FRO in-depth: The future of cryptoassets regulation

Partners **Julia Smithers Excell** and **Stuart Willey**, and associate **Laura Kitchen** of global law firm White & Case take a deep dive on the latest publications from EU and UK regulators aimed at providing supervisory clarity on the nascent cryptoasset market.

Recent publications by EU and UK regulators bring much-needed clarity to the nascent cryptoasset market. Regulators recognise increased speed and a reduction in cost of cross-border money remittance as benefits of cryptoassets; however, they remain concerned by consumer protection and market integrity issues, particularly in relation to market abuse and money laundering.

At the EU level, the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) have considered how the cryptoasset market operates across Member States and have assessed whether the existing regulatory framework is fit for purpose. It is for EU policymakers to determine what action is required to address the shortcomings identified in the reports.

Meanwhile, the UK Financial Conduct Authority (FCA) issued consultation paper CP19/3, which sets out a taxonomy of cryptoassets and provides guidance on which types of cryptoassets fall within the regulatory perimeter. The ensuing dialogue will give market participants the opportunity to shape regulatory policy in this area.

Cryptoassets regulation in the EU

On January 9, 2019, the EBA and ESMA published reports containing their advice on cryptoassets. These reports form a response to the request by the European Commission in its 2018 fintech action plan for European Supervisory Authorities (ESAs) to assess the suitability of the current EU regulatory framework.

EBA and ESMA published advice on cryptoassets

At the same time, ESMA published the outcome of its 2018 survey of EEA Member States' transposition of the Markets in Financial Instruments Directive II (MiFID II) and their application of its "financial instruments" definition to a sample set of six cryptoassets under their particular national regulatory regimes. This covered a range of characteristics, including investment, utility and hybrids of both (including payment hybrids). Pure payment-type cryptoassets such as Bitcoin were excluded. The survey results fed into ESMA's advice.

Pending any regulatory reform, these publications provide some clues about how regulators in Europe may view the provision of cryptoasset services in their territories in the future against the existing regulatory framework. The publications should be reviewed by any participant intending to develop a new cryptoasset service.

A question of interpretation

The results of the ESMA survey show that different Member State regulators have different interpretative approaches to some aspects of the definitions of MiFID II "financial instrument", creating difficulties for the regulation and supervision of cryptoassets.

Those qualifying as "transferable securities", or other types of MiFID II "financial instruments", would render their issuer and related service providers potentially subject to the full set of EU financial rules, including the

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Prospectus Directive, the Transparency Directive, MiFID II, the Market Abuse Directive, the Short Selling Regulation, the Central Securities Depositories Regulation (CSDR) and the Settlement Finality Directive (SFD).

ESMA's advice takes each of these rules in turn and shows how they might apply to cryptoassets, highlighting areas requiring additional review, amendment, interpretation or reconsideration.

Most Member State regulators that responded to ESMA's survey viewed ancillary rights to profit alone (and not alongside ownership or governance rights) as sufficient for a cryptoasset to qualify as a "security", and hence, as a "transferable security" (in addition to the required MiFID II criteria). None viewed a pure utility token as a "transferable security" or a "financial instrument", leading ESMA to conclude that utility tokens fall outside the regulatory perimeter.

Most felt that those qualifying as "financial instruments" should be regulated as such, with necessary changes to accommodate issues such as the risk of forking (i.e. changing the underlying software to create two versions) and the custody of private keys and a potential review of current rules on clearing, settlement, safekeeping and record of title. The vast majority of respondents viewed any move to classify all cryptoassets as "financial instruments" as unwelcome, since it would legitimize them and have unwanted collateral effects.

Respondents' views on the creation of a bespoke new regime outside MiFID II were mixed. However, of the eight Member State regulators that viewed the mooted creation of a new C12 category of "financial instrument" in MiFID II as beneficial for legal certainty and EU harmonization reasons, six believed the full set of EU financial rules should apply.

ESMA provides an overview of how the MiFID II rules are likely to apply to platforms trading cryptoassets qualifying as "financial instruments" and their operators and investment firms, covering minimum capital, organizational, governance and investor protection rules, open access, pre- and post-trade transparency, transaction reporting and record-keeping.

It is not clear to ESMA how to apply MiFID II rules to decentralized trading platforms that use smart contracts to match orders with no identifiable platform operator, without a significant review and amendment of current rules.

