
# MiCA
# Introduction to the Markets in Crypto-Assets Regulation

Whitepaper

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# Introduction

The regulation of crypto-assets has become an increasingly discussed topic in recent years, and has led to a variety of legal approaches within the EU.
To counteract this fragmentation, on the 24th of September 2020 the European Commission proposed a new Regulation on Markets in Crypto-Assets (MiCA).

The Commission attempted to create a tailor-made regulatory framework for all crypto-assets.

In this whitepaper we -Watsonlaw's crypto team- discuss MiCA itself and the various topics MiCA will regulate, from the issuance of crypto-assets and the provision of crypto-asset services to the prevention of market abuse.
This way, we aim to give an overall image of the 'catch-all' regulatory framework that will govern the European crypto-asset market.

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# Introduction to the Markets in Crypto-Assets Regulation

## 1. Digital Finance Package

The Markets in Crypto-Assets (MiCA) draft Regulation was released by the European Commission in September 2020. It is part of the Commission's Digital Finance Package that aims to deliver innovative financial products to EU citizens, while maintaining high levels of investors' protection and ensuring financial stability throughout the Union. The Digital Finance Package puts forward four strategic priorities that transpire within the MiCA Regulation: removing fragmentation in the Digital Single Market, adapting EU law to facilitate digital innovation, promoting virtual finance, and addressing the inherent risks of these technological developments. Regulators expect that through digital friendly legislation that establishes common industry standards and facilitates exchange of information between market actors, they will encourage closer cooperation between innovative start-ups and established firms in the financial sector.

## 2. Political and Historic Context

In 2017, Bitcoin's groundbreaking rise in value alerted regulators around the world of the significant public interest that had accumulated behind the idea of decentralized finance, made possible thanks to the emergence of distributed ledger technology (DLT). By March 2018, the European Commission had published its FinTech Action plan, which called on the European Supervisory Authorities to examine the suitability of existing EU regulatory frameworks with regard to crypto-assets. The reviews conducted by the European Banking Authority (EBA) and European Securities and Markets Authority (ESMA) revealed that existing EU financial legislation is inapplicable to crypto-assets that do not qualify as financial instruments or e-money tokens. Moreover, due to the sheer variety of existing crypto-assets, it was found that tokens are often subject to diverging legal classifications under national law, which disrupts the uniform legal treatment of such digital property across Member States' jurisdictions. Consequently, attentions turned towards the potential dangers that unregulated virtual assets pose to investors and markets, which notably include consumer fraud, cyber security, money laundering and terrorist funding risks.



## 3. Creating Efficiencies

MiCA is aimed at closing regulatory gaps by bringing all crypto-assets falling outside the scope of existing financial regulations, such as the Markets in Financial Instruments Directive II (MiFID II) and Electronic Money Directive 2 (EMD2), within a single legislative framework. In the first place, the Regulation provides common EU definitions to clarify what constitutes crypto-assets, asset-referenced tokens (also known as stablecoins), utility tokens, and crypto-asset service providers (CASPs). Additionally, MiCA attempts to increase transparency levels within the crypto industry by establishing disclosure requirements for token issuers. It creates additional security for investors by stipulating minimum capital requirements for issuers of asset-referenced tokens that will serve as a form of price stabilization mechanism and will guarantee that purchasers' redemption requests can be met at all times. And lastly, MiCA replicates market abuse and market manipulation prohibitions so as to effectively expand the scope of the Market Abuse Regulation (MAR) beyond financial instruments and cover all crypto products, albeit in a substantially less detailed wat. The introduction of these measures is intended to accommodate the need for cutting-edge investment products, while balancing against financial risks intrinsic to DLT markets.

However, besides imposing obligations on token issuers and related service providers, MiCA also benefits the industry by addressing increased legal fragmentation in the regulation of crypto-assets throughout Europe. For instance, within the EU, Malta and Estonia have adopted bespoke domestic crypto regimes that establish licensing and monitoring conditions under which issuers and CASPs have to operate. Similarly, in other Member States with strong blockchain markets, such as Germany, the Netherlands, and Luxembourg, crypto service providers are required to register with their respective national financial authorities or central banks. This means that in order to provide EU-wide crypto products or related services, operators must comply separately with the domestic procedures of each host country. As an EU Regulation, MiCA supersedes any national regulatory frameworks applicable in the various EU Member States, creating a single crypto-asset licensing regime and harmonizing the requirements for issuance and trading of tokens. This legislative development will enable businesses in the sector to access the entire European market via passporting at a single point of compliance.

