

Crypto regulation: MiCA implementation and global convergence

1. Progress on the implementation of the Markets in Crypto-Assets Regulation (MiCA)

The Chair indicated that the implementation of MiCA is well underway in Europe. A large number of regulatory technical standards (RTS) have already been drafted and there is a first implementation deadline at the end of June 2024.

A regulator noted that a very intensive phase of policy development began when MiCA entered into force in June 2023. The EBA is working on the regimes for asset referenced tokens (ARTs) and electronic money tokens (EMTs), for which the application date is the end of June 2024. The policy work on ARTs and EMTs is advancing actively. The EBA has closed 18 of its mandates. Feedback has been received on the proposals, which covered topics such as internal governance arrangements and issues related to reporting, colleges and the prudential package. The 19th consultation paper on redemption plans will be published shortly.

The EBA is encouraging the industry and supervisors to prepare the implementation of these regimes in a consistent and timely manner using the implementation documents published by the EBA. Guiding principles for issuers have been published aiming at fostering an alignment with MiCA rules, especially regarding the fair treatment of potential buyers of ARTs and EMTs and the implementation of sound governance and effective risk management. The EBA's Q&A tool should also be used to answer any outstanding questions regarding interpretation. Separately, the EBA has established a group for supervisors to facilitate the sharing of experiences and develop a common approach to ART and EMT projects. The EBA is also developing a supervisory handbook to foster a consistent approach to MiCA implementation at national and European levels.

A regulator stated that there has also been good progress on the rules for crypto asset service providers (CASPs) and crypto assets beyond ARTs and EMTs. ESMA is in charge of several mandates in these areas. These rules will apply at the end of 2024. Guidance is being provided on the scope of MiCA to facilitate a common understanding of issues such as the difference between crypto assets and financial instruments structured under MiFID rules, the definition of decentralised platforms and reverse solicitation.

The peculiarities and nuances of the crypto sector need to be well understood to calibrate the requirements adequately and proportionately. In this regard, consultation with the private sector is very helpful. One key specificity of crypto assets compared to traditional financial instruments is custody. There are operational

and legal segregation issues that need to be considered in the regulatory framework at both national and European levels. Due to the level of complexity and extent of integration of existing crypto groups, it is also critical to understand where business is being played out and where decisions are being taken. The objective is also for the Level 2 requirements to incorporate the lessons learned from the market failures that happened in the crypto sector, particularly regarding conflict of interest and operational risk.

In a recent statement, ESMA set out several important elements relating to the implementation of MiCA, the regulator stressed. First, member states need to prepare for implementation. This involves designating a national authority to supervise CASPs, which not all member states have done, and consulting on how MiCA will be implemented domestically. The member states that already have a domestic crypto regime will need to plan the transition to MiCA and define the amount of time that will be needed that should be as short as possible. Secondly, the designated national competent authorities (NCAs) need to prepare for the implementation of MiCA, which is a new activity for many of them. The NCAs will need to be properly equipped and to understand the business fully. Thirdly, crypto firms need to be ready to make changes to their internal processes, as most of them have not been regulated previously. They will need to adopt an internal compliance culture and ensure full compliance with the regulation. Finally, investors must be informed about the risks inherent to crypto products that do not exist with other regulated products. To some extent, this should be part of a broader education campaign.

2. Industry perspectives on the MiCA implementation and outstanding issues to clarify in the MiCA requirements

An industry speaker highlighted the importance of the clarity that MiCA should provide for the industry. The established multinational CASPs need to have the ability to plan, raise capital and deploy capital over a years long time horizon, which MiCA will allow.

One important area where clarification is still needed is white paper requirements. A white paper is the body of facts which describes a digital asset protocol. The white paper discloses to consumers and investors the fundamental facts about what an asset does, how it works, the participants that exist on its network and what degree of trust and faith an investor should have in that network. Traditionally, issuers are required to make these disclosures. However, MiCA does not make the issuer

responsible for producing the white paper. Instead, offerors of crypto assets or trading platforms can prepare the white paper. This can create confusion among practitioners around which party should assume the burden of ensuring the information in the white paper is correct. In the scenario where several offerors draft white papers for the same asset, consumers may receive different levels of information in different versions. This risk is exacerbated if the information in the white paper relies on estimates such as sustainability metrics.

While MiCA clearly places a white paper obligation on newly issued tokens, there are ongoing debates about whether the tokens that are already trading will also require a white paper. Some of these hold a significant share of the crypto market today. This question will become even more relevant after December 2027, when this requirement will come into force irrespective of whether a token was trading prior to MiCA. The ongoing Level 2 consultation is an opportunity to clarify this issue, however. One solution could be for all industry participants, including exchanges, investors and issuers, to come together to establish the standards in the same way that the International Swaps and Derivatives Association (ISDA) Master Agreement has established a standard for derivatives.