Applying transparency requirements to platforms trading cryptoassets would also present a significant challenge. Data reporting and record-keeping rules would need amendment to apply to the specificities of cryptoassets, but would not be workable until common identifiers and classifications (CFI codes, ISINs) are developed for cryptoassets.

ESMA also notes that the Market Abuse Regulation may not capture inside information held by miners and wallet providers, and that it is not clear how miners would be treated under the CSDR in terms of governance and technical requirements due to their novel and essential role in the settlement process.

It is similarly unclear how settlement finality would be achieved from an operational and legal perspective under the SFD in a distributed ledger technology (DLT) environment in light of consensus validation, the risk of forks and governance issues with permissionless DLTs, or how national law variables regarding the legal effect of book entries would interface with the CSDR requirement to represent securities in book entry form when applied to cryptoassets.

The application of EU rules on safekeeping and segregation under the CSDR and the Financial Collateral Directive raises the question of whether, in the cryptoasset world, the provision of safekeeping services equates to having control of private keys on clients' behalf and how this applies in different contexts, e.g., multi-signature wallets with several private keys.

Other identified gaps in applying existing legislation to cryptoassets as MiFID II financial instruments include rules to ensure that the protocol and smart contracts underpinning cryptoasset activities meet minimum reliability and safety requirements, and rules addressing the novel cyber-security risks of DLT.

Falling between the gaps

ESMA believes that consumers are exposed to substantial risks where cryptoassets neither qualify as MiFID II financial instruments nor fall within the scope of other EU rules, such as the second Electronic Money Directive (EMD2) or the second Payment Services Directive (PSD2).

Some EU Member States have, or are considering, specific rules to address these, but in light of the cross-border nature of cryptoasset activities, ESMA believes an EU-wide approach will provide a more level playing field. ESMA believes that EU policymakers should consider how to address these risks with a bespoke approach, with risk disclosure rules and warnings as a priority.

Five Member State regulators have reported to the EBA cryptoassets qualifying in their view as e-money within the scope of EMD2. Should a firm carry out a payment service with such assets, its activity would fall within the scope of PSD2. However, the EBA remains concerned about those forms of cryptoassets and related activities potentially falling outside the current regulatory perimeter, including the activities of cryptoasset custodian wallet provision services and cryptoasset trading platforms.

ESMA's report sets out risks for regulators to consider when dealing with cryptoassets. While both ESAs regard cryptoasset activity in the EU as relatively limited, with little current risk to financial stability, they remain concerned about consumer protection, shallow liquidity, operational resilience and market integrity issues where cryptoassets

fall outside the regulatory perimeter. ESMA identifies the most significant risks as fraud, cyberattacks, money laundering and market manipulation, with investor protection undermined where cryptoassets fall outside the current regulatory perimeter, and thus do not benefit from regulatory safeguards.

ESMA questions whether custodial wallet providers are safeguarding and segregating cryptoassets properly for their clients, noting that many also act as cryptoasset trading platforms. It highlights issues associated with DLT including governance, privacy and territoriality.

ESMA and most of its survey respondents also believe that cryptoassets and related activities should be subject to anti-money laundering (AML) rules as a priority. The EBA asks the EC to consider the latest AML guidance by the Financial Action Task Force (FATF) in relation to cryptoassets and the need for a further review of EU AML legislation in relation to providers of crypto-to-crypto exchange services and financial services for Initial Coin Offerings (ICOs). The EBA also notes that the ESAs will be producing a joint opinion in 2019 on the AML and terrorist financing risks associated with virtual currencies.

The EBA advises the EC to carry out a cost/benefit analysis to assess the feasibility of EU-level action to address these issues, as well as the environmental impact of cryptoasset activity, adopting a technology-neutral and future-proof approach.

The EC is due to commission a study on the legal, governance and interoperability aspects of blockchain technology. As the market develops, ESMA highlights the need for further work on the application of the existing regulatory framework to in-scope cryptoassets, and on the scoping of new rules for those which fall outside. The EBA will also continue to monitor where cryptoassets stand in relation to the regulatory perimeter.

Once the Basel Committee on Banking Supervision (BCBS) has concluded its work on the prudential treatment of banks' holdings of, and exposures to, cryptoassets, the EBA will report to the EC on whether the Capital Requirements Directive or the Capital Requirements Regulation will need amendment or clarification.