## 4. Coming Into Force

In a September 2020 communication to the European Parliament and the Council, the European Commission declared the adoption of a "comprehensive framework enabling the uptake of distributed ledger technology (DLT) and crypto-assets in the financial sector" as one of its main priorities in the digital transformation of Europe by 2024. The communication specifically referenced the MiCA proposal, creating the presumption that the rules will go through the ordinary legislative EU procedure within this 3 year period. On the 30th of June 2022, the European Parliament and the European Commission reached a provisional agreement on the final text of the Regulation. The official version and the entry into force of MiCA are expected in the first quarter of 2023. After its entry into force, crypto-asset issuers and service providers will have 18 months to conform to the Regulation. Nevertheless, crypto-asset issuers and service providers should begin considering MiCA's future implications on their businesses if they want to ensure a smooth transition under the upcoming legal regime.

Any questions? Please contact **Willem-Jan Smits** of Watsonlaw.

# Reasons and Objectives

## 1. Introduction

As mentioned in the introductory part of this series, the Markets in Crypto-Assets (MiCA) Regulation is part of the Digital Finance Package, which aims to support digital finance innovation by providing legal certainty for token issuers and related service providers, while simultaneously mitigating the risks associated with the digital ledger technology (DLT). However, the Digital Finance Package is not an isolated, self-standing piece of EU policy strategy. On the contrary, the Regulation responds to a number of legal analysis reports and public consultations, identifying particular risks and opportunities that have to be addressed to promote capital markets innovation and ensure crypto-assets are safe for investors and the overall economy. It is this body of present and potential issues that should be considered as the actual reason for MiCA.

## 2. Increasing the Scope of EU Financial Regulation

In January 2019, two reports were issued by the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA), which examined the applicability of existing EU financial legislation to emerging forms of crypto-assets. The EBA focused its advice on the issue of whether virtual currencies legally qualify as electronic money under the second Electronic Money Directive (EMD2) and consequently whether they fall under its scope. It was found that since most virtual currencies do not satisfy the definition of e-money under EMD2, which notably requires that such digital assets can be redeemed from their issuers, they are also not subject to any of the issuer licensing requirements contained in the Directive. Similarly, ESMA's assessment concluded that while some crypto-assets that grant profit and/or voting rights to investors could qualify as financial instruments (e.g. securities, bonds, derivatives, etc.) and fall within the scope of existing financial rules, the majority of blockchain based products do not.



As a result, both Supervisory Authorities expressed concerns that traditional consumer protection measures, such as disclosing crypto-asset inherent risks within marketing communications, establishing adequate cyber security mechanisms to prevent the theft of digital assets, and setting up of appropriate arrangements to mitigate conflicts of interests and prevent artificial market price movements, could be bypassed by token issuers, crypto exchanges and custodial wallet providers. Their recommendations called for increased legislative uniformity and institutional cooperation at the EU and international levels.

## 3. Regulating Stablecoins

The advent of stablecoins and their potential implications on financial stability was yet another factor that attracted the attention of public authorities. In an October 2019 report called 'Investigating the impact of global stablecoins', the Financial Stability Board (FSB) assessed a number of possible issues that could arise if a stablecoin asset reaches a level of global adoption, thus becoming a global stablecoin (GSC). As an increasing amount of people begin to store wealth digitally by investing money in GSCs, any unpredicted and unwanted price fluctuations would have significant effects on its users' wealth. Such events would have direct effect on spending decisions and overall economic activity. Therefore, it is imperative to establish legally binding stabilization mechanisms, such as adequate asset-backing, good liquidity and independent auditing in order to maintain public confidence in stablecoins. Additionally, should a GSC become the preferred store of value, the ability of banks to amass retail deposits will decline. Besides pressuring financial institutions to resort to riskier forms of funding, such as wholesale funding, a GSC could also seriously undermine the effects of monetary policy and the ability of governments to control inflation by adjusting base interest rates. This is the reason why MiCA seeks to make licensing as credit or electronic money institutions mandatory for issuers of e-money tokens and prohibit issuers of all types of stablecoins (e-money or asset-referenced) from offering interest rates on their tokens.

