



Markets in Crypto-Assets: FAQ on the European Commission's legislative proposals

October 2020

On 24 September 2020, the European Commission (the Commission) published a proposed regulatory framework for Markets in Crypto-Assets (Proposed Framework) as part of its Digital Finance Strategy for Europe 2020. This FAQ addresses the background and the key proposals contained in the Proposed Framework.

WHAT IS THE BACKGROUND TO THE PROPOSED FRAMEWORK?

Since publication of the EU Fintech Action Plan in March 2018, the Commission has been examining the opportunities and challenges presented by crypto-assets in financial services. Following a review by the Commission, it found that whilst some crypto-assets may fall within the scope of existing EU regulation (such as MiFID II), effectively applying existing regulatory frameworks to crypto-asset activities is not straightforward. Furthermore, some EU Member States already have bespoke crypto-asset regulatory regimes, risking market fragmentation, regulatory arbitrage and distortion of the Single Market in financial services. Against this background, the Commission is proposing a bespoke EU regulatory framework for markets in crypto-assets that promotes markets by embracing crypto-assets as welcome technological advances in financial services facilitating the tokenisation of traditional financial assets.

WHY IS THE PROPOSED FRAMEWORK BEING INTRODUCED?

The reasons cited by the Commission include legal certainty; supporting innovation; introducing appropriate consumer and investor protection in relation to crypto-assets; and ensuring financial stability. The Proposed Framework is in the form of a draft Regulation in order to achieve maximum harmonisation across EU Member States' regulatory treatment of markets in crypto-assets.

ARE 'STABLECOINS' REGULATED UNDER THE PROPOSED FRAMEWORK?

Stablecoins are crypto-assets that seek to retain a stable value by referencing one or several fiat currencies or a basket of traditional assets. The Proposed Framework regulates stablecoins that fall within the definition of 'asset-referenced tokens' and 'e-money tokens' with bespoke regulatory requirements applicable to each category (see further below). Issuers of stablecoins that are classified as 'significant asset-referenced tokens' or 'significant e-money tokens' will be subject to enhanced rules, for example, relating to capital requirements and the investment of reserve funds, and are to be supervised by the European Banking Authority (**EBA**).

WHO IS THE PROPOSED FRAMEWORK APPLICABLE TO?

The Proposed Framework is applicable to, and brings in scope, two entity types that currently fall outside the ambit of EU financial services regulation, namely issuers of crypto-assets and crypto-asset service providers.

Issuers of crypto-assets

- Issuers of crypto-assets are defined as any legal person who offers to the public any type of crypto-asset or seeks their admission on a trading platform (noting that natural persons may not issue crypto-assets).
- The Proposed Framework applies various authorisation requirements to issuers of crypto-assets, depending on the type of crypto-asset they are issuing (see below) and whether the issuer holds an existing authorisation (e.g. credit institutions that issue asset-referenced tokens would be permitted to issue such assets without obtaining a separate authorisation under the Proposed Framework).

Crypto-asset service providers

– there are two sub-categories:

- *Providers of crypto-asset trading platforms* are providers exchanging crypto-assets for fiat currencies or other crypto-assets by dealing on own account and ensuring the custody and administration of crypto-assets or the control of crypto-assets on behalf of third parties.
- *Providers involved in the placing of crypto-assets* are providers that receive and transmit orders for crypto-assets, execute such orders on behalf of third parties and/or provide advice on crypto-assets e.g. custodian wallet providers.

Under the Proposed Framework, both types of crypto-asset service provider require authorisation by their competent authority and are subject to a supervisory regime comparable to a scaled-back and adjusted version of the MiFID II regulatory regime. Credit institutions and certain MiFID investment firms would be permitted to provide crypto-asset services without obtaining a separate authorisation under the Proposed Framework.

The European Securities and Markets Authority (**ESMA**) is mandated to establish a register of all crypto-asset service providers. Specific regulatory requirements would apply to crypto-asset service providers under the Proposed Framework, including for the custody of crypto-assets, the execution of orders and the giving of advice in relation to crypto-assets.

HOW ARE 'CRYPTO-ASSETS' DEFINED AND CATEGORISED?

