt an appropriate approach in assessing the treatment for the different types of digital currencies. The nature and extent of control measures imposed will be commensurate with the risks posed by each digital currency category.

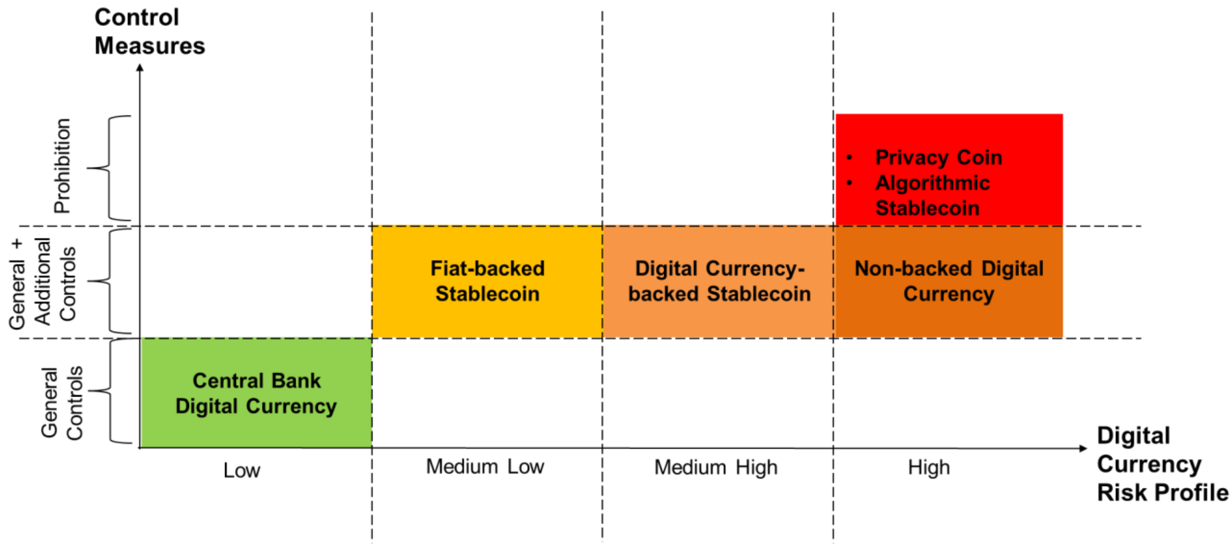
8.2 Depending on the categories of digital currencies, LFIs are required to employ three-level controls as follows:

(i) **General controls**: Standard controls apply to all categories of admissible digital currencies i.e. CBDCs, stablecoins and non-backed digital currencies.

(ii) **Additional controls**: Enhanced controls apply to categories of admissible digital currencies with relatively higher risks i.e. stablecoins and non-backed digital currencies, to supplement the general controls.

(iii) **Prohibition:** Privacy coins and algorithmic stablecoins are not admissible.

**Digital Currency Risk Matrix**



8.3 In relation to paragraph 8.1, the control measures that need to be adopted by LFIs include the following key areas:

(i) Governance and Monitoring Overview;

(ii) Admissibility of Digital Currencies for Trading;

(iii) Policy Review and Implementation;

(iv) Internal Audit;

(v) Removal of Digital Currencies from Trading;

(vi) Risk Warning and Disclosure; and

(vii) Regulatory Reporting.

## A. Governance and Monitoring Overview

8.4 The LFI shall ensure that the overall governance oversight on the risk control measures under paragraph 8.0 is in line with the regulatory expectation of the *Guidelines on Digital Governance Framework*.

<u>Board of Directors</u>

8.5 The Board of Directors of the LFI is expected to:

(i) approve the internal policies and procedures relating to the admission, monitoring and removal of digital currencies for clients to trade;

(ii) ensure that the trading of digital currencies is managed in a prudent and sound manner;

(iii) receive timely updates on the details of digital currencies for trading and any notable issues; and

(iv) promptly notify Labuan FSA upon becoming aware of any matter that adversely affects, or is likely to adversely affect the LFI’s ability to meet its obligations or to fulfil its responsibilities under the Guidelines.

Digital Currency Oversight Committee

8.6 The LFI is required to set up a Digital Currency Oversight Committee (DCOC) to manage the trading of digital currencies.

8.7 The DCOC comprises at least two senior management members with relevant expertise and experience in managing digital currency business or internal control functions within the LFI.

