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Non-Paper on the legislative proposals for an EU framework for markets in crypto-assets

The Commission is preparing a broad package on digital finance, including legislative proposals on crypto-assets, aimed at increasing legal certainty, supporting innovation, increasing consumer and investor protection and ensuring financial stability.

The initiative for crypto-assets would cover specifically:

- A bespoke regime for markets in crypto-assets (MiCA), including 'stablecoins', and crypto-asset service providers not covered elsewhere in the EU financial services legislation;
- A Pilot regime for distributed ledger technology (DLT) market infrastructures for crypto-assets that qualify as financial instruments;
- A targeted amendment to the notion of financial instruments under the Markets in Financial Instruments Directive II, to make it sure that such an instrument can be issued on a DLT.

This document outlines the Commission services' reflections so far on those potential legislative proposals for discussion with the Expert Group on Banking, Payments and Insurance with a view to receive Member States' feedback.

This document is structured as follows:

1) Background
2) Objectives
3) Clarification of the notion of financial instrument under MiFID II
4) Pilot regime for DLT market infrastructures relating to financial instruments
5) MiCA (Markets in Crypto-Assets)

The Commission services invite Member States experts' comments and suggestions, ideally accompanied by data and evidence.

1. Background

These initiatives are part of the package of measures to further enable and support the potential of digital finance in terms of innovation and competition while mitigating the risks. One of the strategy's identified priority areas is ensuring that the EU financial services regulatory framework is innovation-friendly and does not pose obstacles to the application of new technologies. These initiatives would represent the first concrete action within this area, seeking to increase both consumer and investor protection and legal certainty for crypto-assets, facilitating the use of DLT and crypto-assets by innovative firms while further increasing financial stability.

The initiatives would also closely linked with wider Commission policies on blockchain technology. They would build on advice received from the EBA and ESMA on crypto-assets in January 2019, as well as long-standing market monitoring and participation in international fora, a dedicated public consultation, and publically available reports from supervisory authorities, international standard-setting bodies and leading research institutes as well as quantitative and qualitative input from identified stakeholders across the global financial sector.

2. Objectives

These initiatives would be intended to contribute to the overall objectives that will support markets in crypto-assets in the EU. The first objective is legal certainty, which is needed both for crypto-assets that are not covered by existing EU financial services legislation and for the application of DLT in financial services and the tokenisation of traditional financial instruments. The second objective is to support innovation. To promote the uptake of DLT and development of crypto-assets and crypto-assets services, it is vital to put in place a sound and proportionate framework to support responsible innovation and fair competition. The third objective is to ensure appropriate levels of consumer and investor protection and market integrity. The fourth objective is to ensure financial stability.

3. Clarification of the notion of financial instruments (MiFID II)

The regulation of a crypto-asset should follow its economic function. Securities tokens, i.e. crypto assets which have all the characteristics of a financial instrument, should be regulated and supervised under MiFID II (Directive 2014/65/EU). In order to clarify this and ensure full harmonisation on this approach, a modification of the notion of financial instruments (Article 4(15)) could be considered to make it sure that such financial instruments can be issued on a digital ledger.

While more specific and detailed amendments in order to ensure full convergence of the application of this principle (for example on the treatment of hybrid tokens) have been considered, the level of detail needed to ensure convergence in practice and the continuous adjustment necessary for these purposes do not lend themselves for enshrining them in binding regulatory acts. This legislative amendment would therefore be supplemented with an interpretative guidance to increase convergence.

4. Securities tokens: pilot regime for DLT market infrastructures

As regards security tokens (i.e. crypto-asset qualify as financial instruments) and based on the advice received from ESMA and EBA and the public consultation on crypto-assets, the preparatory work has shown that:

- On the one hand, while there is a nascent primary market for security tokens, there is no real financial market infrastructures (such as trading venues, central security depositories) able to create a secondary market for those security tokens, due to some regulatory obstacles. In the absence of a real secondary market, issuances of security tokens are unlikely to reach significant scale;
- On the other hand, it is very difficult for market participants and regulators alike to identify precisely the regulatory obstacles embedded in EU financial service legislation, in the absence of concrete examples of market infrastructures using DLT in the EU.