## 4. Supporting Innovation

And finally, providing legal certainty with regards to crypto-assets was deemed necessary to enable Europeans to benefit from the full potential of this innovative digital finance technology. Full implementation of DLT on capital markets could bring numerous efficiencies, especially with regard to clearing and settlement procedures, which currently rely on constant back-and-forth information exchange between intermediary and supervising institutions. In contrast, a DLT-based market infrastructure could enable a transition from linear to networked model of information sharing, in which overseeing entities and authorized service providers will have a direct, real-time access to everything happening on the DLT network. Yet, in order to achieve widespread adoption, a DLT-based financial markets infrastructure must benefit from sufficient public confidence, which will only develop by making blockchain products more familiar and safe for consumers. Currently, virtual currencies are primarily used by companies as alternative instruments for raising capital. Consequently, the first step towards improving knowledge of crypto-assets among more risk-averse investors is to implement legislation that adequately guarantees their financial expectations. Confidence in the legality of crypto-assets would serve as a future benchmark for realizing the potential benefits that they could have for capital markets as a whole.

## 5. Objectives

The objectives set by MiCA reflect the above-mentioned concerns and new possibilities that increased usage of crypto-assets may bring. First, MiCA puts in place a framework that ensures legal coverage for all crypto-assets, even those that do not constitute securities or e-money under existing Directives. Second, MiCA aims to support innovation in the industry and improve consumer and investor protection by establishing safeguards against common financial risks and preventing abusive or misleading market practices that disturb fair competition and erode the integrity of cryptocurrency markets. And lastly, the Regulation pays particular attention to stablecoins, which do not pose any current threats to financial stability due to their limited degree of adoption, but could in theory disrupt government monetary policy.

Although, more burdensome for issuers and crypto-asset service providers, the new rules are expected to increase the overall reception of crypto products, channeling more funds into this developing technology sector.

Any questions? Please contact **Camiel Vermeulen** of Watsonlaw.

# Choice of Legislative Instrument and Scope

## 1. Choice of legislative instrument

One of the first things to appreciate about MiCA is that this legislative document takes the form of a Regulation. Unlike Directives, Regulations are a form of EU law instrument that is directly applicable in all Member States and does not need to be transposed domestically. The choice of Regulation was made deliberately in order to lay down a framework of rules that is immediately and uniformly applicable throughout the single market. This type of legislative act allows for greater degree of harmonization, as it omits the risk of diverging national law transpositions, and ensures a smoother Union-wide passporting procedure for crypto-assets and crypto related services.

Mica establishes the essence of the new crypto-assets framework that will not change until the adoption of further amendments by the European Parliament and Council. MiCA foresees that the Commission will retain the right to change certain technical details even after MiCA enters into force. This will be done via delegated acts, which will implement modifications that revise the thresholds above which asset-referenced tokens are classified as significant, specify how to calculate the supervisory fees chargeable by the European Banking Authority (EBA), and adjust certain definitions contained by the Regulation to reflect market and technology developments. Such delegated powers to the EU Commission are perfectly normal and serve to fine-tune Regulation provisions by accommodating the practical realities emerging post adoption. They are limited by the power of the European Parliament and Council to object to their implementation.

## 2. Scope

The MiCA draft Regulation applies to all issuers of crypto-assets and services related to crypto-assets in the Union. Its definitions are designed to encompass the widest range of crypto-assets possible in order to capture all blockchain products currently falling outside the scope of EU financial legislation. Furthermore, in line with the Union's objective to pursue international regulatory coordination in the crypto sector, the definition of terms such as 'crypto-asset' and 'DLT' have been devised to conform to the definition of 'virtual asset' set out by the Financial Action Task Force Recommendations. This setup will help authorities address money laundering and terrorist financing issues raised by crypto-assets at the international level and in the future facilitate the offering of DLT products and services across jurisdictions.

