CROSS-BORDER INVESTMENTS IN EU MARKETS IN CRYPTO-ASSETS: LEGAL ASPECTS

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Abstract

As the economic importance of crypto-assets increases, so does the need for regulatory guidance. Especially if these tokens pose risks to financial market stability or consumer protection. With the proposal to regulate the markets for crypto-assets, the European Commission intends to create a legal framework for those crypto-assets that are not regulated so far because they are not financial instruments. The proposal introduces rules for issuers of crypto-assets and service providers including trading platforms and custodians. A harmonized EU framework will prevent regulatory arbitrage when providing cross-border services.

Key words

Crypto-Assets, Asset-Referenced Token, Distributed-Ledger-Technology, Market Regulation

Introduction

The regulation of crypto-assets has been a relevant topic on the agenda of the German presidency of the European Council in the second half of 2020. The basis for the negotiations among EU Member States is a proposal by the European Commission for a “Regulation on Markets in Crypto-Assets”[2] (MiCA Regulation). The European Commission strives to achieve a uniform European regulation for crypto-assets. In the following the scope of this regulation and the specific contents of the individual regulatory areas are described. With the draft regulation, the European Commission attempts nothing less than to incorporate this hitherto largely unregulated subject into an appropriate legal framework.

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2 EUROPEAN COMMISSION, Proposal for a Regulation of the European Parliament and the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937, 24 September 2020, COM (2020) 593 final, 2020/0265 (COD).

The rising importance of crypto-assets can be mirrored by the development of what is probably the best-known asset in this field, namely Bitcoin. The performance of Bitcoin in recent years is remarkable. Whether this is an economically justifiable increase in value or a speculative bubble is assessed differently by financial analysts and will be left aside in this legal evaluation. In any case, the trading activities as well as the market capitalisation of all Bitcoin in circulation show that this asset class has reached a significant size from an economic as well as regulatory perspective. It should be noted that crypto-assets are assets that have not been sufficiently covered by previous financial market regulation, so that from the legislator's point of view a regulatory deficit exists.

The challenge in regulating these technologically innovative assets is firstly to adequately define and delineate what distinguishes crypto-assets from traditional assets. Secondly, the existing financial markets regulatory frameworks must also be brought into line with the new crypto-oriented approach of the MiCA Regulation. It is important that crypto-assets neither face disadvantages nor benefit from advantage compared to traditional assets, as regulatory intervention should be based on fundamental considerations that adhere to the principle of proportionality. Thus, neither the fear of an innovation that is difficult to understand without a technical background and which might constitute new risks, nor an unbroken belief in technology in general as a generator for economic growth and the creation of a new industry sector in Europe should be the decisive factors. Rather, the aim of all market regulation should be to achieve appropriate market standards by reconciling the functioning of the market with the commercial interests of market participants. Thereby the interests of the issuers and investors in crypto-assets as well as the business models of the operators of market infrastructure and other service providers associated with crypto-assets must be taken into account.

The objectives of appropriate market surveillance must be to ensure that there is no manipulation and no unjustifiable risks from an operational point of view. Further, regulatory boundaries for market activities could facilitate investor protection, especially when establishing a level playing field for cross-border services of issuers of crypto-assets and service providers within the EU.

Milestones preceding the MiCA Regulation

Some decisive preparatory work preceded the European Commission's proposal for the MiCA Regulation. More than two years ago the European Commission had already published an action plan concerning technology-based innovation in the financial services sector.[3] Several official bodies thereafter assessed aspects of digital finance and crypto-assets in more detail and delivered reports, such as the Financial Stability Board[4] and the European supervisory agencies for the banking and the securities markets sector, the European Banking Authority (EBA)[5] and the European Securities and Markets Authority (ESMA).[6]

ESMA reported that regulators and market participants were faced with the challenge of deciding which of the existing regulatory frameworks should apply to each crypto-asset under consideration.[7] In this respect, EBA noted in its report that the international standardisation bodies had not yet developed a common categorisation scheme for crypto-assets.[8] ESMA also raised the problem that retail investors perceive certain crypto-assets as a type of financial instrument because the latter are traded on crypto trading platforms even though the formal requirements for a financial instrument are not met.[9] This has been seen by EBA as a consumer protection challenge because the crypto-assets observed lacked the mandatory information and risk disclosures required for regulated financial products.[10]

The advance of a consortium,[11] largely orchestrated by an operator of a dominant social network, to create a crypto-technology-based currency for the purpose of value storage and payment by means of issuance of crypto-coins[12] made waves in the media and at policy-maker level.