8.8 The roles and responsibilities of the DCOC include:

(i) establishing and reviewing criteria and process for the admission and removal of digital currencies for client trading to ensure they remain appropriate and relevant;

(ii) deciding whether to admit and remove a digital currency for client trading based on policies and procedures approved by the board of directors;

(iii) developing and reviewing policies and procedures to ensure effective identification, assessment, and mitigation of risks associated with digital currencies;

(iv) maintaining record of digital currencies held personally by DCOC members, board of directors and other internal stakeholders who may influence admission or removal decisions. This record should be used to implement information barriers to prevent conflict of interest, market manipulation or insider trading;

(v) ensuring that internal policies, decisions, reports and the record of digital currencies are properly documented, kept and readily accessible to Labuan FSA at all times; and

(vi) reporting to the board of directors at least semi-annually covering details of digital currencies available for trading and any notable issues. However, if there are any critical matters such as the removal of digital currencies by DCOC, adverse news with regard to the banning of digital currencies by other regulatory authorities or digital exchanges, DCOC must escalate this to the board of directors immediately.

## B. Admissibility of Digital Currencies for Trading

8.9 The LFI must perform a comprehensive due diligence process to assess all digital currencies prior to offering them for trading and ensure that these digital currencies continue to satisfy the admissibility criteria. The details of the admissibility criteria are as specified under paragraphs 8.10 to 8.12.

8.10 As part of general controls, the minimum admissibility criteria which apply to all admissible digital currencies must include the assessment on the sovereign and sanction related risks e.g. whether the issuer is being sanctioned/from a sanctioned country.

8.11 For *stablecoins* and *non-backed digital currencies*, additional measures would be required in addition to general controls. In this regard, the admissibility criteria must include the following considerations:

(i) Regulatory status of the digital currency in other jurisdictions e.g. whether it has been approved or banned by another regulator;

(ii) Information of the digital currency e.g. nature, purpose, protocols and consensus mechanism;

(iii) Governance arrangement e.g. information about the founder, issuer, management team, key persons, miners and significant holders including audited financial statement of issuer;

(iv) Amount in circulation, liquidity, trading history on volumes and prices of digital currency;

(v) Market risk e.g. ownership concentration of the digital currency by a small number of individuals or entities and price manipulation;

(vi) Adequacy and suitability of the technology associated with the digital currency, cybersecurity risk, cyberattack history as well as operational risk;

(vii) Mitigation of risks associated with the digital currency including risks relating to governance, legal, regulatory, cybersecurity, ML/TF/PF concerns and other illicit finance; and

(viii) Traceability of the digital currency.

8.12 To manage the pecuniary risk in relation to the underlying reserve of *stablecoins*, the admissibility criteria would need to further include the following considerations:

(i) Existence of public information on the value and composition of the reserves of the fiat-backed or digital currency-backed stablecoin and the information is published at least quarterly by the issuer of the stablecoin.

(ii) Independent third-party verification of published information under paragraph 8.12 (i) by a suitably qualified professional at least annually.

(iii) Ability of the stablecoin to maintain a stable value relative to the fiat currency or digital currency backing it.

(iv) Existence of party clearly responsible and liable to investors for the stablecoin.

(v) Existence of redemption policy that enable stablecoin holders to redeem stablecoin in a timely fashion.

(vi) For *fiat-backed stablecoin*, the LFI must ensure that the issuer of the stablecoin maintains reserves that:

(a) are at least equal to the notional value of all outstanding units of the stablecoin in circulation i.e. the value is calculated as the product of the number of stablecoins in circulation and the purported pegged fiat currency value;

(b) are denominated in the reference fiat currency;

(c) are held in segregated accounts with regulated banks or custodians supervised by a recognised and competent regulatory authority; and

(d) consist of high-quality liquid assets.

(vii) For *digital currency-backed stablecoin*, the LFI must ensure that the issuer of the stablecoin maintains reserves that are:

(a) meeting the predefined amount i.e. typically more than the notional value of all outstanding units of the stablecoin in circulation i.e. the value is calculated as the product of the number of stablecoins in circulation and the purported pegged digital currency value; and

(b) denominated in the reference digital currency.

## C. Policy Review and Implementation

8.13 The LFI must review its internal policies and procedures on digital currencies at least annually. This covers:

(i) reviewing the criteria and process for the admission and removal of digital currencies to ensure they remain appropriate as well as reflective of current market conditions and regulatory requirements;

(ii) re-evaluating each digital currency to verify whether it continues to meet the admission criteria and to determine if its removal from trading is warranted. The re-evaluation of digital currencies may occur on more frequent basis in response to material changes or developments such as hard forks, significant technological advancements, or changes in the legal or regulatory environment that may affect the digital currency's suitability for trading; and

(iii) monitoring the implementation of control measures to manage risks associated with the digital currency on an ongoing basis. These risks include but are not limited to cyber security, ML/TF/PF concerns and sanctions.