MiCA's scope is limited by the exemptions to the Regulation listed under Article 2. Broadly speaking, these exemptions divide into two groups. The first group consists of exemptions that apply to crypto-assets qualifying as financial instruments, electronic money, and deposits. For better clarity, tokens that offer holders profit or voting rights, equal to shares and bonds, classify as financial instruments and are out of scope of MiCA. Electronic money, on the other hand, must be tied to a fiat currency and redeemable upon request from the issuer.
And finally, deposits and structured deposits resulting from money left in an account contractually which are repayable at par value by the holding institution. As long as crypto-assets fall under one of these definitions, they are regulated by existing financial legislation pertaining to that specific field, and outside of MiCA's scope avoiding overlaps.

The second group of exemptions applies to trusted entities and persons. Among these are public bodies such as the European Central Bank, the European Investment Bank and all national central banks of the EU Member States. Similarly, insurance and reinsurance undertakings would benefit from the exemption when acting in the course of their business as well as liquidators or administrators when acting in the course of insolvency procedures. MiCA will also not apply to situations where companies provide crypto-asset services internally, as would be the case with subsidiaries providing crypto-asset services exclusively to their parent companies or other subsidiaries belonging to the same corporate group.

## 3. Excluded categories of crypto-assets

In addition to the exemptions listed under Article 2 regarding overlap with other regulations and regarding the issuing entity, the scope of MiCA is also limited by exceptions regarding the offer of the crypto-assets and the rights attached to crypto-assets. Thus, an exemption applies to crypto-assets which are unique and not fungible with other crypto-assets (article 2(2a)). These non-fungible tokens (or NFT's) are a unique digital identifier which cannot be copied, mutually interchanged, substituted or subdivided. This means that the fractional parts of a unique and non-fungible crypto-asset should not be considered unique and not fungible. Also, the sole attribution of a unique identifier to a crypto-asset is not sufficient to classify it as unique or not fungible, the assets or rights represented should also be unique and not fungible for the crypto-assets to be considered unique and not fungible (Recital 6c). A large collection of digital art with minor changes between the pieces of art itself might, when following this specification, still be regulated by MiCA.

Additionally, an exemption applies to crypto-asset services as defined in MiCA, but provided in a fully decentralized manner without any intermediary, as mentioned in recital 12a.

In recital 14b, another group of exemptions is mentioned. Crypto-assets that are offered for free or that are automatically created as a reward for the maintenance of the DLT or the validation of transactions in the context of a consensus mechanism are exempt. No requirements of MiCA should apply to the offering of these crypto-assets. Another group of exemptions is also mentioned in recital 14b. When a utility token represents the purchase of an existing good or service, enabling the holder to collect the good or use the service, and when the holder of the crypto-assets has the right to use them in exchange for goods and services in a limited network of merchants with contractual arrangements with the offeror, this exemption applies.

## 4. Different types of tokens and service providers covered

Having examined the scope of MiCA and the types of tokens, entities and persons falling under its exemptions, we must turn to the remaining classes of crypto-assets and service providers that are within the remit of MiCA. Accordingly, the four main categories of assets affected by MiCA are:

- Cryptocurrencies (e.g. Bitcoin, Ethereum and Litecoin) – DLT-based instruments of payment that can be transferred and stored electronically, and whose prices fluctuate freely in response to market demand;
- E-money tokens (e.g. EURS, USD Coin and Tether) – DLT-based instruments of payment, which refer their price to a single fiat currency and stabilize their value by maintaining asset reserves to back up redemption requests by users;
- Asset-referenced tokens (e.g. Saga and Digix Gold) – DLT-based instruments of payment, which refer to baskets of fiat currencies, commodities, and even other crypto-assets and aim to stabilize their value by maintaining asset reserves to back up redemption requests by users;
- Utility tokens (e.g. Filecoin, Binance Coin and Flow) – DLT-based instruments designed as means of granting digital access to applications, resources and services provided exclusively by their respective issuers.

