

Kirill Greshnikov
Associate
AEQUITAS Law Firm
www.aequitas.kz

NEW IN THE REGULATION OF DIGITAL ASSETS IN KAZAKHSTAN

Digital assets (including cryptocurrencies) are of great potential for the development and change of the economic and financial world; therefore, to date, many countries actively consider the issues relating to the regulation thereof. The Republic of Kazakhstan ("Kazakhstan") is not an exception and actively improves its legislation in this sphere.

In August 2021, together with N. Sholanov we published an article "Cryptocurrency and specifics of operation of cryptocurrency exchanges in Kazakhstan"¹, which considered the key principles and concepts relating to cryptocurrency. From the moment of publishing, certain significant amendments have been introduced into the legislation regulating the use of cryptocurrency and digital assets, therefore, this article presents more relevant information with due regard to the latest amendments.

1. General Information on the New Law on Digital Assets²

For many years, digital assets in Kazakhstan were actually beyond the sphere of application of legislation and their use and circulation were not properly regulated. To change the situation Kazakhstan adopted the Law on Digital Assets, which entered into force on 1 April 2023 and is focused on the regulation of activities in the sphere of digital assets issue and circulation.

The key purposes of the Law are as follows:

- **support of innovations:** adoption of the Law will potentially ensure favorable environment for the development of new technologies and innovations relating to digital assets. It may help developing the blockchain technologies and creating new types of digital assets and relevant services on their basis.
- **investment raising:** well developed and effective legislative framework could attract more investments in digital assets, which may increase their value and total volume of the digital market of Kazakhstan.

The Law consists of 5 sections, which include 14 Articles, and may be conditionally divided into 3 key blocks:

- regulation of mining activities;
- regulation of exchange and trade in digital assets; and

¹ N. Sholanov, K. Greshnikov "Cryptocurrency and specifics of operation of cryptocurrency exchanges in Kazakhstan". https://forbes.kz/finances/exchange/cryptocurrency_and_specifics_of_operation_of_cryptocurrency_exchanges_in_kazakhstan/

² Law No. 193-VII of the Republic of Kazakhstan "On Digital Assets in the Republic of Kazakhstan" dated 6 February 2023 (the "Digital Asset Law" or the "Law").

- regulation of the issue of secured digital assets.

It was expected that adoption of the Digital Asset Law would positively affect the development of digital market and mining in Kazakhstan providing for the legal basis for the regulation of activities of the market participants and better protection of the rights of investors. However, the current version of the Law can hardly improve the situation on the digital market and is actually one of the first careful steps of the law-maker on the way to introduce and use the new facilities in Kazakhstan.

Nevertheless, due to the Law, Kazakhstan will see new regulated market participants, such as digital mining pools, and miners will enjoy better protection after a while, which may stimulate the market development in perspective.

2. Regulation of Secured Digital Assets

One of the key novelties introduced by the Law is more detailed regulation of secured digital assets. Thus, the Law updated and set out the term "digital asset" in a more detailed manner, which now establishes that a digital asset must be assigned a digital code and that it is secured by the fact of invariability of information on the basis of the distributed data platform technology. Specifically, a secured digital asset is now defined as a variety of a digital asset registered by way of a digital platform for the storage and exchange of secured digital assets, which certifies the rights to tangible, intellectual services and assets, except for money and securities (Article 1 of the Digital Asset Law).

The Law also provides for requirements set to secured digital assets, according to which to recognize a digital asset as a secured asset, such asset must:

- certify rights to tangible, intellectual services and assets (except for money and securities);
- have a respective resolution of a person issuing a digital asset regarding the issue of a secured digital asset;
- not be a unit of account or a legal means of payment;
- contain information on a person issuing such secured digital asset;
- have confirmation of property and/or intellectual rights to the asset before its origination as a secured digital asset; and
- have record in a blockchain on movement of the asset and/or right to property (Article 5 of the Digital Asset Law).

Secured digital assets may only be issued by individual entrepreneurs or legal entities of Kazakhstan operating a digital platform for the storage and exchange of secured digital assets and holding a permit for the issue and circulation.

It is worth mentioning that the Kazakhstan law-maker ran counter to the practice of referring digital assets to secured assets established on the cryptocurrency market. Specifically, it is traditionally considered that secured cryptocurrency (as one of a variety of digital assets) is a cryptocurrency, value of which is directly dependent on tangible assets (movable and immovable property, money, precious metals, etc.). For example, Digix Gold Token is considered as one of the most secured cryptocurrencies, which are secured by the most stable precious metal, i.e. gold. This cryptocurrency was issued in March 2018 and its market capitalization now reaches USD 5.3 mln.

