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WHAT WE SEEK – WHERE WE STAND

Current and future Crypto-Regulation

Interview with Alpay Soytürk, Spectrum Markets

Crypto-assets have made their way even into otherwise quite conservative investors' portfolios. Demand for a stricter regulation of crypto-assets by prominent economists – such as for example from Benoît Cœuré, former ECB[1] Director and current Head of Bank for International Settlements' (BIS) Innovation Hub[2] – is becoming ever louder. Alpay Soytürk, Chief Regulatory Officer at Spectrum Markets explains to us the status quo of the relevant regulatory initiatives and how they're different from regular approaches.

Alpay, first of all, is the European Union's approach to crypto-regulation different from other regulatory initiatives?

I would think so. Even if the legislative process remains widely unchanged, there is a recognisable intention to differentiate between an established finance industry and one that is in the being and the future shape of which is not clearly definable yet. Unlike in earlier eras, the technology underlying the change has become much more the central subject matter of regulation.

What do you mean by this, after all, any epoch had their technological leaps?

If you compare the distributed ledger technology (DLT) with the performance progress of the microchip, then you would likely and rightly say, that the latter had and has a much broader impact at a global scale. And it's also true that people have always been investing in tech. The difference with a view to finance is that technology has so far been changing the industry indeed, in that processes became leaner and economies of scale changed products and the speed and structure of the business – but it didn't change the nature of the business. DLT has the chance to totally disrupt the business as the transfer of obligations and property without an entire block of services have become technically possible. In combination with the increased level of participation of a broad community of retail clients, the challenges to regulators are manifold. They must be quick to avoid lagging behind technical developments. They want to create a framework for new technologies having the chance to build, for economic and competition reasons. They must avoid that the use of the technology won't pose a threat to market resilience and integrity. They have the overarching goal of investor protection and finally, the perception of financial industry regulation has changed, too.

How has this changed?

On the one hand, regulation is much more determined by what is technically possible today than it was then. On the other hand, regulation has become much more sophisticated and, even more important, substantially stricter in enforcement. As a result of this development, firms do no longer just expect regulators to stipulate clear, understandable and commonly applicable rules to then internally prepare to abide by.

They have begun to see regulatory authorities at the forefront of the technical developments themselves; being capable of defining the relevant governance frameworks they're at the same time held liable for predicting what the direction for a certain market segment or asset class will most likely be. In contrast to earlier regulations that have often been responses to market anomalies or crises, there seems hardly any dispute this time: established market players, start-ups, institutional and retail investors alike seem to believe that the usage of DLT will prove as revolutionary as the internet. And policymakers may finally give the signal for exploiting the markets opening up through it. The debates about how to set the right course show that we live in an era of competitive governance.

Let us come to the core of the regulations – what are the relevant frameworks

In September 2020, the European Commission (EC) adopted the "Digital Finance Package", drafting Digital Finance and Retail Payments Strategies and proposing legislations on crypto-assets and digital resilience. As part of this package, the EC proposed a new legislation on crypto-assets, called 'MiCA'[3], providing definitions and clear standards and conduct rules with provisions covering capital requirements, custody of assets, a mandatory complaint holder procedure available to investors, and rights of the investor against the issuer. The main difference to MiFID – to which it contains references – is that it governs services in relation to assets that are "a digital representation of values or rights that can be stored and traded electronically" (= crypto-assets). Under the same package, the EC issued a proposal for a "pilot regime[4] for market infrastructures based on distributed ledger technology." The latter addresses market infrastructures that wish to try to trade and settle transactions in financial instruments in crypto-asset form.

One month earlier, in August 2020, the German Ministries of Justice and Finance had published the draft bill for a "Law on the Introduction of Electronic Securities (eWpG)", initially just covering bearer bonds. Effectively, this would divide the future regulation of crypto-assets into the following areas: MiCA for cryptocurrencies, utility tokens and stablecoins, MiFID for security tokens and, in Germany, the eWpG for electronic securities. The fourth, the DLT pilot regime, aims at building a framework for the trading and settlement of crypto-assets).

There is a multitude of keywords used, some of them now also used in legal texts – can you give a brief recap of the most commonly used concepts?

