EUROPEAN COMMISSION'S LEGISLATIVE PROPOSALS ON CRYPTO-ASSETS AND DLT

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By: Giovanni Campi, Judith Rinearson, Jeremy M. McLaughlin, Sofia Karagianni, Daniel S. Nuñez Cohen

On 24 September 2020, the European Commission (Commission) launched its Digital Finance Strategy (Strategy). The Strategy includes, among other elements: (i) a proposal for a Regulation on Markets in Crypto-Assets with its accompanying Annex (Markets Regulation); and (ii) a proposal for a Regulation on a pilot regime for Market Infrastructure based on Distributed Ledger Technology (DLT) (Pilot Regime Regulation).

MARKETS REGULATION

The draft Markets Regulation is the first European Union (EU)-wide effort seeking to effectively address the key problem concerning crypto-assets, namely the lack of clarity around their regulatory treatment. Currently, certain crypto-assets already fall within the EU's regulatory perimeter, while others are not covered by EU law. Crypto-assets that fall outside the scope of the proposed Markets Regulation include: (i) financial instruments (MiFID); (ii) electronic money as defined in the E-Money Directive except where they qualify as e-money tokens for the needs of the draft Markets Regulation; (iii) deposits; (iv) structured deposits; and (v) securitisation.

The Commission's recent proposal aims to create a harmonized EU framework for the issuance, application, and provision of services in crypto-assets. The proposed regulation lays down uniform rules on:

(i) transparency and disclosure requirements for the issuance and admission to trading of crypto-assets;

(ii) the authorization and supervision of crypto-asset services providers and issuers;

(iii) the operation, organization and governance of issuers of asset-referenced tokens and e-money tokens and crypto-asset service providers;

(iv) consumer protection rules; and

(v) measures to prevent market abuse and to ensure integrity of markets in crypto-assets.

General rules for crypto-assets

The proposed Markets Regulation imposes a number of general requirements for issuers of crypto-assets. The regulation defines a crypto-asset as a digital representation of value or rights, which may be transferred and stored electronically, using distributed ledger technology or similar technology. Before any public offer of crypto-assets or before crypto-assets are admitted to trading on a trading platform, issuers should notify a crypto-asset whitepaper at least 20 working days before publication and, where applicable, their marketing communications, to the competent authority of the Member State where they have their registered office or a branch. There is no requirement for issuers of these crypto-assets to obtain the competent authority(ies)' ex-ante approval for a whitepaper or related communications.

The information presented in the whitepaper should include:

(i) a detailed description of the issuer;

(ii) the project and planned use of funds;

(iii) conditions;

(iv) rights;

(v) obligations; and

(vi) risks.

The whitepaper also needs to contain an assessment of why the crypto-asset does not qualify as a MiFID financial instrument. After the notification period, the whitepaper has to be published on the issuer's website and immediately after publication it can be marketed in the European Economic Area. Moreover, Member States have to ensure that issuers can be held liable by token holders under national level legislation for the information provided in the whitepaper.

Notwithstanding, certain public offerings are exempt from publishing a whitepaper, for example where the offering is addressed to less than 150 persons per Member State or the crypto-assets are received as a mining reward. Even where exempted from the obligation to publish a crypto-asset whitepaper, all issuers of crypto-assets, other than asset-referenced tokens or e-money tokens, should act honestly, fairly and professionally; while ensuring that their systems and security protocols meet EU standards.

Stablecoins

Besides the general requirements highlighted above, the proposed Markets Regulation sets out a set of separate requirements for the issuance of stablecoins. The proposed regulation considers stablecoins to fall within three categories:

(i) **asset-referenced tokens**, which are crypto-assets that purport to maintain a stable value by referring to the value of several fiat currencies that are legal tender, one or several commodities or one or several crypto-assets, or a combination of such assets;

(ii) **e-money tokens** whose main purpose are to be used as a means of exchange and purport to maintain a stable value by referring to the value of a fiat currency that is legal tender; and

(iii) the so-called **algorithmic stablecoins** aiming to maintain a stable value, via protocol, that provide for the increase or decrease of supply of such crypto-assets in response to changes in demand.

