Chainalysis

APAC CRYPTOCURRENCY REPORT

Economic trends, regulatory updates, and blockchain analysis enhancements

October 2019

Table of Contents

Introduction: Applying Global Regulatory Guidance in APAC

In June 2019, the Financial Action Task Force (FATF), the inter-governmental body that sets global standards related to anti-money laundering and combating the financing of terrorism (AML/CFT), published its much anticipated guidance on how its 200+ member and observer states, including Japan and the Republic of South Korea, will have to start regulating virtual asset markets in their jurisdictions.

FATF's guidance represents the first major step toward global regulatory clarity, and will have a major impact on the cryptocurrency industry. The minimum requirements it expects from regulators far surpasses current efforts in most countries, and countries will suffer serious economic consequences if they are evaluated to be deficient regarding AML/CFT during mutual evaluations.

Long-term, this regulatory guidance will formalize AML/CFT best practices and help the cryptocurrency industry mature and achieve more mainstream adoption. In the short-term, regulators, financial institutions (FIs), and industry participants will need to further invest in mitigating the risk of money laundering in line with previous recommendations for other value transfer mechanisms.

Each of FATF's member and observer states are now expected to leverage its guidance as a framework for developing or augmenting their own regulations for their individual jurisdictions within a year. After FATF's revised methodology for mutual evaluations is adopted, countries will be assessed based on the new guidance.

Notably, FATF's recommendation 16, which mirrors the "Travel Rule" in the U.S., requires Virtual Asset Service Providers (VASPs) to send originator and beneficiary information to other VASPs or financial institutions who are counterparties to transactions over 1000 EUR/USD (the threshold for the Travel Rule is 3000 USD). This presents a substantial technical obstacle for cryptocurrency businesses to implement the "secure" and "immediate" transfer of information to other obliged entities.

In this report, we examine economic trends in APAC, which highlight the importance of APAC's flourishing cryptocurrency ecosystem to the success of cryptocurrency overall and what's at stake for businesses in the region in terms of regulatory compliance. We also discuss how regulatory activity in both Japan and the Republic of South Korea is pushing toward alignment with FATF, including implementation of recommendation 16. Finally, we share how Chainalysis compliance technology can assist cryptocurrency businesses meet FATF's requirements.

