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The proposed EU framework for crypto-assets

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Executive summary

The EU's regulatory crypto-asset landscape has so far been characterised by fragmentation and uncertainty. This has hindered the scaling-up and development of crypto-asset products and services. The European Commission (EC) reacted to this situation on 24 September 2020, by issuing a Digital Finance Package (DFP) that includes a proposal for an EU regulatory framework on crypto-assets aimed at seizing related opportunities in a risk-controlled environment. The DFP also includes strategy papers for digital finance and retail payments, a proposals for a framework on digital operational resilience, as well as a proposal for a pilot regime for market infrastructures based on the distributed ledger technology (DLT).

A closer look at the proposals for crypto-assets—which include stablecoins, significant stablecoins, and crypto-asset service providers—reveals an approach based on the principles of 'same activity, same risk, same rule', proportionality and complementarity. The proposals are comprehensive and would implement, de facto, the current financial regulatory framework for crypto-asset products and services. This would also create additional duties and accountabilities for all concerned national and regional regulatory bodies. While the intention is laudable and much needed, the timeline for implementation (2024) is too far off, and the nature and extent of the proposed requirements raise the issue of adequacy vis-à-vis the reality of an industry that is, at best, embryonic. The proposal risks the deterrence—instead of the promotion—of the industry if not implemented in a way that encourages and attracts entrepreneurs.

The month of September 2020 witnessed other noteworthy regulatory developments in the digital space, such as the Swiss canton of Zug accepting corporate and individual tax payments in bitcoin and ether, the Swiss Financial Market Authority (FINMA) authorising Sygnum bank's Organised Trading Facility (OTF), the Swiss Parliament completing the approval process for the blockchain law, and several regulators deliberating actions about central bank digital currencies (CBDCs).

The goals of the crypto-assets proposal are to address the current fragmented environment, facilitate the scaling-up of crypto-asset products and services, create legal certainty, improve consumers' choice while ensuring their protection, market integrity, and financial stability.

1. EC proposal for an EU framework on crypto-assets

As part of the DFP, the EC proposes an EU regulatory framework on crypto-assets. This includes a digital finance strategy, a retail payments strategy, proposals for an EU regulatory framework on digital operational resilience, and a proposal for a pilot regime for market infrastructures based on DLT to complete the DFP. The goals of the crypto-assets proposal are to address the current fragmented environment, facilitate the scaling-up of crypto-asset products and services, create legal certainty, improve consumers' choice while ensuring their protection, market integrity, and financial stability. The proposal complements existing EU-wide regulations that already apply to crypto-assets, such as the anti-money laundering (AML) / combating financing of terrorism (CFT) provisions and the Markets in Financial Instruments Directive (MiFID), and it is based on the principle of 'same activity, same risk, same rule'. While the proposal includes provisions on e-money tokens, the focus in what follows is limited to the requirements proposed for the issuance of crypto-assets, stablecoins, significant stablecoins, and for crypto-asset service providers.

- **Crypto-assets**

This category encompasses all digital representations of value or rights that are transferable and storable electronically using DLT. It includes the so-called utility tokens but excludes stablecoins, which receive dedicated and more extensive provisions (see below). The proposal requires issuers of crypto-assets to constitute a legal entity, notify the competent authority, publish a white paper, and comply with several obligations regarding business conduct. The white paper shall only be prepared in the case the issuer targets retail investors. The paper shall describe the issuer(s), the project, the characteristics of the offer, and the rights and obligations attached to the crypto-assets. It shall inform about the underlying technology, highlighting the risks related to the offeror, assets, and implementation of the project. The requirements extend to marketing and communication (which must be fair and not misleading), and to the safeguarding of the funds (which must be placed with a credit institution or authorised crypto-asset service provider).

- **Stablecoins**

The issuance of stablecoins is subject to the authorisation of the issuer by the competent authority of the relevant member state. Such coins may only be offered by a legal entity incorporated in the EU. The issuance of a white paper is mandatory. The above-mentioned requirements may be relaxed if the overall value of the stablecoins does not exceed EUR 5 million or if the offer is limited to qualified investors. The white paper shall describe the issuer's governance arrangements, approach to the reserve, custody of such assets (segregated from own funds), applicable investment policy, nature and enforceability of the rights for coin holders, and relevant complaint handling procedures. The European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) shall develop technical standards governing the approval procedure of the white paper. The white paper is one element of the broader authorisation application that shall have exhaustive information about the issuer, the programme, its governance (internal controls, personnel qualification, policies and procedures governing the handling of reserve assets and stablecoins, and orderly wind-down plans), and all contractual arrangements.

The issuer of a stablecoin is subject to certain provisions that, interestingly, intersect to an extent with the Swiss FinTech license and Banking Law requirements. Thus, the issuer shall always meet an own funds obligation equal to or higher than i) EUR 350,000 or ii) 2% of the average amount of the reserve assets. The reserve assets shall be segregated from the issuers' own assets (and held at a credit institution of an authorised crypto-asset service provider); they will not be encumbered or pledged. The reserve management shall be organised to ensure the ability of the issuer to meet any redemption request promptly. The reserve assets shall be invested only in highly-liquid financial instruments with minimal market and credit risks, and all profits or losses shall be borne by the issuer. The issuers of stablecoins are prohibited from paying interest to the holders.