More specifically, on top of obtaining prior authorization by a national authority should they exceed certain de minimis thresholds, and publishing a whitepaper approved by the national competent authority, issuers of **asset-referenced tokens** should comply with: (i) capital requirements; (ii) governance arrangements; (iii) disclosure requirements; (iv) conflict of interest and complaints handling mechanisms; (v) the obligation to hold reserve of assets along with having policies and procedures governing custody of the reserve assets; (vi) investment of the reserve assets; and (viii) planning on orderly wind-down.

In addition to information included in the crypto-asset white paper, issuers of asset-referenced tokens should also provide holders of such tokens with information on a continuous basis. In particular, they should disclose the

amount of asset-referenced tokens in circulation and the value and the composition of the reserve assets, on at least a monthly basis, on their website. On the supervisory front, they will be subject to scrutiny by national regulators unless, based on certain of their characteristics, including the number and value of transactions as well as the interconnectedness with the financial system, they are deemed *significant* and the European Banking Authority (EBA) will thus play a supervisory role.

As regards **e-money tokens**, issuers should be authorized as an e-money or credit institution and abide by the relevant governance and e-money redemption rules. E-money issuers have to publish a whitepaper and notify it to the relevant national competent authority. As in the case of asset-referenced tokens, granting interest to holders of e-money tokens is prohibited. The draft Markets Regulation also provides for the categorization of certain e-money tokens as *significant*. The significant e-money tokens will be subject to dual supervision from national competent authorities and the EBA. In this regard, the EBA will be responsible for supervising the largest and more interconnected e-money tokens compliance with: capital requirements, remuneration policy, liquidity monitoring, the safe custody and investment rules, interoperability, and the orderly wind-down of its issuers.

Provisions on authorization and operating conditions of crypto-asset service providers

The provision of services in crypto-assets could only be conducted by legal persons that have a registered office in the EU and which have been authorized as crypto-asset service providers under the draft Markets Regulation. In this regard, based on the authorization in one Member State, a crypto-asset service provider will be able to operate across the EU's Single Market. In line with this, crypto-asset service providers that already provide such services are given a transition period of 18 months after the date of the Markets Regulation's application.

Similarly, entities that at the time of entry into force of the regulation, were authorized under national legal frameworks to provide crypto-asset services can use a simplified procedure to apply for an authorization. Nevertheless, credit institutions that fall under the scope of the Capital Requirements Regulation issuing asset-referenced tokens or providing crypto-asset-related services do not have to apply for an additional authorization under the draft Markets Regulation.

Following authorization, crypto-asset service providers can provide their services throughout the EU, while having to comply with their own fund's requirements and insurance policy. At the same time, the draft Regulation indicates that they bear responsibility in the event of outsourcing, and they should safeguard their clients' funds.

It also imposes additional operational and capital requirements on the following crypto-asset services, namely: custody services, operating of trading platforms for crypto assets, exchanging services between crypto-assets and fiat currency or between other crypto-assets, executing of orders for crypto-assets on behalf of third parties, providing placement services, reception and transmission of orders in crypto-assets and advice on crypto-assets. The Markets Regulation envisions an important role for the European Securities and Markets Authority (ESMA) mandating it to establish a register of all crypto-asset service providers, which will also include information on the crypto-asset whitepapers notified by competent authorities.

Regarding **third-country crypto-asset service providers**, the draft Markets Regulation stipulates that persons based in the EU will be able to receive services offered by crypto-asset service providers established in a third-country on the EU person's exclusive initiative (reverse solicitation). If, on the other hand, a third-country firm would solicit EU-based clients and/or promote its services in the EU, it will need to obtain authorization as an EU

crypto-asset service provider. The draft law includes provisions for the Commission to consider the possibility of a future equivalence regime.

The proposed regulation also includes **market abuse requirements** such as the disclosure of insider information, and prohibition of insider dealing and of unlawful disclosure of inside information, and prohibition of market manipulation.

PILOT REGIME REGULATION

The proposed Pilot Regime Regulation aims to enable market participants to operate a DLT market infrastructure (either a DLT multilateral trading facility or a DLT securities settlement system) by establishing clear and uniform operating requirements. The pilot regime or so-called sandbox allows temporary derogations from existing rules. In fact, in contrast with the Markets Regulation, the Pilot Regime Regulation proposes derogations from rules on the trading and settlement of MiFID financial instruments. The overall objective is to remove regulatory hurdles to the issuance, trading, and post-trading of financial instruments in crypto-asset and for regulators to gain experience on the application of DLT in market infrastructures.