Jesse Spiro, Head of Policy, Chainalysis

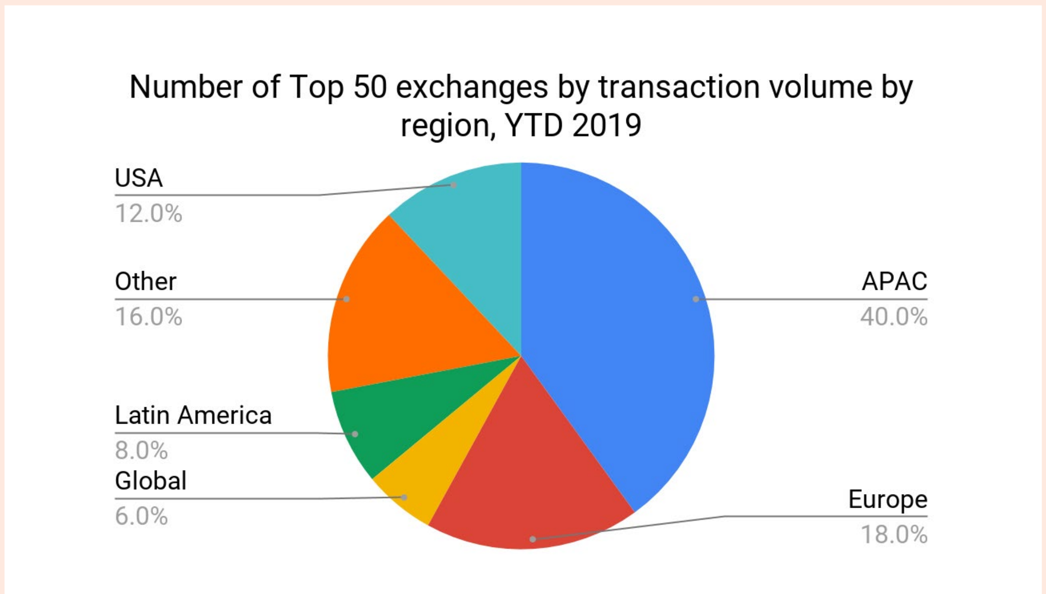
APAC Cryptocurrency Economic Analysis

In order to examine regional economic trends, we needed to map which exchanges were in which region. Because exchanges often operate out of one region but serve customers across borders, simply knowing where an exchange is headquartered isn't the best way to understand which market(s) it serves.

There is no single indicator we use to determine an exchange's market categorization. We attribute exchanges to certain markets by analyzing several factors, including top fiat trading pairs, web traffic origin, company registration and public sourcing information, and conversations with exchanges directly. We categorize global exchanges as exchanges whose activity is not concentrated in one region, but rather is dispersed across many regions. Examples of global exchanges include Binance and Bitfinex.

Here's what we found related to the APAC region.

40% of the Top 50 Exchanges in Terms of Bitcoin On-Chain Activity Are in APAC



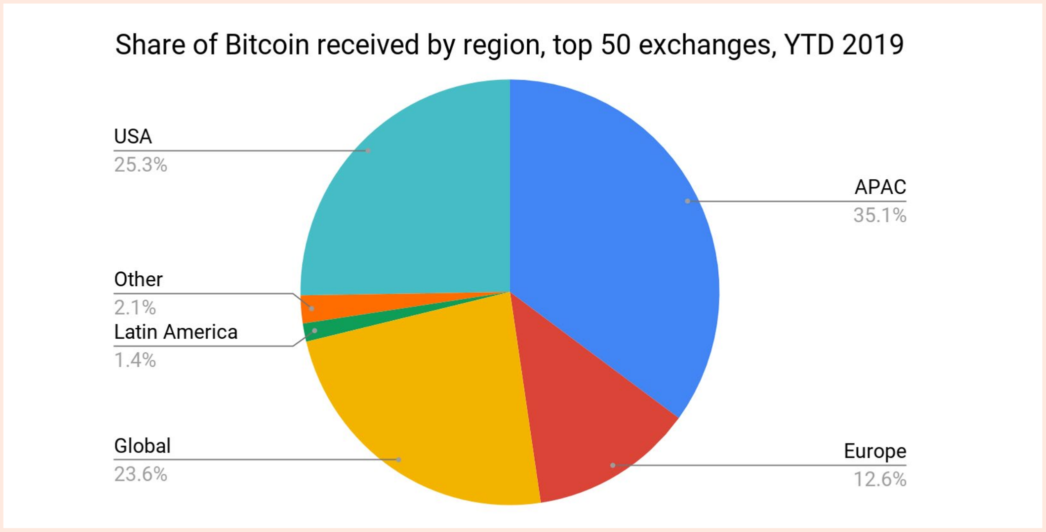
Source: Chainalysis

Based on Chainalysis on-chain transaction data from the first half of 2019, 20 of the top 50 exchanges are in APAC, followed by 9 in Europe, 8 in other regions, 6 in the U.S., 4 in Latin America, and 3 global.

Within the APAC region, most exchanges are in China, followed by the Republic of South Korea and Japan.