Secured cryptocurrencies also called as a "stablecoin" allow guaranteeing stable rate of exchange and prevent from exceptional depreciation of cryptocurrency. The most striking

and obvious instance of a secured cryptocurrency is Tether (USDT), the exchange rate of which depends on the USD exchange rate.

While launched in 2014 by Tether Limited, Tether became a "pioneer" stablecoin and is now the best-selling cryptocurrency in the world. Tether tokens offer stability and simplicity of fiat currencies³ in combination with the innovative nature of blockchain technology, representing an ideal combination of traditional money and cryptocurrencies. It is worth mentioning that all Tether tokens (USDT) are 1 to 1 dependent on a respective fiat currency – US dollar (i.e. 1 Tether = USD 1) and secured by the reserves of Tether. The reserves of Tether Limited exceed the amount required to repay all currently circulated Tether tokens (or at least equal to such amount). At the same time, for the purpose of proper security of USDT, Tether Limited issues auditor opinions each quarter. Such opinions are drafted by BDO Italia and clearly show that all Tether tokens are fully secured by fiat reserves.

Despite the fact that such digital assets are recognized, deemed to be and used exactly as secured digital assets on the digital market, as a matter of fact they do not fall under the requirements set to secured digital assets by the Kazakhstan law-maker. For example, Tether stablecoin was not issued by a Kazakhstan legal entity or an individual entrepreneur, in which connection secured cryptocurrencies recognized worldwide will not be recognized as such in Kazakhstan, but will be referred to unsecured digital assets, which is, in our view, a wrong-headed approach.

Thus, we can say that the existing issues of activities with digital assets in Kazakhstan and the AIFC are at the initial stage of solution and require elaboration of additional acts.

3. Legal Status of Cryptocurrency as an Unsecured Digital Asset

The first attempts of legal regulation of cryptocurrency in Kazakhstan were made by the law-maker in 2020 by adopting the Kazakhstan Law dated 25 June 2020⁴, which introduced new provisions on digital assets into the Kazakhstan legislation. This law defined cryptocurrency (unsecured digital asset) as property.

The Digital Asset Law did not significantly amend the legal status of cryptocurrency and, accordingly, cryptocurrency is still defined as property. In fact, cryptocurrency is a variety of a digital asset, which is not a means of payment and may be divided into two types: secured and unsecured digital assets.

To date, major part of cryptocurrencies are unsecured, and the prices for such cryptocurrencies are formed by the market demand only. Prior to adoption of the Digital Asset Law the Kazakhstan legislation provided for an express prohibition against the issue and circulation of unsecured digital assets in the territory of Kazakhstan with an indication that otherwise may be stipulated by the laws of Kazakhstan. Such wording gave rise to an element of uncertainty, because at that time there were no legislative acts regulating the issue and circulation of unsecured digital assets.

As expected, the law-maker's approach did not change in the Digital Asset Law, in which connection it is still prohibited to organize the issue and circulation of unsecured digital assets. However, this Law introduced certain clarity into the matters relating to the issue of unsecured digital assets, and it was established that the issue and circulation of such assets are prohibited, except for the territory of the Astana International Financial Centre (AIFC)

³ Money the nominal value of which is established and guaranteed by the state (KZT, USD, EUR, etc.).

⁴ Kazakhstan Law on Introduction of Amendments into Certain Legislative Acts of Kazakhstan on the Issues of Regulation of Digital Technologies dated 25 June 2020.

where the cryptocurrency related activities are permitted in case of complying with strict requirements established by the AIFC acts.

4. Regulation of Digital Assets in the AIFC

To date, there are cryptocurrency exchanges working in the AIFC and it is allowed to work with unsecured digital assets there.

Requirements to cryptocurrency exchanges and their licensing procedure are determined by the AIFC acts, according to which a digital asset (cryptocurrency is a variety of a digital asset) is defined as an independent item of circulation. The official definition of a digital asset given in the AIFC Glossary⁵ shows that a digital asset represents a numeric expression of value, which is used as a means of exchange, unit of account or a store of value, and may be bought or sold for a fiat currency, and the digital asset is not guaranteed by the government of any jurisdiction. At the same time, cryptocurrency in the AIFC may be considered as an independent investment vehicle.

