Regulation of Crypto-Assets: The EU Perspective (Update of the MOCOMILA Kyoto Report chapter VII)

Global economic context and relevance to the EU digital finance strategy

Crypto asset volumes still represent a relatively small market share of the global financial system with a total market capitalisation up to US $ 2.5tn[1)] compared with US$ 22tn for the S&P 500 alone and daily trading volumes up to US$ 175bn. Nevertheless, crypto markets are very dynamic. This is why the FSB has warned of emerging risks from crypto-assets to global financial stability in its February 2022 report "Assessment of Risks to Financial Stability from Crypto-assets." At the same time, there is broad consensus among international regulators and practitioners that crypto assets as an emerging new asset class and related distributed ledger/blockchain technology (DLT) will have an immense potential for innovation and efficiency gains in the financial sector. Crypto assets and tokenization might revolutionise the financial markets in similar ways as has securitization in the past.

In the EU, crypto asset regulation is treated as an integral part of the Commission's digital finance strategy[2]. In addition, the EU expects from the crypto asset sector a significant contribution to tackling the economic effects of the COVID-19 outbreak. At the same time, the Commission wants to address investor protection and market integrity concerns.

The EU draft regulatory package on crypto assets

With growing peer-group pressure in the EU neighbourhood to take action, the Commission initiated formal proceedings with an "Inception Impact Assessment – Directive/regulation establishing a European framework for markets in crypto assets"[3]. On 24th November 2021, the EU Council adopted its position in respect of a draft package on crypto asset regulation and mandated its Presidency to initiate formal "Trilogue" procedures with the Parliament and the Commission to finalize the legislative process.[4]

Basically, this regulation can be characterized as a MiFID-type framework to cover crypto assets falling outside existing EU financial services regulation, as well as e-money tokens. Its aim is to

- "establish uniform rules for crypto-asset service providers and issuers at EU level…"
- "establish specific rules for so-called 'stablecoins', including when these are e-money…"[5]

It includes

- an addendum to the "MiFID II" Directive 2014/65/EU clarifying that the existing definition of "financial instruments" as specified in Annex I sect. C includes "such instruments issued by means of distributed ledger technology";

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1) Overview: International Monetary Fund (IMF), Global Stability Report October 2021, chapter 2 p. 43, fig. 2.1.

2 European Commission, Communication on a Digital Finance Strategy for the EU, COM (2020) 591 final

3 EU Commission, Inception Impact Assessment – Directive/regulation establishing a European framework for markets in crypto assets (19 December 2019, Commission Ref. Ares (2019) 7834655).

4 Council press release 886/21 of 24/11/2021.

5 MiCA Regulation (FN 6), Explanatory Memorandum, 10.

- a proposal for a Regulation on Markets in Crypto-Assets ("MiCA" regulation) to cover crypto-assets falling outside existing EU financial services regulation, including "stablecoins" as well as e-money tokens;[6]
- a proposal for a Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology;[7]
- an "EU passport" for crypto assets .

Due to the intention to fill regulatory gaps, the scope of the MiCA Regulation is limited by Art. 2, excluding assets qualifying as financial instruments under Art. 4(1) point 15 of the MiFID II Directive 2014/65/EU, electronic money as defined in Art. 2 point (2) of Directive 2009/110/EC, and certain other instruments. The ESMA's guiding principle in qualifying crypto assets as financial instruments is "substance over form"; they would have to be standardised, transferable and tradable in financial markets. Under MiFID II (Directive 2014/65/EU) Art 4(1)(15)/Annex I sect. C, these are typically transferable securities, money market instruments, units in collective investment undertakings and certain derivatives. In case crypto-assets qualify as a financial instrument, the traditional set of specific regulatory frameworks is applied, in particular MiFID II.
As a result, Security Tokens would be normally captured by and integrated into the MiFID II Regulation rather than being regulated by the MiCA framework. Nevertheless, the proposed EU Regulation on a Pilot Regime for Market Infrastructures based on distributed ledger technology would also apply to crypto-assets that qualify as financial instruments/transferable securities under MiFID II, as specified and limited in Art. 3 of the draft regulation, and insofar to Security Tokens.

On the contrary, the following asset types will be governed by the MiCA Regulation:
- 'asset-referenced tokens': "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, one or several commodities or one or several crypto-assets, or a combination of such assets" (Art. 3 para.1 (3) – this type has to be clearly distinguished from tokenized traditional securities classified as financial instruments. Commonly, this asset type is referred to as "stablecoins";
- 'electronic money tokens': "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 referring to the value of a fiat currency that is legal tender" (Art. 3 para.1 (4) – deemed electronic money for the purpose of Dir. 2009/110/EC and subject to additional stipulations under the Regulation;
- 'utility tokens'**:** "a type of crypto-asset which is intended to provide digital access to a good or service, available on DLT, and is only accepted by the issuer of that token" (Art. 3 para.1 (5).

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5. Outlook

Developments in the crypto-assets industry will have an immense potential for innovation and efficiency gains in the financial sector. Nevertheless, significant risks and

[6] COM (2020) 593 final
[7] COM (2020) 594 final.

legal uncertainties are involved in both private and regulatory law. International financial centers will have to take up these challenges to position themselves as an attractive location through legal certainty, efficient regulation and good reputation in the field. Clear rules on crypto-assets in both private and supervisory law would be a cutting edge in the competition of financial centres in a future where "tokenisation" might revolutionise the financial markets in similar ways as has securitisation in the past. According to the general principles of EU legislation, private law such as classification as property, integration into bankruptcy and heritage estates, enforcement as collateral, seizure, trust etc. is not harmonised and hence subject to national legislation. In particular, Liechtenstein – an EEA Member State which will have to adopt the draft EU regulatory package - has successfully enabled the full deployment of crypto-assets and their underlying technology. Insofar, EU legislators will have to take care with a view to existing comprehensive national regulations to avoid any setback

Basically, specific and comprehensive national and regional supra-national legislation may be an impediment to capital markets integration. This is why global agreements on uniform rules have been proposed, but it seems more than high level principles similar to the FSB approach in respect of stablecoins cannot be expected in the near future. As long as this situation persists, sound and comprehensive national or EU legislation may offer satisfactory solutions in an environment allowing for choice of law and court.