3 EUROPEAN COMMISSION, FinTech Action plan: For a more competitive and innovative European financial sector, 8 March 2018, COM/2018/0109 final.
4 FINANCIAL STABILITY BOARD, Crypto-assets: Report to the G20 on work by the FSB and standard-setting bodies', 16 July 2018.
5 EUROPEAN BANKING AUTHORITY, Report with advice for the European Commission on crypto-assets, 9 January 2019.
6 EUROPEAN SECURITIES AND MARKETS AUTHORITY, Advice of the European Securities and Markets Authority to the Commission on Initial Coin Offerings and Crypto-Assets, 9 January 2019.
7 Ibid. p. 4.
8 EUROPEAN BANKING AUTHORITY, Report on crypto-assets, p. 7; For a description of the different types of crypto-assets, see KAULARTZ, M./MATZKE, R.: Die Tokenisierung des Rechts, NJW 2018, p. 3279 et seq,
9 EUROPEAN SECURITIES AND MARKETS AUTHORITY ESMA, Advice on Initial Coin Offerings and Crypto-Assets, p. 13.
10 EUROPEAN BANKING AUTHORITY, Report on crypto-assets, p. 15.
11 LIBRA ASSOCIATION, An Introduction to Libra, White Paper, June 2019.
12 The terms "Coin" and "Token" are commonly used to describe digital values on a computer network based on distributed ledger technology; cf. STORCK, C., Die schöne, neue Welt der Token – ohne Regulierung und Compliance?, BB 2019, p. 23.

Conceptually, this crypto-coin should be linked to a basket of different central bank currencies in order to keep the coin stable in value – a feature reflected in the term "stablecoins" for those kinds of crypto-assets. Concerns and resistance were expressed by governments and central banks, who saw the idea as a disruptive factor to the monetary sovereignty and financial policies of nations. These coins issued by a private organisation could reach a significant market volume and, in this context, the composition of the currency basket would have an impact on the individual currencies and their exchange rates. Behind this background the finance ministers and central bank governors of the Group of Seven (G7)[13] requested an investigation on the impact of global stablecoins, which resulted in a report that addresses the challenges and risks of stablecoins from the perspective of public policy and regulatory oversight.[14] One of the findings of the working group was that a sound, clear and transparent legal basis is essential for stablecoins.[15]

Concluding from the above reports, the European Commission has recognized a need for legislative action since not only the issuance but also many services related to crypto-assets are not regulated, e.g. operators of trading platforms and custodians for crypto-assets as well as service providers which exchange crypto-assets against legal tender. The absence of rules could pose a risk to market participants and overall market integrity.[16] Further, the proposal takes up the considerations of the G7 working group regarding monetary policy and sovereignty as well as financial stability which emanate from crypto-assets structured as stablecoins that achieve a high level of market penetration.[17]

Subject matter and scope of the MiCA Regulation

The MiCA Regulation aims to create uniform European rules in the following areas: Firstly, transparency and disclosure obligations will apply for the issuance and trading of crypto-assets. Secondly, the provision of services relating to certain crypto-assets will be subject to authorisation and the service providers to supervision. Third, specific operational and organisational requirements will apply to issuers of crypto-assets. Fourth, consumer protection rules will be imposed on the issuance, trading, exchange and custody of crypto-assets. Fifth,

13 Organisation consisting of the world's seven largest industrialized nations.
14 G7 WORKING GROUP ON STABLECOINS, Investigating the impact of global stablecoins, October 2019.
15 Ibid. p. 5.
16 MiCA Regulation, recital 3.
17 Ibid. recital 4.

measures will be taken to prevent market abuse and to ensure the integrity of the crypto-assets market.[18]

The MiCA Regulation applies to crypto-assets which are defined as the "digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology[19] or similar technology".[20] However, the scope of the MiCA Regulation is limited to those crypto-assets that are not financial instruments within the meaning of MiFID II[21] as the European Commission does not intend to deviate from existing rules concerning financial instruments on the basis of a particular underlying technology.[22]