Therefore, a pilot regime on DLT market infrastructures that would be similar to a sandbox approach would be envisaged. This would enable both market participants and regulators to gain experience on the use DLT, the benefits of that technology and the novel form of risks it creates. Since the last meeting of the EGBPI, the idea of a pilot regime for DLT market infrastructures has matured significantly.

The initiatives would establish operating requirements for DLT market infrastructures, permissions to make use of them and the provisions for supervision and cooperation of national competent authorities (NCAs) and ESMA.

A DLT market infrastructure would be either a DLT multilateral trading facility (operated by a MIFID II investment firm or by a market operator) or a DLT Central Securities Depository[1] (operated by a CSD). The market participants wishing to operate a DLT market infrastructure would be required to obtain a specific permission granted by their NCAs under the conditions set out in the new legislation (and on the top of their existing authorisation as investment firm or CSD).

In order to avoid creating any financial stability risks, the DLT market infrastructure would only be allowed to admit to trading or to record on the digital ledger 'simple' financial instruments (i.e. shares and bonds) that are not liquid. To determine whether a share or a bond is liquid, the criteria set out in MiFIR (Markets in Financial Instruments Regulation - Regulation (EU) 600/2014) could be taken into consideration. For example, for shares, the market capitalisation of the issuer should be less than EUR 200 million; for corporate bonds the limit per issuance would be EUR 500 million.

The requirements applying to a DLT multilateral trading facilities would be the same as for an MTF under MiFID, except if the DLT MTF requests exemptions when seeking the

[11] Please note that this is the preliminary views of the Commission services and the terms used are likely to be changed. For instance, the term DLT CSD could be changed in DLT Securities Settlement System.

specific permission. The requirements applying to a DLT CSD would be the same as those for a CSD under CSDR (Central Securities Depositaries Regulation – Regulation (EU) 909/2014), except if the DLT CSD requests exemptions when seeking its specific permission.

A DLT MTF would be able to request, for instance, exemptions from the obligation of intermediation under MiFID. A DLT MTF would also be able to trade securities that are not recorded with a CSD (under Article 3(2) of the CSDR), provided that the DLT MTF ensures the initial recording of these securities on the digital ledger and settle the transactions in security tokens themselves. If the DLT MTF did not request an exemption from Article 3(2) of CSDR, the securities would need to be recorded with a CSD or DLT CSD.

A DLT CSD would be able to ask for exemptions from rules that may be difficult to apply in a DLT context (e.g. derogations from the notion of transfer of orders, securities account, recording of securities, cash settlement…).

These potential exemptions would have to be granted only if strict conditions are met in order to mitigate potential risks. First, the DLT market infrastructure would have to demonstrate that the application of the rules for which an exemption is requested is incompatible with the use of DLT. Second, the DLT market infrastructure would have to demonstrate that the exemption requested is proportionate and to propose compensatory measures to meet the objectives pursued by the provisions for which an exemption is requested.

Furthermore, to avoid any regulatory arbitrage across the EU and ensure a level playing field across DLT market infrastructures, ESMA would have to issue a non-binding opinion on the permission to be granted and the exemptions requested by the applicant, taking into account the objectives of investor protection, market integrity or financial stability and with the view to ensuring the consistency and proportionality in terms of exemptions granted by competent authorities to DLT MTFs.