Exchanges in APAC receive and trade the most Bitcoin

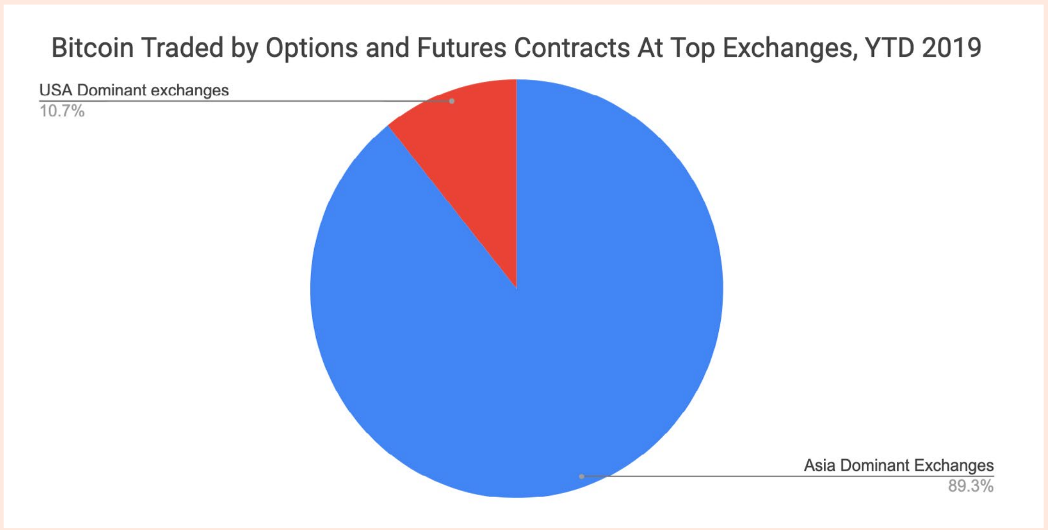
There is more demand for Bitcoin in APAC than in any other region, which in turn drives the high number of cryptocurrency businesses in the region.



Source: Chainalysis

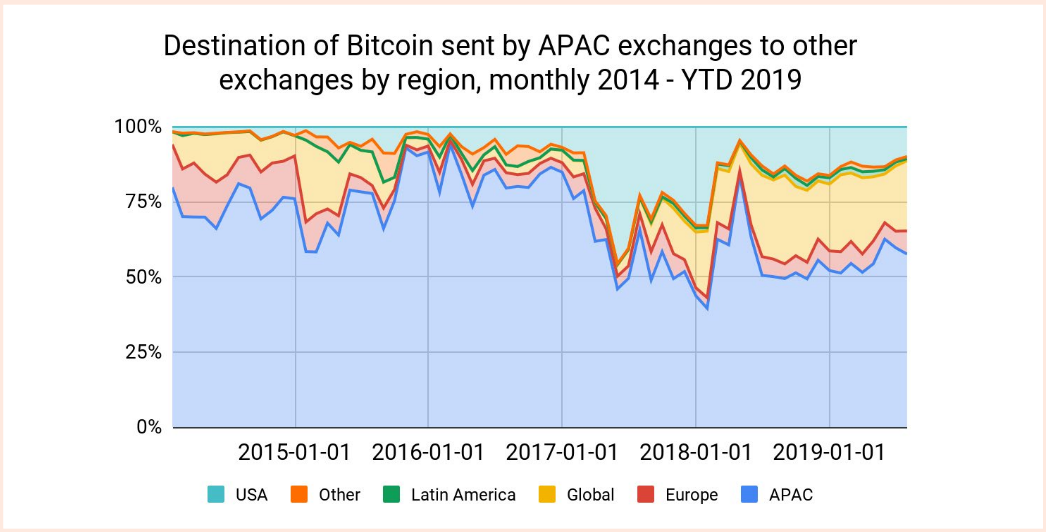
Of the top 50 exchanges, APAC exchanges received the most Bitcoin in the first half of 2019, accounting for 35% of Bitcoin received. Exchanges in North America followed, and global exchanges came in a close third. The largest exchange in APAC in terms of total Bitcoin received was Huobi.

APAC exchanges' share of spot trading volume, which accounts solely for immediate purchases of cryptocurrencies, was in line with other markets. But APAC exchanges dominate the trading of options and futures contracts, with nearly 90% of the 2.36 billion contracts traded.



