Which crypto-asset regulation for the European Union?

The Digital Regulator
Executive summary

Since 2018, several EU member states have developed and implemented more or less comprehensive regulations and regulatory frameworks for crypto-assets and cryptofinance, with the most prominent examples being France, Germany, and Malta. Since around the same time, the call for an EU-wide crypto-asset regulation has grown louder. The European Commission (EC) is now poised to issue the EU framework for markets in crypto-assets before the end of the year.

It is unclear to what extent the crypto-asset regulation that the EU is about to finalise will interfere with the advanced frameworks set up by member states and whether it will require adaptations. On balance, however, an EU-wide crypto-asset regulation is the only way to harvest efficiently and in a risk-controlled way the benefits of crypto-assets and cryptofinance services and products in the context of the European single market.

The last few weeks have witnessed noteworthy digital regulatory developments, such as the G30 welcoming stablecoins in the context of a strong official oversight, several central banks announcing new Central Bank Digital Currency (CBDC) initiatives, and the United States Securities Exchange Commission (SEC) expanding its definition of accredited investors.
In recent years, several European Union (EU) member states have developed their own crypto-asset regulations. The EU is now poised to introduce a single market regulation for crypto-assets.

1. Harmonising the regulation of crypto-assets across the EU

As early as in 2018, some EU member states began addressing the challenges and opportunities associated with crypto-assets and cryptofinance, and developed extensive regulatory frameworks, each with its own peculiarities. In the meantime, several influential EU institutions had been pressing for the introduction of an EU-wide or single-market crypto-asset regulation. Presently, the EU is expected to finalise a single-market crypto-asset regulation by the end of 2020. The proposed regulation will most likely replace the existing national crypto-asset frameworks.

A diverse European landscape – A glance at data from the EU member states reveals substantial differences in their approach towards the challenges and potentialities that arise from crypto-assets and cryptofinance. France, Germany, and Malta stand out with their own well-developed regulatory frameworks.

- France addressed crypto-asset regulation in the context of the PACTE\(^1\) law (the Action Plan for Business Growth and Transformation) which was introduced on 11 April 2019. It includes a framework for crypto-asset-based fundraising and for digital asset service providers. It grants companies that engage in such services and activities the right to a bank account, while requiring them to be licensed by the financial regulator AMF (Autorité des Marches Financiers) to conduct their activities. France’s authorities have also legalised the transfer of securities on blockchain, approved insurers for investing in crypto-assets, supported a ban on anonymous cryptocurrencies, and began testing wholesale CBDC (Banque de France). Further, the Commercial Court of Nanterre has recognised bitcoin as a legitimate currency.

- In Germany, the Federal Financial Supervisory Authority (BaFin\(^2\)) issued a set of guidelines on 21 January 2020 that covered prospectus and authorisation requirements for crypto-assets. They extensively deal with the nature of crypto-assets, officially classifying them as a security under the Prospectus Regulation. Additionally, all crypto-asset issuers working in the German market, irrespective of their location, are required to be licensed by BaFin. Previously, the regulator had published a guidance\(^3\) document on asset tokenisation that clarified what may qualify as a capital investment according to the Securities Law, explaining how tokens may be treated under the applicable German laws.

- Malta passed a bill in 2018 that introduced a comprehensive regulatory framework\(^4\) for crypto-assets and blockchain technologies, gaining the moniker of ‘blockchain island’. Its reputation, however, was tainted over time due to money laundering concerns expressed by the EC and the International Monetary Fund (IMF) and by the departure of crypto-asset firms from the island on grounds of inefficiency.

The absence of a harmonised EU regulation – The EU has actively worked on several fronts in support of distributed ledger technologies (DLT), including crypto-assets.

- In 2018, it issued DLT policy recommendations, launched a blockchain observatory, promoted blockchain partnerships among 22 EU countries, adopted a resolution to support DLT/blockchain, and addressed DLT in conjunction with aspects such as General Data Protection Regulation (GDPR).

- The anti-money laundering (AML) aspects of crypto-assets have been addressed with the introduction of the 5th EU Anti-Money Laundering Directive (AMLD 5\(^5\)) in May 2018. AMLD 5 set the standards for Know-Your-Customer (KYC) and AML regulations for crypto-assets by bringing virtual currency platforms and custodian cryptocurrency wallet providers under its purview. AMLD 5 imposed a compliance deadline of 10 September 2020 for EU member states to upgrade their legislation, and many countries have accordingly redesigned their legislation over the last few months.