To obtain the specific permission to operate a DLT market infrastructure, the applicant would also be subject to additional measures to address the novel forms of risks raised by the use of the underlying technology:

- adequate specific IT/cyber arrangements,
- enhanced information obligations towards members/participants/investors,
- specific rules on the segregation of clients' assets,
- adequate transition strategy in the event that the permission or exemptions granted were discontinued or withdrawn,
- obligation to make a detail report to NCAs, including any difficulty to apply legislation,
- obligation to report information to the NCAs, as soon as possible related to any change to the business model, any cyber threat suffered by the DLT market infrastructure, any concern related to investor protection or financial stability.

During the time-limited experimentation, NCAs would have also the power to impose some corrective measures on the DLT market infrastructure. NCAs would have the power to withdraw the permission or the exemptions granted in case of significant flaws in the services

or activities, breach by the DLT market infrastructure of any exemptions granted or if such DLT market infrastructure has admitted to trading or recorded securities which are not those allowed under the pilot regime.

ESMA would fulfil a coordination role between competent authorities, with a view to building a common understanding of DLT, consistent supervisory practices and ensuring consistent approaches and consistency supervisory outcomes.

This pilot regime is envisaged as a temporary regime to enable market participants, regulators and the ESAs to gain experience on the use of DLT in the EU financial service legislation. After a three-year period, it is intended that the Commission would therefore produce a detailed report on this pilot regime to the Council and Parliament. This report would make a cost-benefit analysis on whether 1) this pilot regime should be maintained as it is, 2) whether it should be extended to new categories of financial instruments, 3) whether some targeted amendments to EU legislation should be brought to enable a widespread use of DLT, and 4) whether this pilot regime should be terminated.

5. Bespoke regime for crypto-assets not covered under existing EU financial services legislation

The bespoke regime, MiCA, is presently being considered in the form of a Regulation to establish harmonised requirements at EU level for issuers that seek to offer their crypto-assets across the Union and crypto-asset service providers wishing to apply for an authorisation to provide their services in the single market. This initiative would replace existing national frameworks applicable to crypto-assets not covered by existing EU financial services legislation.

The legislation would be designed around five main building blocks:

- Scope, subject Matter and definitions
- Requirements on issuers;
- Requirements on issuers of asset-backed crypto-assets (often referred as ‘stablecoins’);
- Requirements for crypto-asset service providers;
- Dedicated rules to ensure market integrity rules;
- Supervision of issuers, issuers of asset-backed crypto-assets, crypto-asset service providers and powers of national competent authorities to ensure market integrity;
- Transitional measures.

5.1. Scope and definitions

MiCA would start by detailing the scope and definitions of the Regulation, whereby the scope of MiCA is limited to crypto-assets not covered by existing EU financial services legislation (e.g. exclusion of crypto-assets qualifying as financial instruments, electronic

money, deposits or structured deposits). MiCA would not be applicable to central banks acting in their monetary capacity.

For the purposes of the Regulation, MiCA would also define among others, the following notions: 'crypto-asset', 'utility token', 'asset-backed crypto-asset', 'significant asset-backed crypto-asset', and the different services related to crypto-assets, such as the service of custody (i.e. wallet providers) and of exchange, the operation of a trading platform. As mentioned during the EGBPI 18 May, MiCA would not provide a full taxonomy of crypto-assets, as the difference between payment/utility/investment crypto-assets is sometimes difficult to delineate. However, beyond the wider category of 'crypto-assets', MiCA would distinguish two subcategories where different requirements would be relevant: 'utility token' and 'asset-backed crypto-asset'.

Considering the constant developments within crypto-assets, the potential regulation would also grant power to the Commission (through a delegated act) to specify purely technical elements of the definitions to adjust them to market and technological developments.

5.2. Requirements on issuers of crypto-assets

In their preparatory work, Commission services identified that EU consumers can purchase unsuitable products without having access to adequate information. Crypto-asset issuances are sometimes accompanied by "white papers" describing the offer of crypto-assets. However, these are not standardised and the quality, transparency and disclosure of risks vary greatly.