Source: Kaiko and Chainalysis

APAC Exchanges Primarily Transact with Other APAC Exchanges

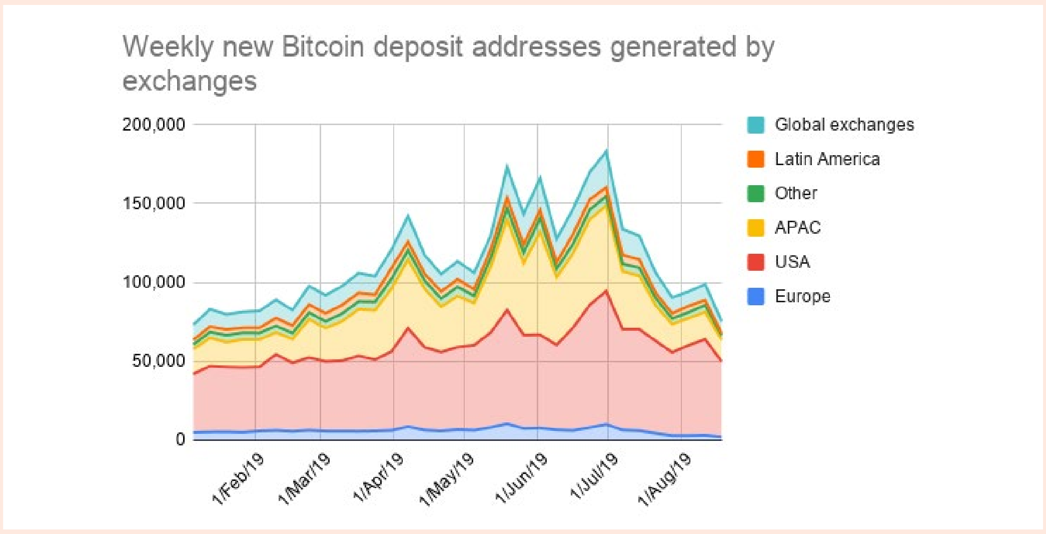


Source: Chainalysis

After the Bitcoin rally and China's tightening oversight of cryptocurrency in 2017, nearly 50% of all funds left the APAC region and went to U.S. exchanges. The subsequent flow of funds out of the U.S. and Europe to global exchanges may be the result of stricter KYC requirements in those two markets. Global exchanges also began to offer more coins for people to trade in the second half of 2017 and therefore became more attractive to professional traders.

Still, from 2014 through the first half of 2019, APAC exchanges sent a majority of their funds to other APAC exchanges. China-based OKCoin was the largest sender and receiver of inter-APAC transactions. Outside of APAC, Bittrex received the most funds from the region, followed by Binance and Bifinex.

APAC exchanges added 1 million Bitcoin deposit addresses in the first half of 2019

