European Supervisory Authorities Recommend EU-wide Approach on ICOs and Crypto-Assets

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In the first week of 2019, both the European Securities and Markets Authority ("ESMA") and the European Banking Authority ("EBA") issued reports advising EU legislators on the regulation of "crypto-assets" and initial coin offerings ("ICOs"). The European Supervisory Authorities ("ESAs"), a body consisting of ESMA, EBA and the European Insurance and Occupational Pensions Authority, concurrently issued a joint report on innovation hubs and regulatory sandboxes.

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The reports aim at clarifying the applicability and suitability of the EU financial regulatory framework to crypto-assets and providing recommendations for regulatory adjustments to address its shortcomings.

ESMA'S ADVICE ON CRYPTO-ASSETS AND INITIAL COIN OFFERINGS.

ESMA's report is based in part on a survey of national competent authorities ("NCAs") in 2018. ESMA defines "crypto-asset" as a type of private asset that depends primarily on cryptography and Distributed Ledger Technology as part of its perceived or inherent value and that is neither issued nor guaranteed by a central bank. Therefore, the ESMA's report does not address a private digital asset that relies on cryptography for its validity but is not recorded on or transacted through a distributed ledger such as blockchain.

In ESMA's view, crypto-assets can be subdivided into four categories:

- **Investment-type crypto-assets** have some profits rights attached, similar to equities, equity-like instruments or non-equity instruments.
- **Utility-type crypto-assets** provide some utility or consumption rights, such as the ability to use them to access or buy some of the services or products offered by the ecosystem.
- **Payment-type crypto-assets** have no tangible value except for the expectation they may serve as a means of exchange or payment for goods or services external to the ecosystem.
- **Hybrids** of the above types of crypto-assets.

Regulation of Crypto-Assets Qualifying as Financial Instruments. ESMA's report focuses on crypto-assets that are classified as a transferable security or other financial instrument ("financial instrument") under the Markets in Financial Instruments Directive ("MiFID II").

ESMA notes that if a crypto-asset qualifies as a financial instrument, the full set of EU financial regulations may apply. Therefore, issuers of crypto-assets that are MiFID II financial instruments, and other persons, will have to comply with a variety of EU rules if, for example, they engage in investment services or activities involving crypto-assets such as placing, dealing on own account, operating a multilateral trading facility ("MTF") or an organized trading facility ("OTF"), or providing investment advice. Applicable EU rules include the MiFID II, the Prospectus Directive, the Transparency Directive or the Market Abuse Regulation.

ESMA notes that the actual classification of a crypto-asset as a financial instrument is the responsibility of individual NCAs and will depend on the specific national implementation of EU law.

In ESMA's view, the existing EU regulation and regulatory system has certain shortcomings when applied to crypto-assets, including:

- risk of regulatory arbitrage resulting from different interpretations of EU laws by NCAs given that such laws were not designed to capture crypto-assets;
- uncertainty in whether holding of private keys on behalf of the client is qualified as regulated custody/safekeeping service (which ESMA tends to believe it is);
- uncertainty in whether miners are in the business of settlement of a transaction in a financial instrument in light of their novel and fundamental role in the settlement; and
- absence of rules addressing the specific technological risks of crypto-assets such as reliability and safety of protocols and smart contracts.

Regulatory Focus on Platforms Trading Crypto-Assets. ESMA puts an emphasis on the regulation of platforms for the trading of crypto-assets, as ESMA regards such platforms as the most common type of intermediary in the crypto-asset ecosystem. ESMA distinguishes among three types of crypto-asset trading platforms in determining the application of MiFID II: If a platform has a central order book or matches orders under other trading models, it may be considered a multilateral system within the scope of MiFID II, whether as a regulated market ("RM"), MTF or OTF. MiFID II also applies to platforms providing services similar to brokers/dealers, *i.e.*, dealing on their own accounts or executing client orders against their proprietary capital.

In ESMA's view, only platforms limited to advertising interests in buying or selling crypto-assets are outside the scope of MiFID II.

The application of MiFID II to such platforms poses various challenges, including:

- difficulty for a platform (qualifying as an RM or MTF) to conduct due diligence of investors regarding their good repute, level of trading ability, competence, resources, and other requirements, given the large number of investors and the fact that many individual investors may not pass such tests;
- uncertainty about qualification of crypto-assets as equity or non-equity instruments, which affects the level of pre- and post-trade transparency;
- for decentralized platforms, the lack of a clearly identified operator; and
- uncertain qualification of hybrid platforms.