The MiCA Regulation distinguishes between three sub-categories of crypto-assets. The first sub-category consists of so-called "utility tokens". The defining characteristic of this sub-category is that these tokens are only accepted by the issuer to enable digital access to a good or service.[23] Thus, utility tokens are comparable to digital vouchers. A second sub-category of crypto-assets are the so-called "asset-referenced tokens". Asset-referenced tokens are structured to be used as stablecoins. The issuer aims to ensure that the token has a stable value. This is achieved by using several currencies, accepted as legal tender, or commodities or other crypto-assets as the underlying for the asset-referenced tokens.[24] The third sub-category, electronic money token, is also asset-referenced since it is linked to a single currency that is legal tender and thereby purports to maintain a stable value.[25]

Though the function of electronic money tokens appears to be similar to electronic money, which is defined in Article 2, point (2) of Directive 2009/110/EC,[26] the difference lies in the legal claim against the issuer to exchange the instrument for legal tender. With regard to electronic money the holder has an unconditional contractual right to claim the redemption of the electronic money from the issuing institution which in exchange has to pay out the face

18 MiCA Regulation, Article 1.
19 Distributed ledger technology ("DLT") is defined as a technology that supports the distributed recording of encrypted data, cf. MiCA Regulation, Article 3 (1) point (1). A prominent example of a DLT-based system is the blockchain. It is characterized by the fact that the data is bundled in blocks and then cryptographically linked, which results in a record of the history of the data changes up to the origin. Cf. HOCHE, M./LERP, B., in: KUNSCHKE, D./SCHAFFELHUBER K., FinTech, p. 225.
20 MiCA Regulation, Article 3 (1) point (2).
21 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, Article 4 (1) point (15).
22 MiCA Regulation, recital 6, Article 2 (2) point (a).
23 MiCA Regulation, Article 3 (1) point (5).
24 MiCA Regulation, Article 3 (1) point (3).
25 MiCA Regulation, Article 3 (1) point (4).
26 Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

value of the electronic money in a currency that is legal tender.[27] For crypto-assets that are linked to a currency no such unconditional right exists, i.e. the issuer may set the conditions for the redemption and exchange against a legal tender, e.g. by setting potential redemption limits and exchange rates not at par with the value of the crypto-asset. [28] The European Commission is of the opinion that a prudent regulation would ensure the confidence in electronic money as well as electronic money tokens and avoid regulatory arbitrage.[29]

In general, the legal framework of the MiCA Regulation would ensure consumer protection in dealing with crypto-assets by requiring token issuers to provide potential buyers with sufficient information on the characteristics, functions and risks of the specific crypto-assets issued.[30]

Issuance of crypto-assets

The MiCA Regulation lays down rules for the issuance of crypto-assets by introducing an authorisation requirement for issuers who, inter alia, also have to meet minimum informational requirements for each issuance. Depending on the type of crypto-asset, the requirements differ in detail. While Title III and Title IV of the MiCA Regulation deal with asset-referenced tokens and e-money tokens, Title II applies as a catch-all to issuer of crypto-assets, other than those covered under Title III and Title IV. All types of crypto-assets have as a common requirement that the issuer must produce an information document (so-called white paper[31]) with a specific content and form.[32]

Asset-referenced tokens

Due to the above-mentioned concerns expressed by various governments and central banks in relation to privately issued tokens with payment function, asset-referenced tokens are

27 Directive 2009/110/EC, Article 11 (2).
28 MiCA Regulation, recital 10.
29 Ibid.
30 MiCA Regulation, recital 14.
31 Explanatory memorandum to the MiCA Regulation, p. 9.
32 MiCA Regulation, Article 5 for crypto-assets pursuant to Title II, Article 17 for asset-referenced tokens and Article 46 for electronic money tokens.

in particular focus of the MiCA Regulation. This becomes apparent from the recitals stating that an authorisation should not be granted to prospective issuer of asset-referenced tokens if the business model constitutes "a serious threat to financial stability, monetary policy transmission and monetary sovereignty".[33] Also, if asset-referenced tokens exceed certain thresholds, e.g. the size of the customer base, the market capitalization as well as the number and value of transactions,[34] the MiCA Regulation foresees a classification of these asset-referenced tokens as significant. Significant asset-referenced tokens are considered to pose greater risks to financial stability which justifies more stringent requirements and supervision.[35]