Comments are due on the FCA guidance for market participants

The EBA will also monitor the need for any guidance to support the common application of current regulatory capital rules to banks' exposures to and holdings of cryptoassets. Pending further regulatory developments, including the outcome of the BCBS work, the EBA notes that regulators and banks should adopt a conservative prudential approach to the treatment of exposures to cryptoassets in Pillar 1, supplemented by Pillar 2 requirements if necessary.

The EBA also calls on the EC to promote consistency in the accounting treatment of cryptoassets, in light of the current absence of clarity about whether, for example, a holding of a cryptoasset should be treated as an intangible asset, potentially leading to questions around the resulting prudential treatment and with divergent approaches undermining the EU level playing field.

Benefits of DLT and ICOs

On the upside, ESMA notes the potential benefits of DLT, referencing its 2017 report on this topic, and of tokenization in its enhancement of the liquidity of traditional assets represented on the blockchain. The speed and efficiency of funding from a diverse investor base via ICOs is also recognized as a benefit, provided appropriate safeguards are in place.

The UK perspective: FCA consults on crypto guidance

On January 23, 2019, the FCA launched its highly anticipated consultation (CP19/3) on guidance for market participants regarding where certain cryptoassets sit in relation to the regulatory perimeter- and whether relevant stakeholders need to be authorized by the FCA. Comments are due by April 5.

Last October, the Cryptoassets Taskforce, comprising the FCA, HM Treasury and the Bank of England, published a final report that trailed the aim of the FCA to clarify the regulation of security tokens for market participants, including ICO issuers and secondary market platforms, which may not realize that they fall within the current regulatory perimeter.

In parallel, the FCA has been monitoring for potential breaches by entities or individuals carrying out regulated activities without the appropriate authorization and will be increasing its anti-avoidance focus on ICO issuers who market securities as non-regulated utility tokens.

CP19/3 sets out the FCA's views on whether tokens are likely to be classed as "specified investments" under the Regulated Activities Order (RAO), "financial instruments," such as "transferable securities" under MiFID II, "e-money" under the E-Money Regulations (EMRs), or captured under the Payment Services Regulations (PSRs).

The FCA uses the term "security token" to denote tokens constituting "specified investments" under the RAO and notes that HM Treasury will be publishing a consultation on potentially broadening the FCA's regulatory remit to capture additional types of cryptoassets.

Security tokens: Inside the regulatory perimeter

The guidance is aimed at helping firms more easily determine whether certain cryptoassets fall within the perimeter by mapping them across to RAO and MiFID II instruments and investments, with case studies, an indicative list of market participants undertaking cryptoasset activities and the types of permissions they may need, and model Q&A.

Factors listed by the FCA as indicative of an RAO "specified investment" include any contractual entitlement to profit share, revenues, payments or other benefits, quasi-voting rights and tradability on cryptoasset exchanges.

The FCA believes the most relevant

RAO "specified investments" are shares, debt instruments, warrants, certificates representing certain securities, units in collective investment schemes, and rights and interests in investments. The FCA's proposed guidance on mapping these across to tokens is summarized as follows:

(a) Shares

Tokens giving holders voting, dividend, capital distribution or similar rights to shares, or which represent ownership or control, are likely to be security tokens. But a token that provides the holder with the right to vote on future ICOs in which the firm will invest, and no other rights, would likely not be considered a share, since the voting rights give only direction and do not confer control-like decisions on the future of the firm.

For a token to be considered a MiFID II "transferable security", it must be capable of being traded on the capital markets, so tokens conferring ownership, control and similar rights that are so tradable are likely to be categorized as "transferable securities".

Even if a token that looks like a share is not a MiFID II "transferable security" e.g., due to restrictions on transferability, it may still be capable of being an RAO "specified investment".

(b) Debt instruments

A token creating or acknowledging indebtedness by representing money owed to the holder is a debenture and therefore constitutes a security token. If it is tradable on the capital markets, being transferable from one legal titleholder to another, it may be a MiFID II "transferable security" too.

(c) Warrants

Tokens giving holders the right to subscribe for different tokens in the future, where the latter are RAO "specified investments", will likely constitute warrants and thus securities.