8.14 Regular review reports detailing the findings from ongoing monitoring and the actions taken or planned to address identified issues must be promptly submitted to the DCOC by the LFI.

## D. Internal Audit

8.15 The LFI is required to ensure that its internal audit oversight includes planned assessments on internal controls relating to the trading of digital currencies.

8.16 The scope, frequency and intensity of the internal audit must be in line with the LFI's annual audit plan as well as its own risk assessment and appetite. For clarity, the requirement under paragraph 8.15 shall be an independent exercise which is distinctive from the annual review expected out of the DCOC under paragraph 8.13 of the Guidelines.

## E. Removal of Digital Currencies from Trading

8.17 Once a decision to remove a digital currency is made by the DCOC, the LFI must implement a detailed rollout plan to ensure that the removal is executed in an orderly manner. The rollout plan, at a minimum, includes the following elements:

(i) **Communication with Clients**: The LFI must make all reasonable efforts to communicate clearly and in advance with clients to minimise potential harm. In particular, the LFI must ensure the following matters:

(a) **Advance Notification Period**: Provide at least 30 calendar days' notice before the removal of the digital currency. If immediate action is necessary due to factors beyond its control, the LFI must provide as much advance notice to clients as practicable;

(b) **Content**: Include details on the timing of the removal of the digital currency, the justification for the removal decision and the options available to affected clients such as selling or transferring the digital currency off the platform, if permitted; and

(c) **Communication Method**: Use written notice via email, publication or alert notification via short message service (SMS) to the client's phone number or through the LFI's website, platform or mobile application, along with any other appropriate public communication channels.

(ii) **Client Support**: The LFI must offer dedicated support by:

(a) responding to phone, email, or chat inquiries from affected clients;

(b) assisting clients with selling or transferring the impacted digital currency if permitted; and

(c) providing tailored FAQs to address common questions and concerns.

(iii) **Ongoing Monitoring of Removal Process**: The LFI must monitor the removal process to ensure it is conducted safely and soundly. This includes rendering expertise to identify financial health issues, potential cybersecurity vulnerabilities, illicit finance risk and other challenges affecting client experience.

(iv) **Impact Analysis**: The LFI must undertake an impact analysis to evaluate the effects of the removal decision on clients, internal business operations, counterparties and third-party service providers involved with the digital currency.

8.18 The LFI must document all key aspects of the digital currency removal decision. This includes:

(i) outcome of monitoring that led to the removal decision;

(ii) approval of the removal decision e.g. meeting minutes;

(iii) data on the estimated impact on the LFI’s customer base;

(iv) communications shared with clients; and

(v) documentation responsive to customer support issues.

8.19 If the LFI reverses a removal decision or re-admits a digital currency, it must issue a public notice on its website/platform to announce the decision.

8.20 Labuan FSA may direct the LFI to remove certain digital currencies from client trading when deemed necessary for investor protection, prevention of ML, TF and PF or for the proper functioning of digital business.

## F. Risk Warning and Disclosure

8.21 The LFI must prominently display risk warnings related to digital currencies on its website and platform. These risk warnings must be clearly visible to clients to ensure they are adequately informed of the potential risks and volatility associated with digital currencies. The details of the risk warnings are as specified under paragraphs 8.22 and 8.23.

8.22 As part of <u>general controls</u>, the risk warning shall at the minimum incorporate the following matters:

(i) Digital currencies are vulnerable to cyber-attacks, which may result in theft. Recovering lost or stolen digital currency is often limited or impossible.

(ii) Risks associated with digital currencies include anonymity, the irreversibility of transactions, accidental transactions, issues with transaction recording, and settlement challenges.

(iii) Technological difficulties experienced by the LFI may hinder access to or use of a client's digital currencies.

(iv) There is no recognised compensation scheme available for providing redress to aggrieved participants.

(v) Labuan FSA does not endorse any of the digital currencies listed by LFIs for trading by their clients.

8.23 For *stablecoins* and *non-backed digital currencies*, <u>additional controls</u> are required and the risk warning should further include the following disclosures:

(i) Digital currencies are not backed by any government.

(ii) Digital currencies are highly volatile and their value can fall quickly (including stablecoins, if they lose their stability peg).

(iii) Investors may lose some or all of their investment.

(iv) Digital currencies may lack liquidity or transferability.

(v) Investing in digital currencies differs from investing in traditional investments such as securities.