For the application for authorisation as issuer of asset-referenced tokens the entity, inter alia, has to provide an operating scheme including the business model and a detailed description of the entity's governance arrangements.[36] A robust governance and clear organizational structures with consistent lines of responsibility should ensure that processes are monitored and any risks identified.[37]

In addition to granting competent authorities with the power to take administrative measures and impose sanctions in case of infringements of statutory provisions[38] the MiCA Regulation also creates a liability regime. In the event of violations with regard to the mandatory substantial and formal requirements for the white paper,[39] rendering the content as not complete, fair or clear or by providing misleading information, the holder of the asset-referenced tokens is entitled to claim damages from token issuer.[40]

Issuers are also required to maintain sufficient financial resources, which must amount to 2% of the reference assets on which the token is based, i.e. assets backing the value of the token (so-called reserve assets[41]), but at least EUR 350,000.[42]

A central aspect of the rules for the issuance of asset-backed tokens is the handling of the reserve assets. Chapter 3 of Title 3 of the MiCA Regulation deals with the reserve assets in terms of their constitution, management, investment and custody. First of all, according to

33 MiCA Regulation, recital 29.
34 MiCA Regulation, Article 39.
35 MiCA Regulation, recital 42.
36 MiCA Regulation, Article 16 (2) points (c) and (e).
37 MiCA Regulation, recital 34.
38 MiCA Regulation, Articles 92 et seqq.
39 MiCA Regulation, Article 17.
40 MiCA Regulation, Article 22.
41 Reserve assets are defined as "the basket of fiat currencies that are legal tender, commodities or crypto-assets, backing the value of an asset-referenced tokens, or the investment of such assets", MiCA Regulation, Article 3 (1) point (21).
42 MiCA Regulation, Article 31.

Article 32 of the MiCA Regulation the issuers of asset-references tokens are obliged to constitute and maintain a reserve of assets at all time, ensure a prudent management and have a policy in place that describes the mechanism used to stabilize the token value.[43] In more detail, the policy has to include information on the type, composition and precise allocation of the reference assets and provide an assessment of credit risk, market risk and liquidity risk stemming from the reserve assets.[44] Further, the issuer must determine whether the reserve assets are invested, explain the investment approach and potential effects of the investment policy on the value of the reserve assets.[45] As a guidance for investment, Article 34 of the MiCA Regulation only allows to invest in highly liquid financial instruments with minimal credit risk,[46] so that the issuer is capable of liquidating the reserve assets quickly and with minimal adverse price effect.[47] The positive or negative income from the investments of the reserve assets as well as fluctuations in value are attributable to the issuer or must be offset by the latter.[48]

Moreover, the issuer must describe the process of the purchase and redemption of the asset-referenced tokens against the reserve assets and list the agents appointed to conduct the issuance and redemption.[49] In this context, the issuer is obliged to inform the holders of asset-referenced tokens of their rights and the conditions for the redemption of asset-referenced tokens.[50]

Additionally, the issuer needs to have a custody policy for the reserve assets that ensures that the reserve assets are segregated from the issuers' own assets and may not be encumbered nor pledged as collateral.[51] In this regard, the issuer has to appoint credit institutions or crypto-asset service providers as custodians for the reserve assets, taking into account the nature of the assets, i.e. underlying currencies should be held on bank accounts kept by a credit institution, financial instruments on a depository's books and crypto-assets in custody of a dedicated crypto-assets service provider.[52]

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43 MiCA Regulation, Article 32 (1), (3) and (4).
44 MiCA Regulation, Article 32 (4) points (a), (b) and (c).
45 MiCA Regulation, Article 34 (1).
46 EBA shall develop "draft regulatory technical standards specifying the financial instruments that can be considered highly liquid and bearing minimal credit and market risk", MiCA Regulation, Article 34 (4).
47 MiCA Regulation, Article 32 (4) points (e) and (f).
48 MiCA Regulation, Article 34 (3).
49 MiCA Regulation, Article 32 (4) point (g).
50 MiCA Regulation, Article 35 (1) and (2).
51 MiCA Regulation, Article 33 (1) points (a) and (b).
52 MiCA Regulation, Article 33 (4).

