Exploring the development of regulatory framework for crypto assets in South Africa

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Abstract

This paper explores the need for, and forms of regulatory framework and laws established to guide and control the growing number of individuals and firms investing and trading in crypto assets in South Africa.

The step taken to regulate crypto assets was necessitated by the 2021 report of the Paris-based intergovernmental organisation referred to as the Financial Action Task Force (FATF) which revealed that there is apparent lack of crypto assets regulation in South Africa. In rising to this challenge, the South African regulatory authority known as the Financial Sector Conduct Authority (FSCA) in October 2022 indicated that crypto assets are digital representation of value and therefore could be categorised as financial product which are to be subjected to FSCA regulations with reference to Section 1(h) of the Financial Advisory and Intermediary Services Act (FAIS). The method adopted was to review the regulatory framework and laws governing crypto assets in South Africa.

It was found that relevant regulatory framework and laws are needed to provide adequate protection for the investing public and to provide avenues for the sustainability and stability of the crypto assets business sector. The paper concludes that providing an efficient regulatory framework for crypto assets in South Africa will assist in limiting the risk of volatility and cyber-attacks to which individuals and firms trading and/or investing in crypto assets are exposed to. Moreover, an awareness of various regulatory controls and laws governing investments in crypto assets will ensure that individuals and firms in this sector tread in the path of caution.

Introduction

In various jurisdictions throughout the world, regulatory framework for crypto assets have been developed. The factors that have led to the development of fragments of regulatory instruments include the desire to promote innovation, the threats to the country's financial system; the level of development of the crypto assets ecosystem and the ability of regulatory agencies to develop regulatory instruments for crypto assets (Webforum, 2023).

The factors above including some jurisdiction-specific factors were responsible for the stance of various countries with respect to the regulation of crypto-assets. For example, Central African Republic and El-Salvador (El Salvador and Cryptocurrency. Available at: https://freemanlaw.com/cryptocurrency/el-salvador/) have recognised Bitcoin as a legal tender while China completely banned the use of cryptocurrency in its jurisdiction (Webforum, 2023)

With respect to the regulation of crypto assets, three approaches are available for various jurisdictions across the world; these are:

Wait and learn: Some countries have decided to observe and monitor development on crypto assets before considering any form of intervention or regulation. A case in point is Ireland where the apex bank does not prohibit trading in crypto assets and at the same time does not issue any regulatory instrument on crypto assets.

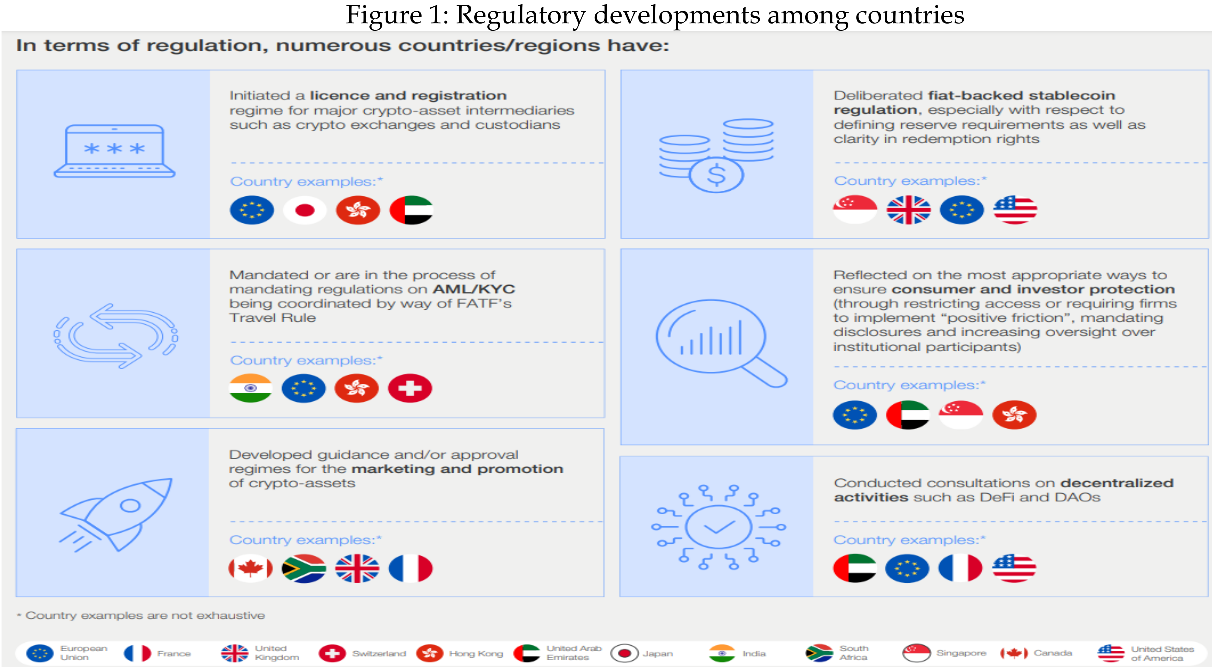
Regulate: Countries in the European Union, the United States, Canada and Australia have backed up crypto assets with legal instruments through existing laws and financial regulations. These laws and regulations include measures to prevent money laundering, scams, frauds, registration and licensing of crypto exchanges and operators.