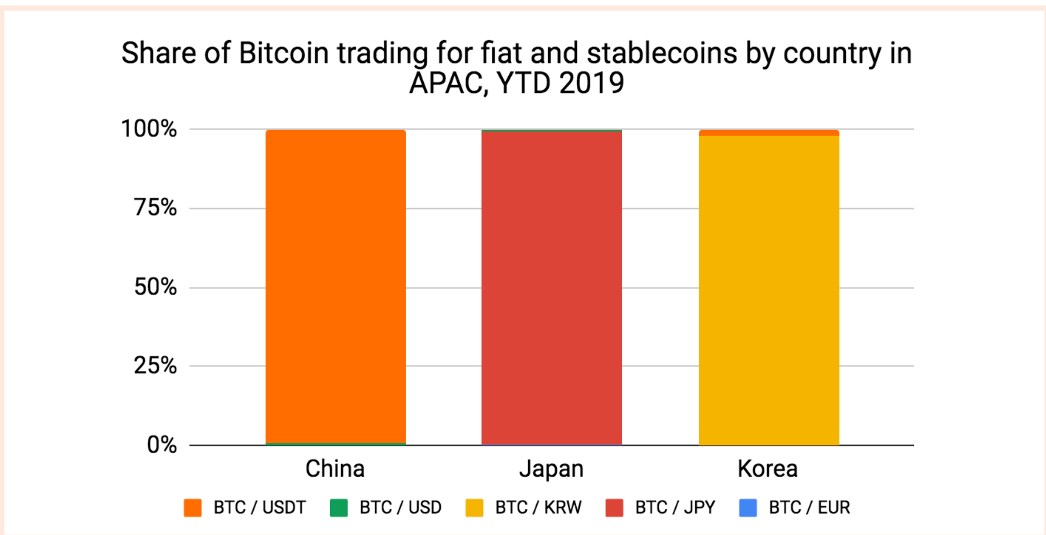


Source: Chainalysis

Exchanges in the United States added the largest number of bitcoin deposit addresses, adding 1.8 million. APAC exchanges have added the second largest number of deposit addresses through August of this year, adding 1 million. APAC exchanges saw a particularly large increase in new deposit addresses in May and June relative to other regions, as the Bitcoin price started to increase. However, new deposit address creation fell most dramatically in APAC after that peak, to its lowest level this year, whereas new deposit addresses at exchanges in the United States have remained relatively high.

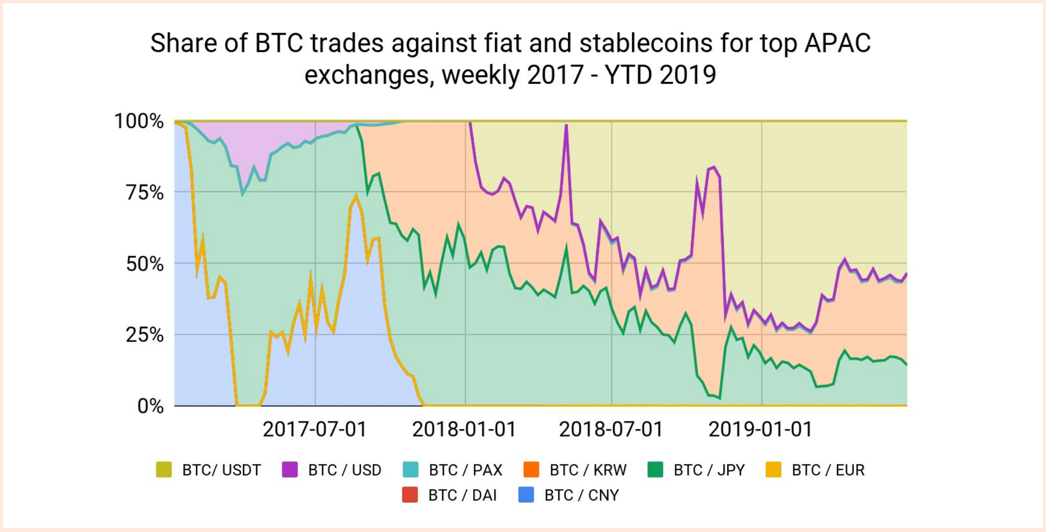
The number of new Bitcoin deposit addresses created at exchanges provides an estimate of user engagement with Bitcoin. Examining this activity provides an upper bound estimate of the number of new people interacting with exchanges on the Bitcoin blockchain, but it should not be considered an upper bound estimate of the total number of new people on exchanges. This is because a person can have multiple deposit addresses on an exchange, and can make deposits on multiple exchanges. People can also interact with some exchanges by making fiat deposits, which would not result in a new bitcoin deposit addresses. They can also interact with exchanges via deposits in other cryptocurrencies. However, as the majority of Bitcoin transactions are currently to and from exchanges, new Bitcoin deposit addresses is a relevant metric of overall user engagement with Bitcoin.