(d) Certificates representing certain securities

Tokens akin to depository receipts would fall into the security token category if they confer rights on the holder in relation to tokenized shares or tokenized debentures.

(e) Units in collective investment schemes

A token acting as a vehicle through which profits or income are shared or pooled, or where the investment is managed as a whole by a market participant, is likely to be a collective investment scheme. References to pooled investments, pooled contributions or pooled profits in the ICO white paper could also render a token to be more like a security.

- **Rights and interests in investments** Tokens representing rights to or interests in certain investments, including those listed above, comprise RAO "specified investments". So a token representing a right in a share is a security token, even though the token itself does not have the characteristics of a share
- **Products referencing tokens** Products that reference tokens (e.g. derivatives) are very likely to fall within the regulatory perimeter as "specified investments" (either as options, futures or CFDs under the RAO) and may also be MiFID II "financial instruments"
- **Jurisdictional differences** The FCA notes that different countries may define a security differently, so the nature of the token must be assessed for every jurisdiction in which the token is sold or in which the firm operates, to determine whether it triggers the application of any securities regulation.

(f) Exchange tokens: Outside the regulatory perimeter

The FCA asks stakeholders if they agree with its conclusion that exchange tokens are not RAO "specified investments" and currently fall outside the regulatory perimeter. While they can be held for the purpose of speculation rather than exchange, the FCA views this as insufficient for exchange tokens to constitute "specified investments". So a cryptoasset exchange that only facilitates transfers of exchange tokens such as Bitcoin, Ether and Litecoin between participants is not carrying on a regulated activity.

The FCA gives a case study from its regulatory sandbox where exchange tokens are used to facilitate regulated payment services and the PSRs cover the fiat currency remittance at each end of the transfer, but not the use of cryptoassets in between which acts as the vehicle for fast remittance. It seeks feedback on whether further guidance on this use case could be beneficial.

(g) Utility tokens

While the FCA regards utility tokens as not constituting MiFID II "specified investments" (even if traded on the secondary market and used for speculative investment purposes), they could be e-money in certain circumstances, so related activities could fall inside the perimeter.

Exchange tokens (e.g. Bitcoin and Ether) are unlikely to represent e-money because they are not usually centrally issued upon the receipt of funds, nor do they represent a claim against an issuer

(h) Cryptoassets as e-money

Exchange tokens (e.g. Bitcoin and Ether) are unlikely to represent e-money because they are not usually centrally issued upon the receipt of funds, nor do they represent a claim against an issuer.

But any cryptoasset could be e-money under the EMRs if it is electronically stored monetary value as represented by a claim on the electronic money issuer, which is issued upon the receipt of funds for the purpose of making payment transactions, accepted by a person other than the electronic money issuer and not excluded under the EMRs. "Electronic storage of monetary value" includes the possibility of using Distributed Ledger Technology (DLT) and cryptographically secured tokens to represent fiat funds, e.g. GBP or EUR.

(i) Stablecoins as e-money

Cryptoassets that establish a new sort of unit of account rather than representing fiat funds are unlikely to amount to e-money unless the value of the unit is pegged to a fiat currency, depending on the facts. The FCA considers that "stablecoins" that are "fiat-backed", "fiat-collateralized" or "deposit-backed" by being pegged to say, US dollars (usually with a 1:1 backing) and used to pay for goods or services on a network, could potentially meet the definition of e-money if they also meet the criteria in the paragraph above.

(j) Indicative list of market participants, potential activities and permissions

Table 1 in CP19/3 shows the main cryptoasset market participants likely to be carrying out regulated activities, some of the more common services they are likely to provide, and the permissions required to carry them out. Exchanges trading security tokens may be carrying out the RAO-regulated activities of arranging deals in investments and making arrangements with a view to investments. If the tokens are also MiFID II "financial instruments", the firm may also need permission to operate a multilateral trading facility (MTF) or an organized trading facility (OTF).

Firms providing custody services as wallet providers in relation to such securities may need to apply to the FCA for the relevant permission for conducting the RAO-regulated activity of safeguarding and administering investments. The FCA seeks input on whether any other key market participants are involved in the cryptoasset market value chain or whether any activities are performed in the cryptoasset market that do not map neatly across to traditional securities.