Ban: Some countries such as Algeria, Bolivia, China and Egypt have banned completely the use of crypto assets (IFWG, 2021)

It has been noted that the crypto economy in the Sub-Saharan Africa is the smallest when compared with all other regions in the world. It accounted for 2.3% of the global volume of transaction in the period between July 2022 and June 2023 while the total on-chain value which the region attracted within the same period is about USD117.1 billion (Chainanalysis 2023). However, it was also noted that cryptocurrency has become popular in some countries in the Sub-Saharan Africa. For example, Nigeria was ranked as No. 2; Kenya ranked as No. 21; Ghana as No. 29 and South Africa as No. 31 on the 2023 Global Crypto Adoption Index by Chainanalysis (Chainanalysis, 2023). Another study indicated that 9.44% (5.8million) South Africans currently buy, sell or trade in crypto currencies with the expectation that this figure will increase to 43% by the year 2030 (Triple A, 2022).

In recent years, crypto assets have experienced rapid growth and are becoming more relevant within the financial system already being regulated in various countries. Crypto assets and the underlying blockchain technology have the potential to transform the financial landscape in these countries. In swift response to this development, regulators and governments are now considering ways and means of regulating the crypto assets ecosystem in order to protect the players from the increasing risks of fraud and scams as well as the challenges of illegal activities such as money laundering and terrorist financing.

Figure 1: Regulatory developments among countries



Source: Pathways to the Regulation of Crypto-Assets: A Global Approach (Webforum 2023)

In recent years, South Africa has shown interest in crypto assets. A good number of people are investing in crypto assets. Aside this, a good number of people engage in the development of blockchain while others engage in entrepreneurship through start-ups and tech-companies. The blockchain developers, entrepreneurs and banks are also exploring various ways by which blockchain technology operations could be improved to provide better satisfaction to the traders of crypto assets.

The main reason why crypto-assets ecosystem needed to be regulated was to protect the traders of crypto assets in view of the high risk involved in the trade. Again, the fall and death of crypto businesses including Futures Exchange (FTX) in the year 2022 necessitated the need for better regulatory framework for crypto assets in South Africa.

Theory of regulation

According to Morgan and Yeung (2007), a theory of regulation is a set of propositions or hypotheses about *why* regulation emerges, *which actors* contribute to that emergence and typical *patterns of interaction* between regulatory actors. These authors classified theories of regulation into two categories; theories "*that assume a relatively clear dividing line between public and private actors and institutions while others view the line as blurred both in theory and practice*" and other theories "*that focus mainly on economically defined goals, factors and influences, while others supplement this focus with attention to more broadly defined political goals, factors and influences*" (Morgan & Yeung, 2007).

However, Cary Coglianese (2017) stated that in view of the similarities in various regulations, the major differences between them can be understood within the context of four components. The first component is the regulator, the second is the target; the third is the type of command while the fourth is the type of consequences. According to this author, a good understanding of these four key components of any regulation "*can help decisionmakers select appropriate responses to problems requiring some kind of regulatory intervention". (Coglianese, 2017).*

A theory of regulation can therefore be said to be a set of propositions developed to understand the reasons for adopting the regulations and those who were instrumental to the adoption of those regulations as well as the forms of interactions expected between the various individuals or organisations within the regulatory system.

In South Africa, crypto currency is legal. This means that the use of crypto currencies by businesses and individuals is legal. This is why many trading platforms and cryptocurrency exchanges are currently operating in the country. However, it must be noted that the South African Reserve Bank has not declared cryptocurrencies as legal tender in the country although businesses and individuals can trade in cryptocurrencies through the registered platforms and exchanges. In other to protect investors in crypto assets from the risks such as scams, cybersecurity threats and market volatility, the government has established some regulatory frameworks.