- **Significant stablecoins**

A stablecoin is classified as a significant stablecoin when certain conditions are met. These conditions include the size of the customer base (must not be smaller than 2 million), value of the stablecoins issued (market cap must not be lower than EUR 1 billion), number of transactions (must not be smaller than 500,000 per day), value of transactions (must not be lower than EUR 100 million per day), size of the reserve assets (must not be smaller than EUR 1 billion), significance of cross-border activities (must involve at least seven member states), and degree of interconnectedness with the financial system. The responsibility to classify a stablecoin as a significant stablecoin is with the EBA. When a stablecoin is deemed significant, EBA assumes supervisory responsibilities and organises a supervisory college. Issuers of significant stablecoins are subject to additional obligations compared with issuers of non-significant stablecoins. These incremental obligations include the requirement to hold the stablecoins in custody with multiple crypto-asset service providers and to assess and monitor the liquidity needs to meet redemption requests.

- **Service providers**

A crypto-asset service provider encompasses the professional provision of custody, trading platform, exchange (crypto-fiat and crypto-crypto), placing of assets, execution, reception and transmission of orders for assets on behalf of third parties, and provision of advice on crypto-assets. The authorisation granted applies EU-wide and may only be provided to legal persons incorporated in the EU. The application for such authorisation shall contain information about the applicant, its operating programme, prevailing governance set-up (internal controls, information technology and security arrangements, and procedures to detect market abuse and ensure the segregation of assets), and policies governing the custody and operations of the trading platform. All service providers are subject to business conduct obligations and prudential requirements (including minimum capital requirements) as well as organisational requirements extending to personnel qualifications, business continuity plans, and compliance mechanisms. The provision of advice on crypto-assets is subject to suitability obligations on the offeror. The ESMA shall establish a public register of all crypto-asset service providers.

This section focused on a subset of the DFP and—within the subset of the framework on crypto-assets—on the proposal addressing crypto-assets, stablecoins, significant stablecoins, and crypto-asset service providers. A single market for crypto-asset products and services is much needed, given the existing significant fragmentation and regulatory uncertainty characterising the EU. This proposal is based on the proportional application of the principle of ‘same activity, same risk, same rule’. It complements provisions such as in the areas of AML / CFT and MiFID, which already apply to crypto-asset products and services. Due to its comprehensive nature, the proposal de facto extends the current financial regulatory framework to crypto-asset products and services. The proposal’s nature and extent suggest the risk that it may deter rather than promote the development of an industry that is currently, at best, embryonic. The implementation date of 2024 is too far off, and the process must ensure that entrepreneurs are encouraged and supported in their endeavours.

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2. Other noteworthy developments

Switzerland achieved several milestones during September 2020 in the areas of taxation, tokenisation, and legal certainty.

- The Swiss canton of Zug announced that it will accept corporate and individual tax payments in bitcoin and ether going forward up to an amount of CHF 100,000. This main crypto-nation hub further consolidated its world-wide position by yet again becoming a global pioneer.
- FINMA approved Sygnum bank's OTF, bringing to life an end-to-end tokenisation offer. This news is important because, to date, tokenisation solutions have predominantly been hindered by unregulated and often partial solutions within the securitisation life cycle.
- The Swiss Senate showed overwhelming approval for the proposed Blockchain Act. Thus, the legislative approval process is complete; the laws are expected to come into effect in early 2021.

Several jurisdictions world-wide have deliberated further CBDCs, increasing the likelihood that a CBDC solution will be implemented soon.

- The Central Bank of Brasil announced that it will implement a CBDC before 2023. The idea is to enable nearly instantaneous transactions via mobile phone and internet banking.
- The Bahamas is planning to launch its CBDC 'Sand Dollar' before the end of the year. If this happens, the country would act ahead of other major world powers such as China. The Bahamas' CBDC is expected to be one-to-one with the Bahamian dollar.
- The US Federal Reserve Board of Governors and several Federal Reserve Banks confirmed that they are actively working on CBDCs, and that the work has accelerated following the coronavirus pandemic.

3. Conclusion

The EC has released a proposal for an EU regulatory framework on crypto-assets. This move was largely expected and much needed given the significant fragmentation and regulatory uncertainty generated by the unilateral initiatives of member states. An EU regulatory framework on crypto-assets shall allow a single market to seize crypto-finance opportunities in a risk-controlled environment. The proposals are comprehensive and would implement, de facto, the current financial regulatory framework for crypto-asset products and services. This framework's implementation is expected to occur by 2024. In the interim and during the accompanying legislative and implementation processes, it is imperative that crypto-finance entrepreneurs are encouraged and supported in their endeavours instead of being deterred by the overwhelming nature and extent of the proposed requirements.

September 2020 was characterised by several noteworthy regulatory developments in the digital space. In Switzerland, the canton of Zug announced that it will accept corporate and individual tax payments in bitcoin and ether, the FINMA authorised Sygnum bank's OTF, and the Swiss Parliament completed the approval process for the blockchain law.

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