(k) Model Q&A

The Guidance Q&A includes model answers to the following questions:

- *If I accept only cryptoassets as a form of payment for my token, can it still be a security token?* The FCA model answer distinguishes e-money regulations where a token must be issued upon receipt of fiat funds vs security tokens, which disregard whether they are exchanged for fiat funds, exchange tokens or other forms of cryptoassets, or in some cases anything at all
- Utility tokens: *My network is/ aims to be fully decentralized and I will not have any control over the network anymore. Does this have an impact on whether the tokens could be regulated or not?* The FCA model answer notes that the more decentralized the network, the less likely it is that the token will confer enforceable rights against any particular entity, so it may not confer similar rights to those of RAO "specified investments"
- *What other consumer protections may apply under UK law to utility tokens or cryptocurrencies that are not specified investments?* The FCA model answer lists Financial Promotion rules, Conduct of Business rules, Principles for Business rules, the Senior Managers and Certification Regime (SMCR) and the accountability regime, the Advertising Codes regulated by the Advertising Standards Authority, Trading Standards, general common law, criminal law and the General Data Protection Regulation

(l) Benefits of cryptoassets

The FCA views the only benefits of the current generation of cryptoassets as increased speed and a reduction in cost of cross-border money remittance when cryptoassets are used as a vehicle for exchange, but notes that this is a rapidly developing market. Firms providing innovative propositions with genuine consumer benefits are encouraged to contact the FCA's Innovate team if they are unsure about which regulated activities apply to their business models.

Consumer protection

The FCA has commissioned research on the use of cryptoassets by UK consumers and will be conducting a follow-up survey in 12 months' time to assess if the guidance has helped consumers to gain a greater understanding of the cryptoasset market. Confusion over consumers' lack of recourse to the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS) is compounded by firms offering both regulated and unregulated cryptoasset products in parallel.

CP19/3 cites examples of consumer harm caused by poor cybersecurity, fraud, market infrastructure failings, volatility, misleading advertising and limited transparency around price formation and prospectus-type disclosures in the white papers typically accompanying ICOs.

The FCA will consult during 2019 on a potential prohibition of the sale to retail consumers of derivatives referencing certain types of cryptoassets, e.g. exchange tokens, including contracts for difference (CFDs), options, futures and transferable securities.

The FCA is also considering whether the complex technological aspects of cryptoassets could potentially create

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equality and diversity considerations for certain consumers, and asks for input on this.

While CP19/3 does not cover the Market Abuse Regulation, the FCA notes that the novel nature of the cryptoasset market may create new abusive behaviors that are not captured by current regulation and market monitoring and surveillance arrangements.

Prospectus and transparency requirements

While issuers of tokens may themselves not need to be authorized, the FCA flags that prospectus and transparency requirements may apply.

If a token is a transferable security and will either be offered to the public in the UK or admitted to trading on a regulated market, the issuer will need to publish a prospectus unless an exemption applies (e.g., for offers made entirely in the UK for less than €8 million in any 12-month period). The FCA points out that for equity-type securities, historical financial information is required as well as a confirmation that the issuer has sufficient working capital and a capitalization and indebtedness statement. New listed issuers of tokens also need to complete an eligibility review with the FCA.

The FCA reminds firms to communicate financial promotions for cryptoasset products and services, regulated or unregulated, in a way that is clear, fair and not misleading, including setting out precisely which activities are regulated and those that are not, and ensuring that consumers can easily differentiate those activities that the firm is authorized by the FCA to conduct.

Money laundering

The FCA also reminds firms that MLD5 will be transposed into UK law by the end of 2019, extending AML and counter-terrorism financing regulation to entities carrying out the following activities, pending formal consultation by HM Treasury:

- Exchange between cryptoassets and fiat currencies
- Exchange between one or more forms of cryptoassets
- Transfer of cryptoassets
- Safekeeping or administration of cryptoassets or instruments enabling control over cryptoassets
- Participation in and provision of financial services related to an issuer's offer and/or sale of a cryptoasset

The development of the cryptoasset market requires clear, effective regulation, which fosters innovation while maintaining robust consumer safeguards. In light of the EU and FCA publications, the market should be primed for reform in the near future. To the extent possible, participants should engage with regulators to ensure that their perspective is represented in an evolving regulatory environment and seek legal advice if in doubt.

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