To carry out the cryptocurrency exchange activities in the AIFC it is necessary to obtain a relevant license – "Operating a Digital Asset Trading Facility". According to the AIFC acts, management of a cryptocurrency exchange includes the activities carried out to enter into contracts between the counterparties with a view to buy, sell or exchange digital assets for a fiat currency, as well as to exchange one digital asset for another.

To start functioning in the AIFC cryptocurrency exchanges must strictly comply with requirements established by the AIFC acts, among which are compliance with technological requirements, obtainment of a license, etc.

The key document in the course of licensing of a cryptocurrency exchange in the AIFC is a high quality business plan.

To obtain a license it is necessary to confirm the fact of compliance with the mandatory conditions of the AIFC, as well as to perform additional actions and submit additional documents, among which are:

- internal control documents (policies on counteraction against laundering of illegally gained proceeds and financing of terrorism, management risk, prevention and settlement of the conflict of interests, compliance monitoring programs and procedures, investment strategy), and a business plan;
- selection of candidates to the key (Approved) and important (Designated) roles – CEO (General Director), CFO (Financial Director), Compliance Officer (employee responsible for compliance with regulatory requirements), MLRO (employee responsible for the money laundering reporting), Internal Audit Manager, Risk Officer (employee responsible for mitigation of risks). The said list of employees is not exhaustive and in a number of cases, if so agreed upon with the AIFC, additional positions may be included in the list or, on the contrary, certain positions will not be required.

More precise requirements to a cryptocurrency exchange will be determined in the course of discussions with the regulator⁶, because the AIFC considers each case on an individual basis.

To obtain a license an applicant company must pay a respective licensing fee in the amount of seventy thousand US dollars (USD 70,000). However, in light of the fact that Kazakhstan

⁵ AIFC GLOSSARY, AIFC act No. FR0017 of 2018.

⁶ In this case, the regulator will be the Astana Financial Services Authority (AFSA).

considers activities with cryptocurrency as innovative activities, the license will be obtained in the framework of a specialized regulatory sandbox, which provides for preferential conditions for innovative activities (Fin Tech Lab under the AIFC). In this case, the amount of the licensing fee will be 10% of the full amount, i.e. USD 7,000. The license term is 2 years of the moment of its issue.

One of the steps of the licensing process is obtainment of the In-Principle Approval (preliminary approval), which is a part of the entire licensing procedure. In other words, this is a principle approval of the license issuance with certain conditions. Obtainment of the In-Principle Approval prior to registration of a new company with the AIFC is required to understand in general the possibility to obtain the license in the future and the scope of conditions for the license issuance, which are developed by the AFSA for each project depending on the type of activities and the documents submitted at the initial stage. Such pre-authorization conditions normally include setting up of a company, formation of the charter capital, further work on policies, submission of qualification documents for the management personnel, etc. The application must be submitted together with a number of corporate documents, which include about 7 different internal policies of a company.

After obtaining the In-Principle Approval, it is possible to start registering the very company with the AIFC. According to the existing practice, to register a company with the AIFC it is necessary to submit at least the following documents:

- 1) resolution of the shareholders or the board of directors to set up a company in the AIFC;
- 2) charter or foundation agreement of the registered company;
- 3) filled out application forms for registration;
- 4) copies of passports of the shareholders, directors, partners and other individuals involved in registration;
- 5) copy of a certificate of registration/certificate of state registration of the founder (in case one of the shareholders or partners is a legal entity);
- 6) copy of the charter of the parent company; and
- 7) information on beneficial owners of the company.

5. Current Status of Mining

One of the most important novelties is that the Law referred mining to licensable types of activities.

Digital mining is a process of generation of new blocks in a blockchain, which is performed on account of computing capacity of a computer. In other words, digital mining is the mining of digital assets (specifically, cryptocurrency).

Prior to entry into force of the Digital Asset Law, issues relating to the procedure for regulation of digital mining were governed by certain provisions of the Informatization Law⁷.

Specifically, with respect to mining the Informatization Law provided for a notification procedure in case of commencement of activities, according to which a miner had to properly inform a governmental agency regarding digital mining activities. As a rule, this notification procedure did not give rise to any complexities and only required submission of relevant information and documents by a miner.

⁷ Law No. 418-V of the Republic of Kazakhstan "On Informatization" dated 24 November 2015.

This approach drastically changed with the adoption of the Law. From now on, to carry out mining activities it is necessary to obtain a special license, which is issued for two categories:

- category I — digital miners owning relevant infrastructure – data processing centers meeting respective requirements to equipment, location and safety;
- category II — digital miners owning equipment who lease slots at the data processing centers and do not pretend for the energy quota.