The main requirement of MiCA on issuers would therefore be to mandate the publication of a harmonised whitepaper/information document accompanying an issuance of crypto-assets in the EU with mandatory disclosures (detailed description of the issuer, the project and planned used of funds, conditions of the offer, rights and obligations attached to the crypto-assets and risks). Certain exemptions to this whitepaper would also be implemented for small offerings of crypto-assets (value under €1 million within a twelve-month period) and for offerings aimed at qualified investors as defined in the Prospectus Regulation.

Beyond the whitepaper, the issuer of crypto-assets would have to be incorporated in the form of a legal entity (either established in the EU or in a third country) and also respect other requirements (fair communication with holders of crypto-assets, management of conflicts of interest, maintaining all IT systems to European standards).

The whitepaper (and marketing communications related to the issuance) would not be subject to pre-approval by NCAs, but they should be notified to NCAs before their publication. The NCAs would also be provided by the issuer with adequate details in order for them to determine whether the crypto-asset in question in fact does not qualify as a financial instrument under MiFID II or e-money under EMD. If the whitepaper does not comply with the mandatory disclosures, the NCA of the Home Member State would have the possibility to suspend or prohibit the offer, or make it public that the offer does not comply with EU regulation. Once the whitepaper is published, the issuer would be allowed to market and

distribute its crypto-assets in the EU or to seek an admission of these crypto-assets on a trading platform for crypto-assets.

5.3. Requirements on asset-backed crypto-assets (often described as ‘stablecoins’)

Asset-backed crypto-assets would be defined as a type of crypto-assets that can be used for payments and that purport to maintain a stable value by referencing one or several currencies, commodities or other crypto-assets, or a combination of such assets. Issuers of asset-backed crypto-assets would have to be established as an EU legal entity. They would be subject to:

- Organisational requirements (especially the obligations to have contractual arrangements with third-party entities that ensure the operation of the stabilisation mechanism, the investment of the reserve or the custody of the reserve);
- Capital requirements (inspired from EMD2);
- Rules on conflicts of interest;
- Rules on the stabilisation mechanism and the reserve of assets;
- Rules on the custody of assets (e.g. if the crypto-asset is backed by fiat currency, such assets should be placed with a credit institution);
- Rules on the investment of the reserve of assets (when these assets are not just kept into custody but invested);
- Mandatory complaint holder procedure;
- Procedure for an orderly wind-down.

In addition, issuers would be obliged to disclose the rights attached to the asset-backed crypto-asset, including any potential direct claim on the issuer or the reserve of assets. Where no such direct claim/redemption rights or claims is envisaged by the issuer of asset-backed crypto-assets, MiCA would provide holders with minimum rights. Issuers of asset-backed crypto-assets would also be required to publish a whitepaper with additional mandatory disclosures, compared to other crypto-asset issuers.

There would also be a provision preventing issuers of asset-backed crypto-assets and crypto-asset service providers from granting any interests related to the length of time during which a holder of asset-backed crypto-assets holds such crypto-assets.

The Commission would be empowered to take a delegated act to specify specific circumstances and thresholds allowing for the differentiation between asset-backed crypto-assets and significant asset-backed crypto-assets.

Issuers of significant asset-backed crypto-assets would be subject to additional capital requirements and to liquidity management and interoperability requirements. To avoid regulatory arbitrage between the status of e-money issuer and that of asset-backed crypto-asset issuer, the proposal would indicate that issuers of e-money that meet the criteria of significance set out in MiCA, would be subject to additional requirements applicable to assets-backed crypto-asset issuers (including enhanced capital requirements and requirements on the reserve).

The authorisation and ongoing supervision of asset-backed crypto-asset issuers would be conferred to NCAs. When authorising the issuer, the NCA would also approve the whitepaper. Once the asset-backed crypto-assets has been designated as significant, the supervision of the issuer could be conferred to EBA. The supervision of e-money issuers that would meet the criteria of significance under MiCA could also be transferred to EBA.

