

CRYPTO PERSPECTIVES AND REGULATORY OUTLOOK



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Crypto-assets regulation – What's next?

MiCAR represents a major advancement in bringing clarity of applicable common rules, legal certainty and accountability to the crypto-asset markets. As we approach its implementation, ESMA has nearly finalized its policy mandates and is shifting efforts towards supervisory convergence. The EBA's experience in establishing common approaches for the already applicable requirements on ARTs and EMTs is a good starting point and the collaboration between ESMA and EBA will continue to strengthen with a view to deliver consistency of approaches, for instance with the publication of Q&As

As we progress in implementing the MiCAR framework we discover areas where further clarity and alignment with existing rules on traditional finance would be needed (one example being transaction reporting to supervisors). The review of MiCAR will offer the opportunity to fill gaps.

ESMA and EBA are also working closely to provide inputs for the MiCAR-mandated report on the latest developments in crypto-assets, including decentralized finance (DeFi) and the appropriate regulatory treatment of decentralized crypto systems.

As known, MiCAR does not contain specific requirements for decentralized autonomous organizations (DAOs) or the deployment of smart contracts in decentralized settings, nor does it address the concept of full decentralization. This could lead to regulatory fragmentation or, even worse, loopholes. While supervisory convergence through soft law is important, it may not be sufficient to ensure legal certainty and enforceability in all instances. There is a need to clarify the scope of MiCAR and other existing financial sector rules to address gaps that could pose significant or systemic risks through spillover effects (as the digital centralised ecosystem is interconnected with the decentralised ecosystem as well as with the traditional financial system).

Although the approach on whether and how to regulate DeFi is still being developed, several issues deserve close attention. A fundamental challenge is that the dynamics of open-source software and infrastructures collectively managed by participants can differ significantly from those of traditional financial actors and their IT systems. At the same time, similar or even additional risks may arise depending on the use of the software, infrastructures, and the activities performed on top of them.

To address these challenges, several initiatives could be considered. First, common approaches could be established to monitor developments in DeFi and related risks, particularly regarding the size of DeFi activities, leverage, and interconnections with supervised entities. One way to reduce data gaps is for the EBA and ESMA to collaborate on developing standard templates for harmonized supervisory data collection, which is already set under MiCAR.

If DeFi is to be regulated, new approaches (combining hard and soft law) will need to be developed, focusing on activities and outcomes to address smart contracts with financial applications. A harmonized framework for DAOs and financial asset tokenization could be considered,

although challenges remain due to the lack of harmonization in civil, securities, and corporate laws across the Union.

Overall, any new framework should encourage compliance by design for DeFi protocols, focusing on risk mitigation and consumer protection. For instance, the framework could include rules for smart contract testing and audits, as well as transparent governance structures that allow for accountability and timely human intervention. Users should be made aware of the risks they face. Additionally, it would be useful to consider how and under what conditions smart contracts and DAOs could be classified as compliant with agreed standards and to define liabilities and ownership rights to benefit users.

Another important topic is interoperability. There is a risk of "balkanization" of DLT platforms, especially with proprietary infrastructures. The EU framework should support open systems. Standardization could be incentivized without stifling competition, market diversity, or innovation.

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Calibrating regulation for decentralized ecosystems is indeed complex. Provided that the size and use of DeFi protocols do not pose systemic risks, a *step-by-step experimental approach* at the Union level *could be preferable to foster learning by doing*. For instance, an EU regulatory sandbox coordinated by the ESAs could be introduced to test how to adapt current rules to decentralized settings and promote the development of protocols that meet desired outcomes. Experience from the DLT Pilot regime could be leveraged.

Appropriate (hard or soft) regulatory initiatives could encourage broader and more responsible participation of institutions and individuals in DeFi ecosystems. We should seize the opportunity to fully exploit and incentivize the benefits of transparency, verifiability, and traceability of on-chain information.



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Consumer protection solutions as a trigger for the crypto market development

For years, we have been observing the growth of global crypto market and the number of its investors, including retail ones. We have also witnessed the increasing interconnection of this market with the structures and entities of the traditional financial market.

Information about significant drops in cryptocurrency prices and, unfortunately, various types of abuses often appear in the public space. There is no doubt that a regulatory framework for the crypto market is essential.

The regulations proposed at the EU level regarding crypto-assets are a breakthrough in many aspects. We are dealing with a matter that, in principle, was created in order not to be “limited” by restrictive regulatory frameworks. MiCAR is unique because it is the first attempt to propose a regulatory and supervisory framework for this market in a comprehensive way. Due to MiCAR, but also taking into account the existing EU acquis in the field of financial markets regulations (in particular MIFID), the

EU will become the largest single market with a stable legal framework for crypto-assets in the world. Entities offering or providing crypto-assets services will have access to 440 million people, ensuring equal operating conditions.

First of all, it seems that the scope of MiCAR is adequate to the threats that may potentially be associated with this market. The EU legislator decided to supervise and introduce clear rules for stablecoins, as they are of key importance for the cryptocurrency sector and constitute a key connection between cryptocurrency markets, traditional financial institutions and retail market participants, including due to activities as close to the customer as payment services. Stablecoins therefore require appropriate regulatory and disclosure standards if the cryptocurrency ecosystem is to develop in a sustainable and secure manner.

MiCAR has several main goals, including supporting innovation and ensuring market integrity, but it is increasing consumer confidence and reducing risk that receives the most attention in the text. In every area of the financial market, access to reliable information about the product and entities whose services you intend to use is a key issue. It is no different, or perhaps more important, in the case of the crypto-asset market. Taking into account that MiCAR introduces solutions that protect clients against excessive risk, encouraging them to invest safely, entities offering crypto-assets and providing services will have the opportunity to enter the mainstream of the financial market and develop their activity in conditions of equal competition.