A 'crypto-asset' is defined broadly in the Proposed Framework as a digital representation of value or rights which may be transferred and stored electronically using distributed ledger, or similar, technology. The Proposed Framework creates three categories of crypto-assets, namely, utility tokens, asset-referenced tokens and electronic money tokens (**e-money tokens**). The Proposed Framework only applies to crypto-assets that do not fall within the definitions of:

- 'financial instrument' or 'structured deposits' (under MiFID II);
- 'electronic money' (under EMD2);
- 'deposits' (under the Deposit Guarantee Directive 2014/49/EU); and
- 'securitisation' (under the Securitisation Regulation (EU) 2017/2402).

The Proposed Framework, therefore, captures crypto-assets not already dealt with under existing financial services legislation, with pre-existing legislation having an elevated status in circumstances where a crypto-asset could come within both regulatory regimes. The Proposed Framework proposes to amend MiFID II to make clear that the existing definition of 'financial instruments' includes financial instruments that are based on or utilise distributed ledger technology.

The sections below outline the characteristics of each category of crypto-asset and provide an overview of some of the key proposals that apply to each category of crypto-asset under the Proposed Framework.

Asset-referenced tokens

Definition

A type of crypto-asset that purports to maintain a stable value by referring to the value of several fiat currencies that are legal tender, or one or several commodities or one or several crypto-assets, or a combination of such assets.

Context and commentary

More stringent regulatory requirements are applied to asset-referenced tokens under the Proposed Framework as these are expected to be the most widely used category of crypto-asset.

The main purpose of asset-referenced tokens is to become a means of exchange that purports to maintain a stable value vis-à-vis, for example, fiat currencies. Such tokens are capable of qualifying as electronic money, depending on their specific characteristics.

Key proposals with respect to issuers of asset-referenced tokens

- *Authorisation requirement:* asset-referenced token issuers must be authorised by their home state competent authority (unless already regulated as a credit institution or as a MiFID investment firm) in advance of issuing tokens to the public or seeking the crypto-asset's admission to a trading platform. The EBA is required to publish draft regulatory technical standards specifying the required contents of the authorisation application.
- *Approval of white paper requirement:* asset-referenced token issuers must publish a pre-approved (by their competent authority) white paper containing mandatory disclosures, as set out in the Annex to the Proposed Framework, in advance of issuing the tokens. The white paper is to inform prospective purchasers about the characteristics, functions and risks of the crypto-asset and the obligations and rights attached to it, along with information about the issuer and the planned use of funds by the issuer.
- *Reserve assets requirement:* asset-referenced tokens must be backed by reserve assets at all times and any creation or destruction of asset-referenced tokens has to be matched by an increase or decrease in reserved assets. The Proposed Framework is not prescriptive about the proportion of reserved assets to be maintained by the issuer.
- *Capital requirements:* issuers of asset-referenced tokens are required to have own funds equal to the higher of €350,000 or 2% of the average amount of reserved assets.
- *Consumer protection requirements:* asset-referenced token issuers are required to act honestly, fairly and professionally and to communicate with the holders of asset-referenced tokens in a manner which is fair, clear and not misleading.
- *Significant asset-referenced tokens:* additional obligations apply to issuers of 'significant asset-referenced tokens' (with 'significant' status determined by reference to prescribed qualifying criteria) including own funds requirements, liquidity management and interoperability. Such issuers are to be supervised by the EBA.
- *Other requirements:* issuers of asset-referenced tokens must have robust governance arrangements in place, to maintain effective conflicts of interest policies and to provide monthly updates to holders of their tokens on (i) the amount of tokens in circulation and (ii) the value and composition of reserved assets.

E-money tokens

Definition A type of crypto-asset the main purpose of which is to be used as a means of exchange and that purports to maintain a stable value by reference to the value of a single fiat currency that is legal tender.

Context and commentary As the Commission's Fintech Action Plan aims to be technology neutral, the Proposed Framework would largely align the regulation of e-money tokens with the regulation of electronic money under EMD2.