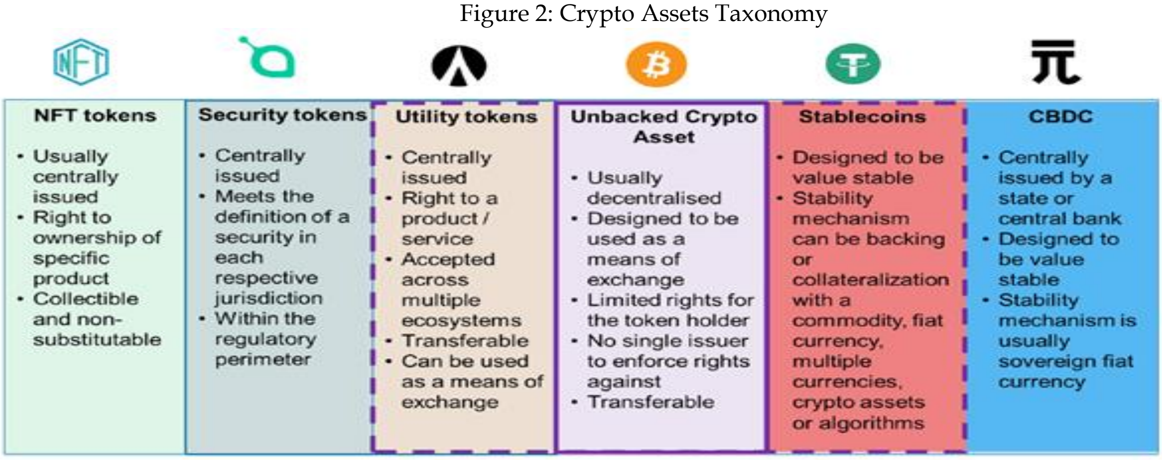
The IFWG CAR WG Position Paper defined Crypto Assets as:

i. *a digital representation of value that is not issued by a central bank, but is capable of being traded, transferred or stored electronically by natural and legal persons for the purpose of payment, investment and other forms of utility.*

ii. applies cryptographic techniques; and

iii. uses distributed ledger technology (DLT)

Figure 2: Crypto Assets Taxonomy



Source: Regulating the Crypto Ecosystem the Case of Unbacked Crypto Assets, IMF note 2022/007

According to the IFWG (2021) and IMF (2022) Crypto assets have been categorised as follows:

Non-Fungible Tokens (NFT) – A unique digital asset that represents ownership of a specific item or asset e.g. art, music, in-game items, videos, and more.

Security tokens - are tokens that provide the holder with rights like that of traditional security.

Utility tokens - are tokens which provide the holder with access to an existing or prospective product or service.

Unbacked crypto assets - These crypto assets are transferable, primarily designed to be used as a medium of exchange and are often decentralised.

Stablecoins - This type of crypto asset aims to have a stable price value. This objective is normally pursued by the crypto asset being linked to a single asset or a basket of assets, for example, fiat funds, commodities such as gold, or other crypto assets. Prominent examples include Tether, Binance USD, and USD Coin.

6.Central Bank Digital Currency (CBDC) - A CBDC can be defined as a form of money that is denominated in fiat currency (central bank money), in an electronic form (SARB)

Crypto assets functions and activities

The crypto asset market showcases a variety of roles and activities with some likened to those found in the traditional financial system. Some of these essential functions are summarised in the table below:

Table 1: Essential Functions and Activities in the Crypto Asset Ecosystem

Functions	Activities
Creation, issuance, distribution, redemption and underlying infrastructure	• Creating, issuing, and redeeming crypto-assets, distribution, underwriting, placement, market-making, marketing, and sales • Operating infrastructure and validating transactions
Wallets and custody	• Provision of custodial (hosted) wallet and custody services • Provision of non-custodial (unhosted) wallets
Transfer and transactions	• Payment for/of goods, services, gifts, and remittances. • Exchange between crypto-assets or against fiat currencies, clearing and settlement
Investment, leverage and risk management	• Use as collateral to borrow/purchase other crypto assets • Trading/borrowing/lending of crypto assets • Direct/outright exposures to crypto assets • Synthetic/derivative exposures to crypto assets

Source: FSB Regulation, Supervision and Oversight of Crypto-Asset Activities and Markets Consultive document 2022

Development of crypto assets regulatory framework in South Africa

In South Africa, the process of understanding and documenting issues relating to crypto assets was initiated in 2014 through a joint initiative of the South African Revenue Service (SARS); the South African Reserve Bank (SARB), the Financial Sector Conduct Authority (FSCA); the Financial Intelligence Centre (FIC) and the National Treasury. These bodies issued a statement to the public alerting them of the inherent risks of crypto assets.

The Intergovernmental Fintech Working Group (IFWG) was established in 2016 for the purpose of gaining the understanding of the ever-increasing role of fintechs and innovation in the financial sector of South Africa. The group was also established to explore how risks and opportunities can be assessed more proactively in both traditional financial and the crypto assets markets. The IFWG's Innovation Hub was established to foster collaborative efforts of the IFWG, through participation with other organisations such as the South African Reserve Bank (SARB), the Financial Sector Conduct Authority (FSCA); the Financial Intelligence Centre (FIC); the South African Revenue Service (SARS); the National Credit Regulator (NCR); the Competition Commission and the National Treasury.