Regulatory relevant categorisations are utility, payment and security Tokens. Utility tokens which are sometimes also referred to as known as app tokens, enable access to certain services or products. Payment tokens include classic crypto currencies such as Bitcoin and used as an alternative means of payment. Security tokens, also known as equity tokens or asset tokens, derive their value from an external, tradable asset. While utility tokens and payment tokens are not securities, security tokens grant rights and obligations for companies and investors similar to securities. When issuing utility tokens, the term Initial Coin Offering is used while issuing security tokens is referred to as Security Token Offering or Equity Token Offering.

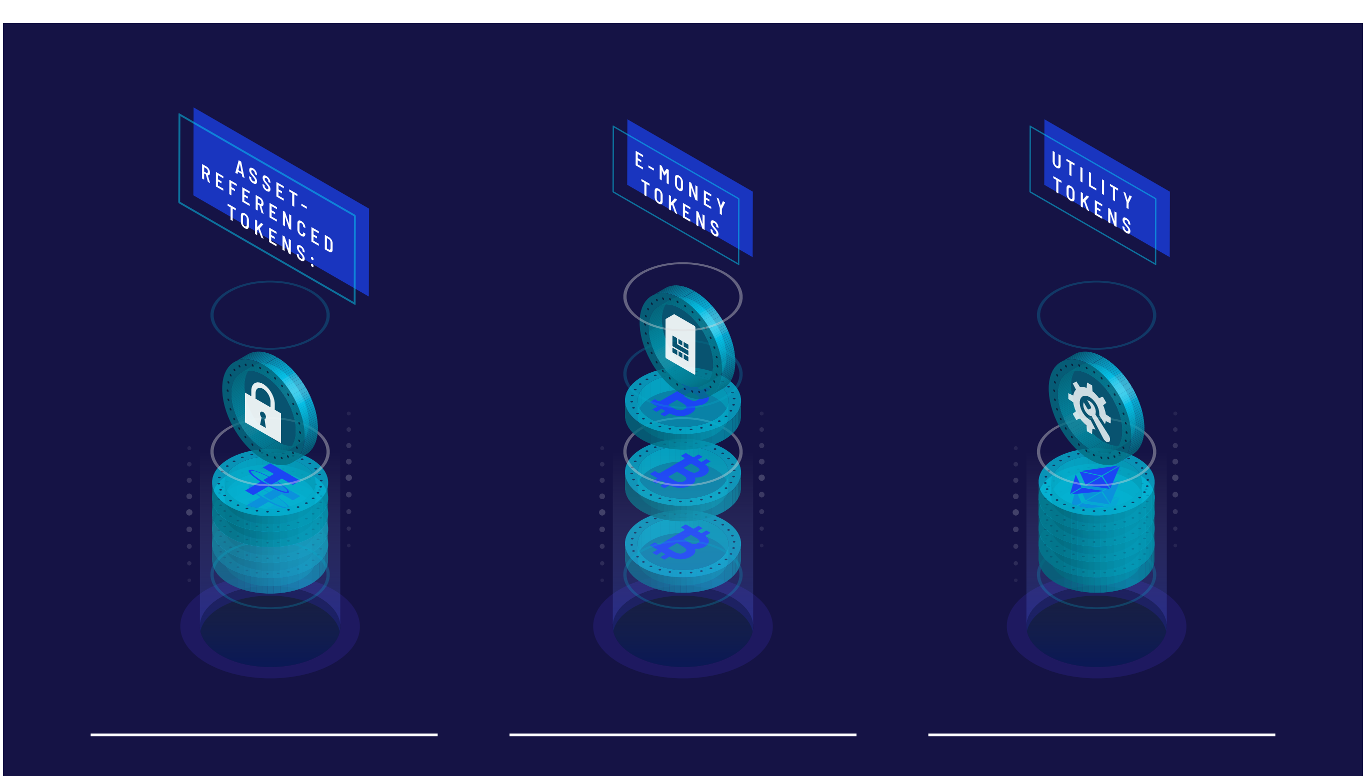
What is MiCA and what is the delineation to MiFiD?

The draft MiCA regulation doesn't cover all types of crypto-assets. Security tokens, i.e., tokenised financial instruments, are not in the scope of MiCA but continue to fall under the provisions of MiFID. As an EU regulation, MiCA, which is supposed to be adopted in the course of 2022, will come into force in all Member States immediately. After entry into force – which starts with the publication of MiCA in the Official Journal of the EU and the Council – there will be an 18-month-period for the application of the regulation.