An industry representative emphasised that the European MiCA framework is very welcome from the perspective of digital asset service providers (DASPs) and custodians. There are many different crypto regulations across Europe at present, which makes it difficult for DASPs to operate cross-border. However, it is important to ensure that DASPs can interact with supervisors who understand their business and their technology, notably during the registration process. These firms will need to be compliant with many new requirements, such as those around Know Your Transaction (KYT) and Know Your Address (KYA).

Some issues also still require further clarification, the industry representative noted. It is not always easy to understand what comes under MiFID or MiCA. For instance, there is still a doubt about which regulatory framework applies to some utility tokens. There are quite different requirements between MiCA and MiFID in terms of reporting processes, tax treatment and so on, which creates legal uncertainty and harmonisation and security issues that require high legal fees to clarify. Hopefully, greater clarity will emerge as a result of the ongoing implementation process of MiCA.

A second industry speaker considered that with the implementation of MiCA significant progress is being made in the EU on the regulation of crypto assets and CASPs. During the next European cycle, it will be important however for crypto regulation to go beyond the mitigation of risks related to speculative crypto investment and seek to create a comprehensive vision of a broader tokenised ecosystem. This should be part of European policymakers' upcoming five year vision for the modernisation of the European financial system and the EU's strategic autonomy agenda.

This requires pursuing three key priorities. The first is the regulation of CASPs. These centralised intermediaries must be regulated because they safeguard customer

assets and their platforms must be managed in accordance with customers' best interests. The second is the regulation of stablecoins, which are critical for the viability of the crypto ecosystem, as they facilitate on chain payment mechanisms. The third key priority is the treatment of the decentralised ecosystem, including DeFi (decentralised finance) and self hosted wallets.

The two first priorities are addressed in MiCA. CASP requirements are well defined, the industry speaker felt, with a forward-looking understanding of the importance of these service providers for the broader digital asset and tokenised ecosystem, despite some outstanding issues remaining to be fine-tuned and clarified at Level 2, concerning notably white papers and custody rules.

The treatment of stablecoins in MiCA is more ambivalent and cautious and there is a risk that the Level 2 work may exacerbate the challenges present in the Level 1 requirements. Caution about how to integrate stablecoins into the current financial ecosystem is understandable, since stablecoins are a potential source of risk. At the same time, they are a key tool to facilitate the development of a tokenised economy, which may lead to significant cost reductions and efficiency gains and reduce dependency on large central intermediaries. This also raises other public policy questions, notably in the area of competition law.

Concerning decentralisation, Europe has rightly decided to postpone the regulation of DeFi. The development of the DeFi ecosystem is still in the early stages and is difficult to anticipate. There are financial use cases, but the potential of decentralised tools extends well beyond this, including applications for gaming, event participation and storing government records such as ID documents.

3. Policy approach to crypto assets and CASPs in other jurisdictions

A regulator stated that Japan has one of the most comprehensive regulatory and supervisory frameworks on crypto and stablecoins. The Japanese framework for CASPs, which was established in 2017, has three key objectives: providing certainty for new entrants; mitigating risk while promoting responsible innovation; and ensuring that retail and wholesale investors are adequately informed before they decide to invest. CASPs are required to register with the Japanese Financial Services Agency (J FSA) and are subject to prudential requirements, customer protection requirements relative to e.g. the segregation of assets and the protection of information, advertisement restrictions and KYC requirements. So far, the experience has been positive. The number of CASPs registered in Japan has doubled since the framework was implemented.

Japan also implemented a new framework for stablecoins in June 2023, which involves a registration of e money stablecoin issuers with the J FSA. Some non bank institutions, such as trust banks and money sender service providers, are also allowed to issue stablecoins

with a proportionate approach, which is a specificity of Japan. In addition to issuer regulation, entities providing stablecoin brokerage and custodial services are required to register with the J FSA and are subject to the same regulatory requirements as CASPs.

The activities of foreign issuers and service providers in Japan are also governed by tough requirements. Providers that wish to solicit investors residing in Japan have to store the assets of Japanese investors in locally regulated entities. This approach shielded Japanese investors from the collapse of FTX for example. The J FSA permits foreign issued stablecoins to be traded in Japan under the condition of equivalence. Foreign issuers must be supervised and regulated in their home country to the same level as they would be in Japan. CASPs that trade foreign issued stablecoins must also hold the necessary resources to facilitate redemption in the case of an issuer collapse. The Chair observed that the creation of domestic regulatory touchpoints makes sense so long as there is not a sufficiently aligned set of requirements at international level.

A Central Bank official explained that the UK has taken a phased approach to regulating stablecoins and unbacked crypto. A first phase of work has started on sterling denominated stablecoins and other crypto assets will be considered more broadly in a second phase.

The focus in the UK so far has been on stablecoins, as these are most likely to be used for payments and they can expose users and the financial system more widely to risk if they are not regulated safely and sustainably. Their use could also grow very quickly if they were to be deployed by firms with large customer bases and they could quickly become systemic, as anticipated in the Libra/Diem model.