An example of impediments to DLT innovation are the requirements for the use of a central securities depository (CSD) in post-trading of securities. In fact, current rules were conceived with a centralised structure in mind, and so can inhibit the decentralised setup that characterises blockchain technologies. The pilot regime would, if adopted, empower supervisors to exempt DLT market infrastructures from certain CSD Regulation related requirements. Importantly, this initiative could lead to efficiencies in the trade and post-trade areas, and drive down costs to the benefit of investors.

On a more practical level, the pilot regime establishes the conditions for acquiring permission to operate a DLT market infrastructure, sets limitations on the transferable securities that can be admitted to trading, and frames the cooperation between the DLT market infrastructure and competent authorities.

DLT multilateral trading facility

As regards the operation of a DLT multilateral trading facility, the draft regulation requires them to be operated by an investment firm authorized in accordance with MiFID or by a market operator. In this respect, a DLT multilateral trading facility should: (i) ensure the initial recording of DLT transferable securities; (ii) settle transactions in DLT transferable securities against payment; and (iii) provide the safe-keeping of DLT transferable securities.

As regards permissible exemptions, a DLT multilateral trading facility is allowed to request: (i) a temporary derogation from the MiFID intermediation obligation so as to provide access to retail investors, given that adequate safeguards in terms of investor protection should be in place and that such retail investors are fit and proper for anti-money laundering and combatting the financing of terrorism purposes; and (ii) an exemption to admit to trading DLT transferable securities that are not recorded in a CSD in accordance with the CSD Regulation but instead recorded on the DLT multilateral trading facility distributed ledger.

DLT securities settlement system

In line with this, DLT securities settlement systems will have to be operated by a central securities depository as authorized in accordance with CSD Regulation. As in the case of DLT multilateral trading facilities, a CSD operating a DLT securities settlement system should be able to request one or several exemptions on a

temporary basis, subject to the approval of the relevant competent authority. These exemptions concern: (i) admitting natural and legal persons with sufficient experience on the functioning of the DLT and post-trading as participants, which currently cannot participate in securities settlement systems; (ii) settling transactions with e-money tokens instead of cash settlement provided that the CSD ensures delivery versus payment; (iii) deviation from reconciliation measures, asset segregation rules, the dematerialized form, the transfer of orders, the security account, and the book-entry form as set out in the CSD Regulation; and (iv) excluding other CSDs with legacy systems from participation in its settlement system.

Securities allowed to be traded on a DLT market infrastructure

The draft legislation provides that transferable securities that can be admitted to trading on, or recorded by, DLT market infrastructures will be limited to: (i) shares with a market capitalization less than EUR 200 million; and (ii) public bonds other than sovereign bonds, covered bonds, and corporate bonds with an issuance size of less than EUR 500 million. Overall, the operators of DLT market infrastructures should establish a clear and detailed business plan describing how they intend to carry out their services and activities, including a description of critical staff and technical aspects concerning the integrity, security, and confidentiality of all data on the DLT.

The license to operate a DLT market infrastructure

Permission to operate the pilot regime is temporary for a period of up to six years. After 5 years from the entry into force of the Regulation, the pilot regime will be reviewed by ESMA. The pilot project will be subject to strict requirements, so that market operators who no longer meet the relevant criteria can no longer run the pilot.

Next steps

The draft regulations are now in the hands of the EU co-legislators (European Parliament and Council of the EU) for review and adoption. The Commission hopes to have the final Regulations implemented by 2024.

KEY CONTACTS

GIOVANNI CAMPI
GOVERNMENT AFFAIRS ADVISOR

BRUSSELS
+32.2.336.1910
GIOVANNI.CAMPI@KLGATES.COM

JUDITH RINEARSON
PARTNER

NEW YORK, LONDON
+1.212.536.3928
JUDITH.RINEARSON@KLGATES.COM

JEREMY M. MCLAUGHLIN
PARTNER

SAN FRANCISCO
+1.415.882.8230
JEREMY.MCLAUGHLIN@KLGATES.COM