While the vast majority of Bitcoin trading pairs in Japan and Korea trade against traditional fiat currency, 99% of Bitcoin spot trades in China are now against Tether



Source: Kaiko and Chainalysis

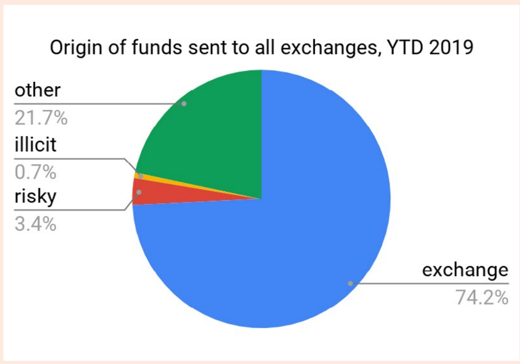
Japanese exchanges only trade using the Japanese Yen, and Korean exchanges mostly trade using the Korean Won, indicating strong banking relationships with established exchanges that accept fiat. Meanwhile, in China, Tether has become the most popular currency in Bitcoin to fiat and stablecoin trading pairs.

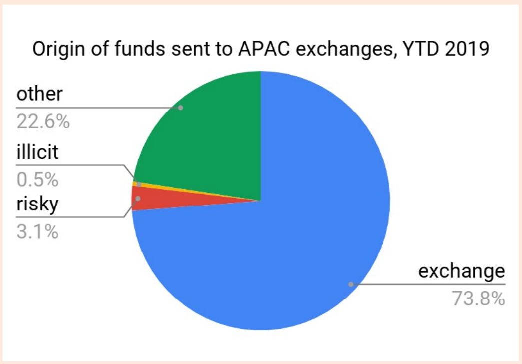


Source: Kaiko and Chainalysis

As visualized in the chart above, this transition took place when China outlawed trading between Bitcoin and the Chinese Yuan, and Tether took the Yuan's place as the trading pair of choice. Note the spike in Bitcoin to Korean Won in mid 2018 is likely due to faked trading data.

Illicit and risky activity in APAC is in line with global trends





The majority of funds received by APAC exchanges is from other exchanges, with a total of 3.6% of funds coming from illicit or risky addresses.

22.6% of funds come from other sources, which include merchant services, hosted wallets, mining, unknown activity, and additional categories.

Both Japan and Korea have comparable exposure to risky activity, with approximately 3% of total funds received by APAC exchanges coming from risky categories. But while Japan has a higher concentration of risky activity coming from gambling and high risk exchanges, Korea has higher exposure to peer-to-peer exchanges. Korea has a significantly higher share of exposure to illicit categories than Japan, at 1.1% versus 0.09% respectively, but most of the illicit funds received by Korean exchanges came from scams. Korea received the second most amount of funds from known scams in 2019, second only to China, largely driven by involvement in BitConnect.

Overall, it is difficult to overstate the importance of APAC to global cryptocurrency markets. APAC is home to the most number of top exchanges, receives the most Bitcoin, trades the most volume, and is a driving force in the adoption of stablecoins. As it happens, APAC—Japan and the Republic of South Korea in particular—is also leading the industry in adopting the AML/CFT regulations in line with the FATF guidance.

Japan Regulatory Climate

Historically, the Japan Virtual Currency Exchange Association (JVCEA) has set the standard for regulation and oversight, and has taken a self regulatory approach. To date, the JVCEA is the only self-regulatory organization that exists within the cryptocurrency industry. Recently, however, Japan's Financial Services Agency (FSA) has taken a more active approach in the regulation of the cryptocurrency space, which shows further alignment with the FATF standards.

In May, the Japanese House of Representatives approved a new bill drafted by the FSA to amend two national laws that apply to cryptocurrency assets, the Payments Services Act and the Financial Instruments and Exchange Act.

The proposed amendments seek to: tighten cryptocurrency regulation in order to promote user protection; more staunchly regulate crypto derivatives trading; mitigate industry risks such as exchange hacks; and establish a more transparent regulatory framework for the asset class. The bill also sets limits on cryptocurrency margin trading, capping leverage to two to four times the initial deposit. The revised acts are expected to come into force in April 2020.