Regulation of Crypto-Assets Currently Outside of Scope of MiFID II. With respect to crypto-assets that remain unregulated, ESMA notes substantial risks for investors and consumers arising from fraud, cyber-attacks, money laundering and market manipulation. ESMA suggests a bespoke regime for unregulated crypto-assets at the EU level to address such risks and to secure a regulatory level playing field across the EU. Particularly with respect to ICOs, given the unsatisfactory quality of "white papers", such a bespoke regime should provide for appropriate disclosure, including the risks arising from the issuer or the project, the rights attached to the crypto-asset, the underlying technology used and potential conflicts of interest.

Amendment to Anti-Money Laundering Regulations. The EU only recently addressed AML risks of virtual currencies in its 5th AML Directive and imposed duties on providers of exchange services between virtual currencies and fiat currencies as well as on custodian wallet providers. ESMA and EBA (in its report discussed below) recommend, in line with the Financial Action Task Force's view, bringing providers of crypto-asset exchange services and providers of financial services in connection with ICOs within the scope of anti-money laundering regulations.

EBA'S REPORT TO THE EU COMMISSION ON CRYPTO-ASSETS

In its examination of crypto-assets from the perspective of EU banking, payment services and electronic money regulations, EBA concludes that in rare cases where a payment-type crypto-asset qualifies as electronic money, the second Electronic Money Directive ("**EMD2**") or the second Payment Services Directive will apply with respect to such crypto-asset. For example, the EBA would consider the resulting crypto-asset as

electronic money in this scenario: the initiator of a blockchain-based network open to merchants and consumers issues tokens that (i) are intended to be the means of payment in the network, (ii) are issued on the receipt of fiat currency, (iii) are pegged in value to that fiat currency and (iv) can be redeemed at any time for that fiat currency. Such tokens constitute electronic money under EMD2 since they (i) are electronically stored, (ii) have monetary value, (iii) represent a claim on the issuer, (iv) are issued on receipt of funds, (v) are intended for the purpose of making payment transaction, and (vi) are accepted by persons other than the issuer.

EBA calls for clarifying the accounting treatment and prudential treatment of crypto-assets held by financial institutions and taking a closer look at the business practices of financial institutions in relation to crypto-assets. EBA plans to provide further guidance on these issues to financial institutions holding crypto-assets and recommends that EU legislators take steps to promote consistency in these matters across jurisdictions. EBA further intends to develop appropriate reporting standards for activities relating to crypto-assets.

ESAS' REPORT ON FINTECH: REGULATORY SANDBOXES AND INNOVATION HUBS

ESAs' report compares innovation hubs and regulatory sandboxes in the EU Member States and aims at reconciling both regulation and financial innovation.

ESAs develop best practice principles for such "innovation facilitators" and add specific principles for innovation hubs and regulatory sandboxes. The best practice principles are intended to promote convergence in the design and operation of innovation facilitators and include recommendations for pre-establishment considerations and operational features, such as requirements on entry conditions, objectives and functions as well as communication to participants and the public. ESAs also suggest promoting coordination and cooperation between innovation facilitators at the EU level in an EU network.

OUTLOOK

Roadmap to an EU-wide Regulatory Approach? It is expected that EU legislators will carefully take the recommendations of ESMA, EBA and ESAs into consideration. Amendments to the anti-money laundering regulations are likely to be the first immediate step given that anti-money laundering issues are commonly considered the most pressing regulatory concern in the crypto-asset area. Whether the recommendations will lead to an EU-wide approach remains to be seen. It will be

challenging to agree on a model that wins the support of all stakeholders, particularly within the Member States that have already implemented, or are in the process of implementing, bespoke crypto-asset regulations. The division among the stakeholders within the EU legislative bodies regarding regulation of ICOs has already come to light in context of the proposed EU regulation introducing an EU-wide regime for crowdfunding platforms.

Impact on Discussion on Bitcoin as Financial Instrument in Germany? Interestingly, ESMA concludes in its report that pure payment-type crypto-assets "are unlikely to qualify as financial instruments." This statement seems to run counter to the view of the German Federal Financial Supervisory Authority (BaFin) that Bitcoin and other cryptocurrencies should qualify as "units of account" and therefore as financial instruments. That view has been challenged by the Higher Regional Court of Berlin (*Kammergericht*). In considering the current conflict of opinions, it is helpful to recall BaFin's earlier approach to loan originating funds. In 2015, BaFin changed its view that loan originating funds must obtain a banking license in Germany, expressly referring to ESMA's view that loan originating funds are permissible under the European regulations. It is therefore conceivable that, given the clear statement of ESMA regarding crypto-assets, BaFin will reconsider its approach toward cryptocurrencies, particularly as EU-wide crypto-asset regulation might be on the horizon.

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Please do not hesitate to contact us with any questions.

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