The Crypto Assets Regulatory Working Group (CAR WG) of the Intergovernmental Fintech Working Group (IFWG) published the final Position Paper (CAR Paper) on crypto assets for South Africa in June 2021 termed the IFWG: CAR WG Position Paper on Crypto Asset. This position paper signified a regulatory and policy response to crypto assets activities in South Africa. The CAR-WG made 25 recommendations for crypto assets and related activities. These recommendations include the definition of entities providing crypto assets services; amendment of FIC Act by adding CASPs to the list of accountable institutions; the Financial Intelligence Centre (FIC) will assume the supervisory role and duties to ensure compliance by those CASPs that would become accountable institutions with the requirements of the FIC Act; the CAR WG will continue monitoring the crypto asset ecosystem as well as defining and implementing monitoring programmes to track progress with the implementation of the recommendations; Crypto assets will remain without legal tender status and not be recognised as electronic money.

Crypto assets will not be allowed for settlement obligations in financial market infrastructures such as the South African Multiple Option Settlement (SAMOS) system; the Financial Surveillance Department of the South African Revenue Board (SARB) should assume the supervisory and regulatory responsibility for the monitoring of cross-border financial flows in respect of crypto asset services; Crypto Assets Trading Platforms (CATPs) should be required to report crypto asset transactions to the Financial Surveillance Department of the SARB; CASPs offering custodial services and/or digital wallet provisioning should be accommodated within the appropriate licensing activity under the CoFI Bill, and as a financial service as contemplated under section 3(1) of the FSR Act; the current stance that collective investment schemes and pension funds should not be allowed to have exposure to crypto assets should be maintained and many other policy recommendations

The CAR WG Paper also provides a roadmap for a regulatory framework for CASPs. The CAR Paper proposed the FSCA to be the regulatory authority to license, supervise and investigate Crypto Asset FSPs.

In November 2020, FSCA published a draft for public comments on the declaration of crypto assets as a financial product within the FAIS Act. This declaration was also aimed at providing a form of control for the CASPs and assist in mitigating the risks in the crypto assets sector. However, the proposed Conduct of Financial Institutions Bill (COFI) will become an instrument for achieving these objectives after the CAR WG had concluded discussions in this regard.

In October 2022, crypto assets referred to as a 'digital representation of value' was officially declared as a financial product in terms of the FAIS Act. Crypto assets were therefore subject to section 1(h) of the Financial Advisory and Intermediary Services Act (FAIS). All existing crypto assets service providers were also mandated to register with FAIS by the end of 2023. They were also expected to register with the Financial Intelligence Centre (FIC) as well as complying with Anti-Money Laundering (AML) and the Counter -Terrorist Financing (CTF) requirements. The effect of this declaration is that individuals and businesses acting as brokers or advisors in respect of crypto assets are expected to register as an FSP. The declaration also placed a significant regulatory controls and licensing regime under the oversight and supervision of FSCA. (FSCA FAIS Notice 90 of 2022; FAIS Act, 2002).

As a follow up to the declaration, an information was published by the FSCA through paragraph 3(2) of the FSCA FAIS notice of 2022 demanding that all Crypto Asset FSPs to provide information on their businesses and its operations.

It is envisaged that other relevant issues with respect to crypto assets will be addressed by COFI Bill as a form of legal framework governing the conduct of all financial institutions in South Africa. Broad regulations regarding financial activities in the crypto assets sector will be included in the licensing conditions to be specified in the COFI Bill beyond the scope of crypto assets activities which are currently under the scope of the Financial Advisory and Intermediary Services (FAIS) Act.

In South Africa, advertisements of crypto assets are now regulated by the South African Advertising Regulatory Board through its Code of Advertising Practice amended in January 2023 to accommodate new requirements for advertisement of crypto assets. These new requirements demand that advertisers of crypto assets must state that investments in crypto assets may lead to capital loss so that members of the public investing in crypto assets will exercise caution. In addition, professionals, influencers, and ambassadors operating in the crypto assets social media space must also comply with the rules in the social media code to avoid sending wrong and misleading messages to the public.

On taxation, the South African Revenue Service (SARS) classifies crypto assets as intangible assets. Therefore, any gains from trading in crypto assets are subject to tax on a rate depending on the trader's income tax bracket. However, the current maximum rate of 45%.

Conclusion

In view of the growing interest in crypto assets in some countries in Sub-Saharan Africa including South Africa, the need for crypto assets laws and regulations cannot be overemphasised. These laws and regulations are necessary to the protect the investing public from the cyber threats and volatility in the crypto assets market as well as ensuring the stability and growth of the crypto assets sector. South Africa is one of the countries that has taken the bull by its horns through the enactment of laws and the development of regulatory frameworks on crypto assets.

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