Last November, the Bank of England published a discussion paper on a proposed regulatory regime for systemic payment systems using stablecoins. The requirements set out seek to achieve the same regulatory outcomes as with existing forms of money and payment systems, in accordance with the principle of 'same risk, same regulatory outcome' and provide legal certainty. The regulation will aim to ensure that stablecoins are in fact stable with requirements on backing assets to eliminate credit, liquidity and market risks and enable coin holders to make robust legal claims against issuers. Stablecoin arrangements will also be subject to a comprehensive risk management framework and have to demonstrate a level of resilience equivalent to what is required of traditional payment systems. Rules will moreover be established to ensure that consumers are protected when they interface with stablecoins via wallets. In particular, it is important to address the issues related to custody. Under the UK framework, legal rights will be protected through beneficial ownership.

An industry speaker welcomed the UK's approach to crypto, which considers the broader applications of crypto technology in a range of societal use cases. Understanding this broader perspective can help to answer some of the more tactical questions on the implementation of crypto requirements. As for the US, no clear approach on stablecoins has yet been set out.

There is a strong push happening between Congress and the current US administration to develop clear rules for stablecoins. This would probably support the US dollar denominated stablecoin market, which represents 98% of the total market. It remains to be seen however whether the US will be a pathfinder in this market.

4. International consistency and coordination in crypto regulation

The Chair observed that significant progress is being made on international coordination in the crypto asset space, which is a topic of focus for international standard setters. IOSCO in particular has responded to the developments happening in the global crypto market. Policy recommendations for crypto and digital asset markets were published in November 2023 and policy recommendations for Decentralized Finance (DeFi) in December 2023.

A regulator emphasised that international guidance is required in the crypto asset sector due to its borderless nature and the rapid pace of technological innovation in this area. Japan's regulation and supervision of crypto assets and stablecoins is increasingly aligned with other FSB countries. However, the FSB must also engage with other countries not part of the FSB via standard setting bodies like IOSCO and the Financial Action Task Force (FATF) to ensure there is a truly global regulatory framework. FATF is working to identify concentrations of activities or investors in jurisdictions with regulatory gaps. This is not about naming and shaming; rather, it is about capacity building and exchanging views on how these countries can further align their regulatory frameworks.

A Central Bank official agreed that international guidance is essential. Continued international regulatory and supervisory cooperation will reduce policy gaps and minimise regulatory arbitrage. The cooperation in this sector can build on the collective international achievements in existing sectors of finance. Looking ahead, it will be important for international partners to continue to seek consistency in implementing standards and address any outstanding gaps. Custody and vertical integration are two key areas where further progress is needed. There is a consensus on the international standards that have been adopted, but there is a long way to go on implementation.

The proposed UK stablecoin regulation is designed to support safe innovation in the payments space, while addressing potential financial stability risks. While the UK proposals generally align with the principles that have been developed at international level, there is some deviation. Systemic stablecoins would be required to be fully backed in unremunerated deposits at the Bank of England in order to eliminate the credit, liquidity and market risks associated with other choices of backing allowed by international standards. Making the deposits unremunerated will also encourage issuers to focus their business models on payment related activities.

A regulator agreed that international consistency is extremely important in this area. Fully implementing MiCA will require a disciplined journey at EU level. The regulatory picture is well advanced and currently, much of the effort is being directed towards ensuring supervisory convergence in Europe in order to avoid regulatory arbitrage. There will also be in the short term a transition process towards MiCA for member states that have already implemented a domestic regulatory regime for crypto-assets. Looking beyond Europe, an impressive amount of work has been done at the international level in a limited timeframe. A consensus has been reached on the requirements; it is now a question of implementation. Looking beyond the membership of the FSB is important because otherwise, with players operating in this market on a global scale, there is a risk of loopholes. In addition, there is a risk that platforms with inadequate business or governance models will choose to operate from countries that are less regulated and not fully cooperative.

5. Interconnection between crypto assets and traditional finance (TradFi)

A regulator considered that there is currently only limited interconnection between crypto assets and TradFi. However, this connection is being monitored by regulators and supervisors, as the situation might evolve in the future. Supervisors will need to have access to adequate data to assess interconnectedness and related financial stability risks. In this regard, some measures have been taken in the banking space. The Basel Committee on Banking Supervision (BCBS) has issued a prudential standard on banks holding crypto assets, which assigns a very high risk weight to these assets if certain conditions are not met.

Generally speaking, TradFi institutions have so far taken a conservative approach to crypto assets, but this may change with the development of stablecoins. Caution is needed on the part of regulators and supervisors, as banks may decide in the coming years to increase their engagement in crypto asset businesses or activities such as brokerage or custody or invest directly in crypto assets. There are many multifunction crypto asset intermediaries operating in the market providing a range of services, which could also make it attractive for TradFi providers to enter this space.