Crypto-asset service providers

Title 4 of the MiCA Regulation sets the authorisation and operating conditions for crypto-asset service providers. For the provision of certain services additional requirements apply, such as for the custody and administration of crypto-assets on behalf of third parties,[53] the operation of a trading platform for crypto-assets,[54] the exchange of crypto-assets against fiat currency or exchange of crypto-assets against other crypto-assets[55] and the advice on crypto-assets.[56]

An essential requirement for the custody and administration of crypto-assets is a policy with internal rules and procedures that ensure the safekeeping and control of the crypto-assets, including the accessibility to the assets through the safekeeping of cryptographic keys.[57]

As regards to the operation of a trading platform, the operator is responsible for checking the suitability of each crypto-asset before it is admitted to trading on the platform. Firstly, the crypto-asset must comply with the operating rules of the trading platform. Secondly, the operator has to assess the issuer in terms of its reputation, experience and track-record. Another condition is that the crypto-asset does not contain any technical function that would lead to the owner being anonymized. In this respect, the holder of the crypto-assets should always be identifiable by the operator of a trading platform or by the responsible authorities.[58] The latter condition stems from the intention of the legislator to require a strict governance and organisational obligations for the purpose of anti-money laundering and combatting of financing of terrorism through crypto-assets.[59]

The rules for the advice on crypto-assets require authorized providers of such service to assess whether the crypto-asset is appropriate for the client considering the client's knowledge and experience, objectives, financial situation including the ability to bear losses, and the client's understanding of risks involved in an investment in crypto-assets.[60] In principle, these requirements correspond to those stated in Article 25 of the Directive on markets in financial

53 MiCA Regulation, Article 67.
54 MiCA Regulation, Article 68.
55 MiCA Regulation, Article 69.
56 MiCA Regulation, Article 73.
57 MiCA Regulation, Article 67 (3).
58 MiCA Regulation, Article 68 (1).
59 MiCA Regulation, recitals 8 and 57.
60 MiCA Regulation, Article 73 (1) to (3).

instruments (MIFID II)[61] for the provision of investment advice requiring an assessment of the suitability and appropriateness of the financial instrument for the client.

Conclusion

The economic importance of crypto-assets gradually increases, and the MiCA Regulation has been proposed by the European Commission just in time to provide guidance for the developing markets of crypto-assets. The proposal is well thought out and the legal framework addresses the most critical issues. The competent authorities are given the capacity to authorize issuers of crypto-assets under the condition that those entities can demonstrate that they fulfil the necessary organizational and operational requirements. Especially if asset-referenced tokens pose risks to financial market stability or consumer protection, a prudent rulebook regarding the management of the reserve assets is mandatory. Also, the obligation to provide sufficient information about the conditions under which the tokens are issued and inherent risks for prospective purchasers of such tokens is sensible. However, when assessing the proposed rules for the investment of the reserve assets, the legislative bodies in Brussels should also draw parallels to the existing regulation that deals with the investment in similar highly liquid assets, i.e. the Money Market Funds Regulation.[62] In principle, it should be considered whether an issuer of a (significant) asset-referenced token ought to have investment and risk management functions comparable to managers of money market funds.

The Fact that services provided in connection with crypto-assets become regulated under an EU framework will facilitate the development of a new market infrastructure in Europe while at the same prevent regulatory arbitrage when providing cross-border services.

Beyond the MiCA Regulation, for crypto-assets that are financial instruments within the meaning of MiFID II, the legislator is prepared to allow for the adaption of the existing rules of financial markets regulation. In this regard, the European Commission has proposed a

61 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, Article 25 (1) and (2).
62 Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds.

regulation by which a market infrastructure for transferable securities based on DLT could be created.[63]

Through the proposed regulations on markets in crypto-assets and DLT-infrastructure, the European Commission demonstrated that the crypto-technology is an important pillar for the future of the European common market and cross-border transactions. Risks and regulatory challenges have been adequately addressed to allow for a DLT-based industry to prosper within an EU legal framework.

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