8.24 The LFI is required to disclose the following information on its website/platform to ensure transparency:

(i) Admission criteria of digital currency for trading;

(ii) Ongoing monitoring policies and procedures; and

(iii) Execution process for removal of digital currency.

8.25 The LFI is required to publish a Key Features document on its website/platform for each digital currency. The details of the Key Features document are specified under paragraphs 8.26 and 8.27 of the Guidelines.

8.26 As part of <u>general controls</u>, the Key Features document needs to include the following information:

(i) Name of the digital currency;

(ii) Country of origin of the issuer; and

(iii) Access details specifying whether clients can access the platform directly for trading of the digital currency or only through the LFI and outlining the process for accessing the platform. If the platform is not owned by the LFI, to provide details of the platform operator.

8.27 For *stablecoins* and *non-backed digital currencies*, <u>additional controls</u> are required and the Key Features document must further include the following information:

(i) Issuer details of the digital currency;

(ii) Essential characteristics and governance of the digital currency;

(iii) Information about the underlying DLT or similar technology used for the digital currency;

(iv) Risks associated with the digital currency including price volatility, cybersecurity threats, fraud, hacking and financial crime; and

(v) For fiat-backed and digital currency-backed stablecoin, information on the backing reserves, stabilisation mechanism and redemption process.

## G. Regulatory Reporting

8.28 The LFI is required to submit the statistical reporting on the digital currency transactions in accordance with the requirements set forth under the Statistical Management System.

**Labuan Financial Services Authority**
**30 December 2024**

## APPENDIX I LIST OF POLICY DOCUMENTS TO BE READ TOGETHER WITH THE GUIDELINES

1. The Guidelines are to be read together with the following guidelines:

   (i) Guidelines on Travel Rule for Labuan Digital Financial Services

   (ii) Guidelines on Anti-Money Laundering, Countering Financing of Terrorism, Countering Proliferation Financing and Targeted Financial Sanctions for Labuan Key Reporting Institutions

   (iii) Guidelines on Market Conduct for Labuan Digital Financial Intermediaries

   (iv) Guidelines on Technology Management

   (v) Guidelines on Technology and Cyber Risk Management for Labuan Banking and Insurance Business

   (vi) Guidelines on Digital Governance Framework

   (vii) Guidelines on Minimum Audit Standards for Internal Auditors of Labuan Banks

   (viii) Directive on Accounts and Record-Keeping Requirement for Labuan Entities

   (ix) Guidelines on the Establishment of Money Broking Business in Labuan IBFC

## APPENDIX II RISK MATRIX FOR ASSESSING THE DIGITAL CURRENCY RISK PROFILES

The table below shows a summary of the characteristics and risks of digital currencies that are considered in deriving their overall risk profiling:

| Category | CBDC | Stablecoin | Non-backed Digital Currency |
|---|---|---|---|
| **Issued by** | Sovereign government or central bank | Private entity | Private entity |
| **Underlying Rights of Digital Currencies' Owners** | Direct claim on central bank | • Depends on the design of stablecoins.<br>• There may be no direct claim against an issuer or redemption right against the reserve asset. | No direct claim against an issuer |
| **Price Volatility** | Low | Less volatile than non-backed digital currency | High |
| **Elements of Anonymity** | • Transactions can be designed to be completely anonymous, pseudonymous or protected via authentication process.<br>• However, identity of issuing government is clear. | Majority are pseudonymous by default while some are anonymous i.e. privacy coins. | Majority are pseudonymous by default while some are anonymous i.e. privacy coins. |
| **Sovereign and Sanction Related Risks** | A country may face bankruptcy or sanction resulting in loss of public confidence on the CBDC. | The issuer may be originating from a sanctioned country. | The issuer may be originating from a sanctioned country. |
| **Legal, Regulatory and Governance Risks** | Yes | Yes | Yes |

| Category | CBDC | Stablecoin | Non-backed Digital Currency |
|---|---|---|---|
| **Liquidity Risk** | No | Yes | Yes |
| **Credit Risk** | No | Yes | Yes |
| **Market Risk** | Similar to fiat currency the CBDC represents | • Concentration risk<br>• Digital run risk which may be triggered by confidence shock | • Speculation<br>• Concentration risk<br>• Digital run risk which may be triggered by confidence shock |
| **Technological and Cybersecurity Risks** | Yes | Yes | Yes |
| **Potential Illicit Finance Risk** | Yes, including ML, TF and PF risks | Yes, including ML, TF and PF risks | Yes, including ML, TF and PF risks |
| **Overall Risk Profiling** | **Low Risk** | **Medium Low to High Risk** | **High Risk** |