- In 2019, crypto-assets came into the limelight, with the EU announcing many policies in relation to the stablecoin project Libra and within the context of the discussion around CBDCs.

- Since 2018, EU bodies such as the European Banking Authority (EBA), European Securities and Markets Authority (ESMA), and Association for Financial Markets in Europe (AFME) have escalated their demand for a harmonised crypto-asset regulation across the EU.

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An EU-wide crypto-asset regulation is largely welcome.

The forthcoming EU-wide crypto-asset regulation – The need for a harmonised crypto-asset regulation across the EU is undisputed—most importantly to inhibit member states from digressing further with their own initiatives. Moreover, it is critical to harvest the opportunities provided by crypto-assets and cryptofinance in the most efficient and risk-controlled way. A lot has been written in recent months on the likely shape that the EU-wide crypto-asset regulatory framework will take.

- Harmonise, at the EU level, the requirements pertaining to crypto-asset issuers and service providers. This includes the authorisation to provide such services across the European single market. The regulation also aims to increase legal certainty as well as consumer and investor protection.

- There is a common understanding that the regulation will contain a bespoke regime for markets in crypto-assets, including ‘stablecoins’, and crypto-asset service providers. The new regulation would probably replace the existing national frameworks dealing with crypto-assets that are not covered under the existing EU financial services legislation.

- Several analysts have speculated that in addition to listing license and operating requirements for crypto-asset issuers and service providers, the regulation will contain rules for ensuring market integrity and will create a sandbox-like pilot regime for promoting distributed market infrastructure for crypto-assets. Such a regime would enable both market participants and regulators to gain experience in the use of distributed market infrastructure such as multilateral trading facilities.

An EU-wide crypto-asset regulation is largely welcome. The uncertainties surrounding it concern the adaptations it will require with regard to the highly comprehensive frameworks in place in some jurisdictions such as Germany, France, and Malta. The proposed EU framework will probably leave little room for interpretation for individual member states and will place crypto-assets within the existing financial market regulatory framework. Thus, the regulation of crypto-assets will be similar to that of traditional assets. On balance, irrespective of its degree of compatibility with the existing national frameworks, the regulation will enable efficient management of the opportunities and challenges associated with crypto-assets and cryptofinance.

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2. Other noteworthy developments

The G30\(^7\) welcomes stablecoins, but favours strong official sector oversight in implementation. Thus, the G30 provides further positive support to stablecoins.

- The report ‘Digital Currencies and Stablecoins: Risks, Opportunities, and Challenges Ahead’ recommends strong supervision by the authorities, a sufficiently long phase-in period, and the resolution of all risks and threats before allowing widespread implementation. It also stresses the importance of data protection and effective management of the cross-border dimension.

- CBDCs continue to dominate the regulatory landscape with pronouncements by the Bank for International Settlements (BIS\(^8\)), Banco do Brazil\(^9\), Reserve Bank of Australia\(^10\), and the US Federal Reserve Bank of Boston\(^11\).

- The Federal Reserve Bank of Boston announced a partnership with the Massachusetts Institute of Technology on a multi-year project to develop and test use cases of a CBDC.

- The Central Bank of Brazil announced the formation of an expert group to assess how a CBDC could fit with the national payments ecosystem and what its impact would be on the economy and the society.

- The Reserve Bank of Australia announced that it is developing a proof-of-concept (PoC) for CBDCs that will explore aspects of wholesale CBDC on a private Ethereum network.

- The BIS assessed the rise in CBDCs focusing on drivers, approaches, and technologies and looked at the economic and institutional motives behind the current CBDC projects. It concluded that an increasing number of central banks are considering ‘hybrid’ or ‘intermediated’ architectures, and that currently, a PoC tends to be based on DLT rather than conventional infrastructure.

SEC\(^12\) expands the definition of accredited investors, emphasising the role of financial literacy. This development is welcome as it adapts regulations to the reality of evolving markets.

- The SEC has expanded the definition of who can invest in private capital markets. It has given access to investors designated as ‘qualified’ based on market knowledge, education, or professional designation, rather than on financial liquidity. The definition of accredited investors was historically based solely on specific income or net worth tests and thresholds.
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