MiCA aims at uniformly governing transparency and disclosure requirements for the issuance and trading of crypto-assets as well as for the approval and supervision of providers of crypto-assets and their issuers. The focus is on the issuers of asset-referenced tokens and e-money tokens. The regulation is intended to regulate the operation, organisation and management of issuers of asset-referenced tokens as well as e-money tokens and service providers in the field of crypto-assets. Further, consumer protection regulations for the issuance, trading, exchange and custody of crypto-assets as well as market abuse prevention provisions are envisaged. MiCA is understood to supplement existing regulation, aiming at covering companies that issue crypto-assets or provide services relating to crypto-assets. Crypto-assets that are already covered by other regulations are expressly excluded from the scope of application. Also, MiCA doesn't apply to group-internal provisions of crypto asset services and credit institutions and financial services institutions and payment institutions are exempted from certain MiCA regulations.

How are crypto-assets categorised under the regulation?

MiCA defines crypto-assets as the digital representation of a value or right that can be electronically transmitted and stored and that uses DLT. It divides crypto-assets into:



Asset-referenced tokens	E-money tokens	Utility tokens
These are crypto values that are intended to serve as a medium of exchange and which, through reference to fiat currencies, commodities or other crypto values, should have a stable value (stablecoins).	These are crypto-assets that are intended to serve as a medium of exchange and which are denominated in a fiat currency. However, the scope of application must be clearly delimited here since crypto-assets that constitute e-money within the meaning of the e-money directive are not covered by MiCA.	Crypto-assets that offer digital access to applications, services or sources on the DLT and are only accepted by the issuer.

According to MiCA, both asset-referenced tokens and e-money tokens can each be classified as significant asset-related tokens or significant e-money tokens according to the regulation. In this case, further requirements apply. MiCA stipulates regulations for the offer and marketing of crypto-assets. A distinction is made between asset-referenced tokens and e-money tokens on the one hand and other crypto values on the other hand. For other crypto-assets, the issuer (must also be a legal person and meet certain behavioural requirements) must create and publish a whitepaper and report it to its NCA[5]. The whitepaper must describe, among other things, the essential characteristics of the crypto asset and outline the associated risks. These rules don't apply if the crypto-assets are offered for free or if the annual turnover of the offerings does not exceed EUR 1 million.

The issuance of asset-referenced tokens is, among other things, subject to an explicit permission from the NCA. In the case of asset-referenced tokens the white paper must be approved by the NCA. The general requirements for the issuer of asset-referenced tokens include that the issuer must be a legal person, resident within the EU and meeting a minimum capital requirement of at least EUR 350,000. These rules don't apply if the asset-referenced tokens are sold solely to professional investors (and can only be held by them) or if the annual issuance of the tokens is not above EUR 5 million. Stablecoins whose value is derived from an algorithm that calculates the value by the number of tokens based on supply and demand are also out of scope this regulation.

How about e-money, can everyone issue e-money tokens in future?

According to MiCA, the issue of e-money tokens is reserved to credit institutions and e-money institutions. A whitepaper must also be created for e-money tokens and be reported to the NCA. And although MiCA does not apply to crypto-assets that represent e-money under the e-money directive, a large number of regulations from the E-Money Directive apply here, too.

The provision of crypto-assets services itself is also subject to MiCA. For example, only legal persons that are established in the EU and have received the NCA's permission are entitled to provide these services while the permit then applies throughout Member States. Service providers must also establish conflicts of interest policies and procedures and meet several further requirements, depending on the service provided. And where the focus is on payment tokens, i.e., the transfer of values without an investment focus, firms must also comply with the PISA[6] framework.

What is the application scope of the DLT pilot regime?

The DLT pilot regime addresses market infrastructures that wish to try to trade and settle transactions in financial instruments in crypto-asset form. The so-called 'sandbox' approach of the DLT pilot regime allows temporary derogations from existing rules. This aims at enabling regulators to gain experience on the use of DLT in market infrastructures, though ensuring that they can deal with risks to investor protection, market integrity and financial stability.

Under existing regulation, the combination of trading and post-trading activities within one legal entity is not permitted; trading and settlement must be performed by separate market infrastructures. According to the Central Securities Depositories Regulation (CSDR), financial instruments admitted to trading on a trading venue (under the MiFID definition) must be recorded with a central securities depository (CSD).