Licensing of digital mining allows the state to exercise control over the activities of miners and ensure compliance of their activities with legislation requirements. This also allows protecting the rights and interests of investors and users of cryptocurrency.

To obtain a license miners need to confirm that they meet the qualification requirements, among which it is worth distinguishing as follows:

- miner must have the status of a Kazakhstan legal entity or an individual entrepreneur;
- miner must have under the right of ownership or any other legal ground a digital mining data processing center or a right to place software and hardware complex for the purpose of digital mining in the data processing center held under the right of ownership; and
- it is allowed to carry out mining activities only through a digital mining pool.

According to provisions of the Law, mining is now assessed as the business activities only. The state tries to strengthen regulation of these activities to avoid potential problems with uncontrolled mining. At the same time, the law-maker established a prohibition on any other business activities for the persons engaged in digital mining.

6. Digital Mining Pool

It is highly interesting how the law-maker decided to "force" miners to mine through the digital mining pools, which the Law actually made a new regulated entity of the Kazakhstan market.

A digital mining pool (DMP) is an *"accredited legal entity providing the service of uniting the capacities of the software and hardware complex for the digital mining of digital miners, which distributes digital assets among the digital miners, which were gained as a result of their joint activities"* (Article 1.10 of the Digital Asset Law).

In other words, DMP is a union of miners for joint work. The idea of DMPs is that miners unite their computing capacities/resources and work together to mine cryptocurrency. In fact, DMPs provide miners with the services on the basis of some sort of "membership" of miners with DMPs.

As such DMPs are not unique and new for the cryptocurrency market and have been used for a long period of time by miners, because they allow mining cryptocurrency in a more convenient, profitable and simpler way.

When miners unite their computing capacities, they work together to mine cryptocurrency. Once they mine cryptocurrency, it is divided among the miners depending on the scope of computing capacity contributed by each miner to their joint activities. This is the essence of DMPs.

It is assumed that DMPs should give advantages to miners as compared with independent mining. The key advantage is a greater probability to find a block (mine cryptocurrency).

Concurrently with a greater probability to mine cryptocurrency DMP guarantees that the award for a found block (mined cryptocurrency) will be distributed among all DMP members in proportion to their contribution to work, which allows gaining income even in case of having small capacities and mitigates the risk of zero income.

The important advantage of DMP is convenience and reliability. Many DMPs provide convenient interface to monitor over the mining process and get statistical information on income.

However, use of DMPs for the Kazakhstan miners bears a number of disadvantages. An obvious disadvantage is the fact of "forcing" miners to mine cryptocurrency through DMPs. Such decisions made by the law-maker scarcely ever get positive reaction from the market entities. Some miners say that this limits their freedom of choice and control over the mining process. Furthermore, mining pools may be centralized and controlled by few participants, which contradicts the ideology of decentralization.

Another disadvantage is the presence of fees, which DMPs normally charge for their services, which may reduce the total income from mining. Since miners must carry out their activities through DMPs now, the first pools appearing in Kazakhstan may potentially set high fees and miners will have to agree. This disadvantage is closely connected with the issue of centralization, because work in a pool may result in greater centralization, since major part of computing capacities may be gathered by several major pools, which will "dictate" the rules.

Another disadvantage may be a security risk. Mining pools may be exposed to hacker attacks, which may lead to the loss of income of all miners of a pool. As a rule, the mined cryptocurrency is not stored at DMP; however, we do not exclude that the Kazakhstan pools may choose another way and decide to force miners to store cryptocurrency in an internal wallet until distribution.

The Law contains a restriction, which is of great importance for mining. This restriction obligates all Kazakhstan miners to sell at least 75%⁸ of the mined digital assets (in case of selling them) only through the specialized exchanges holding a license of the Astana International Financial Centre. The remaining 25% of digital assets may be sold on foreign exchanges. This may be considered, in fact, as a kind of restriction of access to international cryptocurrency markets, because major part of cryptocurrency mined in Kazakhstan will not leave the country. This restriction will also allow the governmental agencies to collect and process more precise information on the income of digital miners and DMPs for the purpose of taxation.

Development of mining in Kazakhstan may potentially become an important factor of the country's economic development, but this requires elaboration of a clear and transparent regulatory framework with due account for potential negative consequences.

⁸ Until 1 January 2025, this restriction obligates miners to sell at least 50% of digital assets.