The amendments to the Payments Services Act include tighter restrictions on custodial services and security of storage. The amendments to the Financial Instruments and Exchange Act include clarification that Initial Coin Offerings (ICOs), Security Token Offerings (STOs), and derivatives—which make up a large share of the Japanese market—fall under that law.

The revised laws still do not clearly define regulation of anonymity-enhancing cryptocurrencies.

Many believe that Japan's virtual currency regulation will set a global benchmark for regulating the sector, as they have been at the forefront in many respects previously.

Republic of South Korea Regulatory Climate

In August, the Financial Intelligence Unit (FIU) in the Republic of South Korea under the Financial Services Commission (FSC) disclosed a plan to directly regulate cryptocurrency exchanges. Currently, the FIU indirectly controls cryptocurrency exchanges through administrative guidance to banks.

The FIU plans to seek an amendment to the Act on Reporting and Use of Certain Financial Transaction Information, which reflects the FATF's guidance. The amendment is expected to pass the National Assembly.

Once passed, the government will enhance the transparency of cryptocurrency transactions by introducing a "cryptocurrency exchange licensing system," as recommended by FATF.

The Republic of South Korea is particularly inclined to pass measures that improve transparency of cryptocurrency given the increasing amount of hacks cryptocurrency exchanges have suffered in the past year.

The Republic of South Korea also has an ongoing initiative to encourage blockchain technology development by creating regulatory "sandboxes." Busan was recently declared Korea's blockchain "regulation-free" zone, and Jeju Island is redoubling its efforts to earn the same designation to attract industry development.

FATF Recommendation 16 and Blockchain Analysis

FATF recommendation 16 was proposed to assist in building more global financial integrity within the cryptocurrency ecosystem. However, some of the requirements raise serious challenges to the existing technology and ecosystem.

In particular, compliance with recommendation 16 poses a number of challenges for implementation, which can be grouped into two categories:

Protocol

- The technology needs to be able to allow VASPs to share more dynamic identifiers on a scale larger than any existing payment system
- Solutions proposed to date have led to questions regarding scalability and feasibility

Governance

- An entity or entities will need to be established to develop, administer, and maintain solutions
- Thus far, the industry and governments have not been able to agree on a unified governance structure
- There has been difficulty in establishing consensus and adoption around one system

How Chainalysis can help

Chainalysis helps VASPs and financial institutions identify counterparties in real time, one of the most difficult challenges to meet recommendation 16, and has initiated product enhancements to assist in meeting some of the challenges in complying with the recommendation.

Chainalysis has already released the first feature enhancement for its cryptocurrency transaction monitoring solution, Chainalysis KYT (Know Your Transaction): alerts for transactions between VASPs that exceed 1000 USD/EUR.

All VASPs are required to have records on obligated transactions. KYT now enables VASPs to automatically filter, identify, review, and export legacy obligated transactions.

In addition, Chainalysis KYT can assist with monitoring for potential circumvention of recommendation 16. If a VASP sends funds directly to another VASP on behalf of a user without reporting, the VASP should obtain the necessary information from that user to then be transmitted. Alternatively, at the receiving exchange or VASP, a similar check should be performed, and the VASP can ask their user to provide the information regarding the non-compliant transactions.

Chainalysis KYT can also be used to check for “smurfing” or a form of “structuring.” If identified, the user also should be asked to add the information regarding the transactions.

Chainalysis

ABOUT CHAINALYSIS

Chainalysis is the blockchain analysis company providing data and analysis to government agencies, exchanges, and financial institutions across 40 countries. Our investigation and compliance tools, education, and support create transparency across blockchains so our customers can engage confidently with cryptocurrency. Backed by Accel, Benchmark, and other leading names in venture capital, Chainalysis builds trust in blockchains. For more information, visit www.chainalysis.com.

GET IN TOUCH:

info@chainalysis.com

FOR MORE CONTENT:

visit blog.chainalysis.com

Building trust in blockchains