Since the use of DLT can accelerate the processes of trading and settlement and bring them as close together as if being conducted simultaneously, the DLT pilot regime, once adopted, allows a DLT market infrastructure to facilitate the trading of DLT transferable securities, their initial recording, the settlement of transactions in DLT transferable securities and their safekeeping.

Can an existing MTF or CSD provide their services on DLT-basis?

Not directly but by establishing dedicated legal entities. A DLT market infrastructure, under the pilot regime, must be either a DLT multilateral trading facility (DLT MTF) or a DLT securities settlement system (DLT SSS). The operational governance frameworks are similar to the existing ones, i.e., a DLT MTF must be operated by a market operator that is approved under the laws of MiFID whereas a DLT SSS must be operated by a CSD approved under the laws of the CSDR.

If an operator of an MTF wants to obtain authorisation as a DLT MTF, the same basic rules apply as are applicable for the operation of a 'traditional' MTF. However, if it can meet specific technical and organisational (including reporting) requirements, it may apply for being made exempt from the book-entry obligation or the obligation to recording with a CSD. If an authorisation is granted, it will have a maximum initial duration of six years so as to align with the tenor of the pilot regime the further shape of which shall be decided upon by European legislative bodies five years after its entry into force.

What is your personal view on MiCA?

After reviewing the draft MiCA, I think that the proposed regulations represent a clear regulatory framework for the existing and the developing European crypto asset market. It may facilitate a uniform governance framework for the development of crypto asset market, appreciative of the service, asset or client type concerned and supporting a "same activity, same risk, same rules" approach. This is crucial since the status quo constitutes an unlevel playing field. For firms that provide services in association with crypto-assets that qualify as financial instruments within the meaning of MiFID, various regulations become applicable. Subject to the relevant services provided, and besides MiFID itself, these are the Prospectus Regulation, the Transparency Directive, the Market Abuse Regulation (MAR), the Short Selling Regulation, the CSDR, and the Settlement Finality Directive.

And what would be your judgement of the DLT pilot regime?

Again, I believe the regime is an important cornerstone for the development of trading and settlement services based on distributed ledger technologies. Direct access for retail investors to DLT MTFs while abiding by high consumer protection standards is in accordance with Spectrum Markets' philosophy. A fully tokenised trading lifecycle would also mean an unparalleled degree of transparency and simultaneity providing a lot of protection against abusive acts. However, for the technology to unfold its full potential, I think that other areas of law must consider DLT, too. I would also promote that the range of DLT transferable securities admitted to trading or recorded, or both, on a DLT market infrastructure should not be limited to certain types of shares, bonds or ETF units.

Why are you promoting this?

I think the separation of categorisations between different types of tokens is inconsistent with the rules stipulated for MTFs that aim at a registration as DLT MTF. The secondary market for derivative products on crypto-assets is currently an important component for investments in these products. While we can't eliminate the current volatility within these crypto-asset markets, as a MiFID-regulated MTF we can ensure a safe and transparent environment for trading on the secondary market, providing retail investors with the opportunity to participate in the valuation movement of these assets without the need to physically own them and with a fraction of the capital needed.

How about the enforcement of the new rules?

I believe there is at least a risk that the attribution of competences to NCAs under Art. 4 (1) of the draft regulation may entail effects that are detrimental to the intention of the regulation. What is meant to empower NCAs to impose stricter rules where appropriate or necessary may tempt others to loosen the regime in an attempt to attract more operators to their jurisdiction. Then again, I appreciate that the legislative process has been consultative, transparent and convergent throughout the EU, providing legal certainty for a common market that would otherwise constitute a patchwork rug of jurisdictions. I believe that the more complex an underlying technology gets and the more challenging the interaction will become between this technology, the multiple layers of legacy and future infrastructures and the existing and new legislations inherent to it, the stronger the focus on engagement and dialogue between stakeholders should be.

Thank you very much!

[1] European Central Bank
[2] The Innovation Hub is the BIS' technology think tank and advisory unit
[3] Regulation on Markets in Crypto Assets
[4] Proposal for a regulation on a pilot regime for market infrastructures based on distributed ledger technology
[5] National competent authority
[6] Oversight framework for electronic payment instruments, schemes and arrangements

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