The Proposed Framework requires e-money token issuers to provide electronic money holders with a claim on the issuer to a value at par with the currency referencing the e-money token. The introduction of this redemption requirement will eradicate one of the principal differences that exists at present between regulated electronic money and currently unregulated e-money tokens.

Key proposals with respect to issuers of e-money tokens

- *Electronic money institutions ("EMIs")*: issuers of e-money tokens that qualify as 'electronic money' under EMD2 are not be subject to the Proposed Framework and would remain subject to EMD2 and regulated and classified as an EMI under EMD2.
- *Authorisation requirement*: issuers of e-money tokens must be authorised by their home state competent authority as an EMI under EMD2 (or depending on their wider business model as a credit institution) and e-money tokens are deemed to constitute electronic money for the purposes of EMD2.
- *Redemption requirement*: issuers of e-money tokens must grant token users a claim against the issuer to redeem their e-money tokens at any time and at par value against the currency referencing those tokens.
- *White paper requirement*: e-money token issuers must publish a white paper containing mandatory disclosures. A prospective e-money token issuer is required to notify its competent authority of its intention to issue e-money tokens by submitting its white paper however, approval of the white paper is not required.
- *Significant e-money tokens*: the Proposed Framework includes a regime whereby the EBA may designate certain e-money tokens as 'significant e-money tokens' (and a separate regime whereby an e-money token issuer may apply to become authorised by the EBA as an issuer of a token classified as a 'significant e-money token') where the e-money token fulfils a number of criteria set out in the Proposed Framework such as the size of the customer base of the issuer and the number and value of transactions in that e-money token. Additional requirements apply to issuers of significant e-money tokens such as the custody of reserve assets, the investment of reserve assets, enhanced rules on remuneration requirements, interoperability and liquidity management and orderly wind-down policies. As with 'significant asset-referenced tokens', 'significant e-money tokens' would be supervised by the EBA.

Utility tokens (and crypto-assets other than asset-referenced tokens or e-money tokens)**Definition of 'utility token'**

A type of crypto-asset which is intended to provide digital access to a good or service, available on distributed ledger technology and is only accepted by the issuer of that token.

Context

The Proposed Framework imposes less onerous regulatory requirements in respect of utility tokens and other crypto-assets (that are not asset-referenced tokens or e-money tokens) to ensure that all possible crypto-assets are within scope.

In the interests of proportionality, the Proposed Framework allows derogations from regulatory requirements where the crypto-asset is, for example, offered for free or only available to a limited group of qualified investors e.g. such issuers may derogate from the white paper requirement (in order to assist SMEs and start-ups to launch smaller crypto-asset projects).

Key proposals with respect to issuers of crypto-assets other than asset-referenced tokens or e-money tokens (which includes issuers of utility tokens)

- *No authorisation requirement:* issuers of crypto-assets other than asset-referenced tokens or e-money tokens (which includes issuers of utility tokens) are not required to be authorised as a regulated entity but would be required to be a legal entity.
- *White paper requirement:* subject to the exceptions outlined above, issuers of crypto-assets other than asset-referenced tokens or e-money tokens (which includes issuers of utility tokens) are required to publish a white paper, containing mandatory disclosures, and submit this to its competent authority by way of notification of its intention to issue the crypto-asset, although competent authority approval of the white paper is not required. Mandatory disclosures would include, for example, information on risks relating to the issuer and the token itself and the rights and obligations attached to the token.
- *Consumer protection requirements:* token issuers are required to act honestly, fairly and professionally and to communicate with the holders of crypto-assets in a manner which is fair, clear and not misleading.

HOW DOES THE PROPOSED FRAMEWORK INTERACT WITH EXISTING EU AML/CTF REQUIREMENTS?

Since the deadline for transposition into national law of the 5th Anti-Money Laundering Directive (**MLD5**) on 10 January 2020, two categories of crypto-asset service providers facilitating exchanges between fiat currency and crypto-assets (namely custodian wallet providers and crypto-asset exchange platform providers) are required to comply with anti-money laundering and counter-terrorist financing requirements (**AML/CTF**) (albeit that, as of the date of this publication, MLD5 has not yet been fully transposed into Irish law in this respect).