It is essential to introduce mechanisms thanks to which the client will have a full picture of the crypto-assets he intends to buy, including their specificity and functions, as well as the risk associated with a given offer. The client should also have comprehensive information about the entity with which he or she intends to enter into a business relationship, which is obliged to have appropriate competences and reputation. It is important for the development of a stable and more predictable market that MiCAR also eliminates many uncertainties on the part of crypto-asset holders, introducing, among others, a permanent right of redemption at any time.

Taking into account the specific nature of the crypto-assets market and its functioning in the digital space, it is also important for holders and potential holders to provide them with reliable, clear and non-misleading marketing materials. Furthermore, easy access to information on which crypto-asset

provider has been authorised to provide such services across the Union, is important here.

MiCAR also emphasises mechanisms to warn customers about fraudulent entities, but also obliges crypto-assets service providers to warn customers that particular crypto-assets or crypto-asset services may be inappropriate for them.

MiCAR introduces solutions that protect customers, encouraging them to invest safely.

Taking into account MiCA's comprehensive approach to consumer protection and counteracting market abuse, often based on solutions that have been present on the traditional financial market for years, the regulation in this scope seems to have no gaps.

MiCAR is a pioneering legislative text in terms of regulating crypto market and it undoubtedly places the European Union as a global pace setter it provides regulatory certainty and stronger protections for consumers.

As the crypto market dynamically evolves and matures, MiCAR's impact on the EU cryptoasset landscape and its global implications will need to be closely monitored by interested parties. The results of these observations should provide an answer as to whether and to what extent further regulatory measures should be considered in relation to activities related to cryptoassets that currently fall outside the scope of MiCAR.



FERNANDO RESTOY

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Emerging regulatory responses to financial stability risks posed by stablecoins

Although cryptoassets are not yet part of the core of the global financial system, their potential to pose risks to financial stability cannot be overlooked, particularly if they gain widespread traction for payments. In the evolving cryptoasset market, some categories of stablecoins hold greater potential to be used as a payment medium than others. This is particularly true for centrally issued stablecoins which aim to maintain a stable value relative to a fiat currency by relying on traditional financial instruments as reserve assets – a category referred to as an “e-money token” in the EU Markets in Crypto-Assets Regulation (MiCA).

While this type of stablecoin is currently used mainly to settle transactions and store value in cryptoasset markets, traditional financial institutions have started using them as digital settlement assets, and leading payment service providers are exploring their integration into their networks. In this context, financial stability risks could materialise, especially if certain business models achieve rapid scalability and wider retail payment use.

A scenario involving widespread usage could give rise to a variety of risks with potential implications for financial stability. These include the possibility of currency substitution in emerging market and developing economies; substantial impacts on economic activity and the functioning of the financial system in the event of operational disruptions; negative confidence effects on money and payments in the event of an issuer’s failure; and increased market, credit and operational risks for financial institutions that play multiple roles within a stablecoin arrangement.

With these considerations in mind, policymakers are taking action to address the potential financial stability risks that stablecoins may pose. Internationally, the Financial Stability Board and standard-setting bodies are working towards a consistent policy response. Concurrently, at the national level, some jurisdictions are modifying their regulatory frameworks.

A recent paper¹ by the Financial Stability Institute compares established or proposed regulatory frameworks for stablecoin issuers in 11 jurisdictions. Emerging regulatory strategies at the national level share common requirements: issuers are typically required to maintain reserves equivalent to the value of their circulating stablecoins, ensure segregation and custody of assets, and establish clear redemption procedures. Regulations also contain prudential, governance, risk management, anti-money laundering and countering the financing of terrorism requirements as well disclosure obligations. Most frameworks follow two authorisation regimes for issuing stablecoins: (i) banks and certain non-bank financial institutions under existing regimes, and/or (ii) a newly established crypto-specific licence.

Disparities in regulatory regimes could contribute to inconsistencies and policy ineffectiveness.

However, national regulatory regimes show discrepancies and inconsistencies that can prevent effective coordination across jurisdictions. For instance, the terminology used to classify stablecoins varies significantly across regulations. Notable differences also exist in restrictions on reserve assets, the nature of stablecoin holders’ claims and the treatment of redemption fees.

In addressing stablecoins that present substantial financial stability risks, two

primary approaches can be identified: the first involves the creation of a distinct category for “significant” or “systemic” stablecoins, as exemplified by MiCA and the proposed regime in the United Kingdom (UK), respectively. This approach is accompanied by increased prudential requirements that typically encompass stricter reserve asset requirements, mandatory audits, and supervisory oversight. The second approach empowers authorities to enforce additional requirements or impose restrictions when they deem that stablecoins pose a risk to monetary and financial stability.

Within the current landscape, MiCA emerges as one of the world’s first comprehensive regulatory frameworks for cryptoassets. While it provides a robust stablecoin regime, aspects such as reserve assets’ requirements for significant stablecoins might eventually need a reassessment. Following the example of other jurisdictions, like the UK, it is worth considering requiring systemic stablecoins to be fully backed by central bank deposits with the aim of enhancing holders’ confidence and mitigating run risk. Moreover, defining requirements for entities operating the support infrastructure for significant e-money tokens, coupled with more explicit guidelines on the use of permissionless ledgers for their transfer mechanisms, could prove beneficial.

As stablecoin markets evolve, authorities need to monitor developments, collaborate internationally and implement global standards to ensure a consistent approach to the financial stability risks posed by stablecoins.²

1. *FSI Insights No 57, April 2024 (bis.org)*

2. *By Fernando Restoy and Denise García*