Requirements for the content of an application as an issuer of asset-backed crypto-asset issuer, scope of the authorisation including the EU passport and rights for an NCA to withdraw an authorisation would also be detailed. EBA would be granted with equivalent powers for significant asset-backed crypto-assets.

5.4. Crypto-asset service providers

MiCA would regulate the following services: 1) custody and administration of crypto-assets on behalf of third parties; 2) operation of a trading platform for crypto-assets; 3) exchange of crypto-assets against fiat currency by using proprietary capital; 4) exchange of crypto-assets against other crypto-assets by using proprietary capital, 5) reception and transmission of orders for crypto-assets on behalf of third parties, 6) execution of orders on behalf of third parties; 6) placing of crypto-assets; 7) advice on crypto-assets and 8) payment transactions in asset-backed crypto-assets.

MiCA would impose on these crypto-assets service providers to have a registered office in the EU. All crypto-asset service providers would be subject to common requirements:

- Prudential requirements (depending on the nature and risks of the service(s) provided);
- Organisational requirements (including the obligation to have a procedure to detect market abuse);
- Rules on the safekeeping of clients' funds;
- Rules on the information to clients;
- Mandatory complaint handling procedure;
- Rules on conflicts of interest.

Furthermore, the provision of each service above-mentioned would be subject to specific requirements. These rules would be inspired by the rules applying to MiFID II investment firms with some adjustments to make the framework proportionate and to take into account the specificities of the crypto-asset market. To avoid any regulatory arbitrage, the payment transactions in asset-backed crypto-assets would be subject to relevant rules of the payment services directive II (PSD II – Directive (EU) 2015/2366).

NCAs are envisaged to be in charge of the authorisation of the crypto-asset service providers. Once authorised, they would be allowed to provide their services across the Union.

5.5. Market integrity

As also mentioned during the EGBPI 18 May, it could be disproportionate to impose all the requirements of the Market Abuse Regulation (Regulation (EU) 596/2014 "MAR") on crypto-asset issuers and crypto-asset service providers. At the same time, it is crucial to ensure the market integrity in the crypto-asset markets. Therefore, MiCA would apply key requirements of MAR. The bespoke rules on market abuse would apply where a crypto-asset or an asset-backed crypto-asset is admitted to trading on a trading platform for crypto-assets. When their crypto-assets are admitted to trading on a trading platform for crypto-assets, issuers would have the obligation to disclose inside information related to their crypto-assets. In addition, the following behaviours would be prohibited: unlawful disclosure of information, insider dealings and market manipulation. NCAs will be in charge of enforcing these rules.

5.6. Supervision

Member States would designate a competent authority as a single point of contact, even if the supervision of these crypto-asset issuers and crypto-asset service providers is split between several competent authorities. The specific powers granted to NCAs, rules for cooperation, administrative measures or sanctions by the home NCAs and precautionary measures that can be taken by host NCAs would also be set out. The powers of EBAs as regards issuers of significant asset-backed crypto-assets would also be detailed.

5.7. Transitional measures

MiCA would also include a grandfathering clause for crypto-assets issued before the entry into force (i.e. no obligation to publish a whitepaper) of the regulation. However, this would not apply to asset-backed crypto-asset issuers and for crypto-asset service providers that would still be required to obtain approval from a NCA before operating in the EU. Crypto-asset service providers that are already authorised under a bespoke national regime for crypto-assets would also have the possibility to benefit from transitional arrangements.

Next steps

The target for the adoption of the proposals by the Commission is Q3 2020.

Member States are invited to express their views on the outlined proposals

- What are your views on the amendment envisaged to the notion of 'financial instrument' under MiFID II?
- What are your views on with the approach of the pilot regime for DLT market infrastructures?
- Does MiCA cover the issues Member States would expect to see?

- Are there any specific issues not addressed that should be part of MiCA?
- What are your views on the supervisory arrangements envisaged for asset-backed crypto-assets?