Whilst the Proposed Framework proposes to regulate a broader category of crypto-asset service providers than are currently in scope under MLD5, the Proposed Framework does not impose AML/CTF requirements on crypto-asset service providers (or crypto-asset issuers) that are not currently within scope of MLD5. The Financial Action Task Force has recommended that crypto-asset service providers that are not currently in scope under MLD5 should become subject to EU AML/CTF rules. However, as the EU is proposing to overhaul its entire AML/CTF framework in 2021, it is not likely that legislative amendments will be made to MLD5, in advance of this process, to bring currently excluded crypto-asset service providers in scope of EU AML/CTF rules.

WILL THE USUAL PASSPORTING RULES APPLY TO REGULATED INSTITUTIONS?

Crypto-asset issuers (excluding issuers of asset-referenced tokens) will be able to offer their services across the EU, once authorised in one EU Member State pursuant to EU passporting rules, regardless of whether they are incorporated in the EU or a third country.

Crypto-asset service providers and issuers of asset-referenced tokens will only be able to benefit from the EU passporting regime if they are incorporated in the EU.

WHAT IS THE ROLE OF COMPETENT AUTHORITIES?

The EBA is the proposed supervisory body for significant asset-referenced tokens and issuers of significant e-money tokens. Other crypto-asset issuers and crypto-asset service providers are to be supervised by their national competent authorities. To ensure effective supervision, EU Member States are required to designate a competent authority as the single point of contact for information sharing purposes with other national competent authorities, even if, in practice, supervision is split between several competent authorities.

Nominated competent authorities would be required to administer administrative sanctions for breaches of the Proposed Framework, to cooperate with each other for the purposes of supervising compliance and to share information for that purpose.

WHEN WILL THE PROPOSED FRAMEWORK APPLY?

By 2024, it is envisaged that the Proposed Framework will be applicable to crypto-asset issuers and crypto-asset service providers with transitional periods for authorisation requirements.

The Proposed Framework is to be reviewed by the European Parliament and Council of Ministers before it is ultimately adopted. As the Proposed Framework is subject to amendments by these bodies, the final version of the Proposed Framework may differ from its current form. This review period is likely to exceed 18 months. Once adopted, it will be published in the Official Journal of the European Union. Upon its date of publication, it is proposed that certain aspects of the Proposed Framework would enter into force within 20 days (for example, the offering rules surrounding the publication of a white paper for crypto-asset issuers), whilst other provisions would be subject to an 18-month transition period (for example, it is proposed that crypto-asset service providers that already provide services at the time of publication of the Proposed Framework would have 18 months to obtain authorisation from their relevant competent authority).

The Proposed Framework provides for EU Member States with existing crypto-currency regulatory regimes (such as France and Germany) to establish a simplified authorisation procedure in recognition of the domestic authorisation processes already in place.

CONTACT US

For more information, please contact any of the below or your usual William Fry contact.



Shane Kelleher
PARTNER
Head of Financial Regulation
+353 1 639 5148
shane.kelleher@williamfry.com



Louise McNabola
CONSULTANT
Financial Regulation
+353 1 639 5196
louise.mcnabola@williamfry.com



John Aherne
PARTNER
Asset Management/Funds
and Financial Regulation
+353 1 639 5321
john.aherne@williamfry.com



Patricia Taylor
PARTNER
Asset Management/Funds
and Financial Regulation
+353 1 639 5222
patricia.taylor@williamfry.com



Lisa Carty
PARTNER
Litigation and Regulatory
Investigations and Enforcement
+353 1 639 5386
lisa.carty@williamfry.com



Derek Hegarty
PARTNER
Litigation and Regulatory
Investigations and Enforcement
+353 1 639 5040
derek.hegarty@williamfry.com



Ian Murray
PARTNER
Insurance and Financial
Regulation
+353 1 639 5129
ian.murray@williamfry.com

WILLIAM FRY

DUBLIN | CORK | LONDON | NEW YORK | SAN FRANCISCO | SILICON VALLEY

T: +353 1 639 5000 | E: info@williamfry.com

williamfry.com