Similarly, the types of services covered by MiCA will be as follows:

- custody and administration of crypto-assets on behalf of third parties, as provided by virtual wallets that directly control crypto-assets or access to private cryptographic keys;
- operation of trading platforms for exchange of crypto-assets against fiat currencies or other crypto-assets as well as all related brokerage activities, such as executing and transmitting orders on behalf of third parties and placing (marketing) crypto-assets to specified purchasers;
- providing transfer services for crypto-assets on behalf of third parties;
- and finally, provision of advice and portfolio management on crypto-assets;

Of course, while these examples and definitions may serve as general guiding points, whether a token or service falls into the scope of MiCA must be examined on a case-by-case basis by reference to the specific characteristic of each asset class and business.

# Offering of Crypto-Assets and Admission to Trading

## 1. Present Regulatory Environment

With the exception of a few European national jurisdictions that have adopted domestic crypto-assets regimes, such as Malta and France, the admission and offering of crypto-assets on European capital markets is subject solely to the listing rules of individual trading platforms. MiCA is changing that by imposing uniform disclosure and investor protection requirements on crypto-asset issuers comparable to those that apply to issuers of financial instruments. This part of the whitepaper will look at the provisions included in MiCA in relation to all crypto-assets that are not asset-referenced or e-money tokens. The latter types of stablecoins will be covered in a subsequent chapter.

## 2. Primary Requirements for the Offering of Crypto-Assets and Admission to Trading

Under MiCA, crypto-asset issuers offering their tokens to the EU public or seeking their admission to trading platforms must comply with three primary requirements The first of those requirements stipulates that issuers must be registered as legal entities in an EU Member State. Having a centralized institution responsible for pursuing the assertions made to investors at the time of offering makes it much easier to obtain accountability in cases of misrepresentation and fraud. Therefore, the obligation of incorporation serves as an incentive for issuers to be objective in their public claims, refrain from making unrealistic declarations regarding the future prospects of their coins, and act in the best interest of token holders.

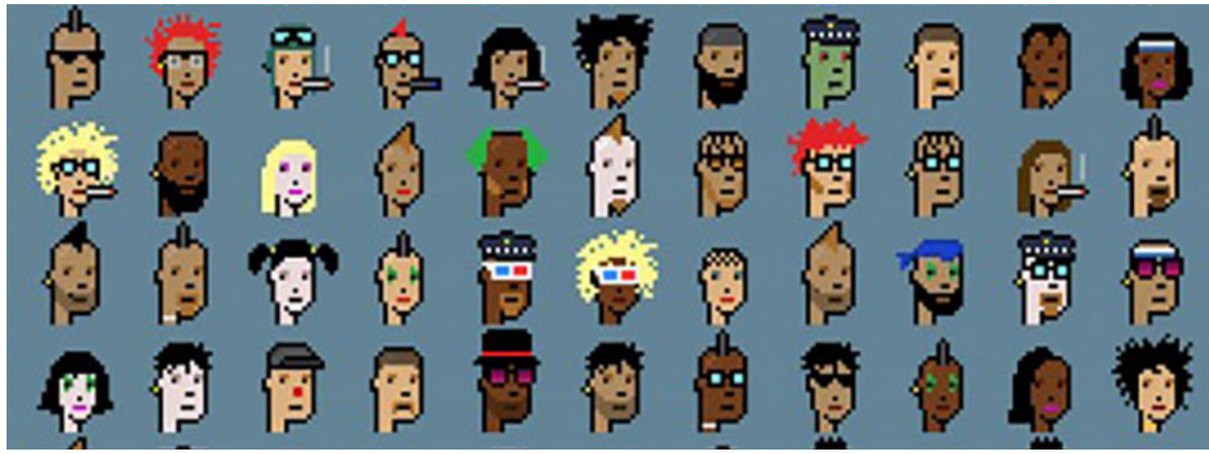
Second, crypto-asset issuers will have to draft and publish whitepapers in which they publicly disclose essential marketing information regarding their products. Pursuant to MiCA, whitepapers are expected to describe the issuing company and team involved in designing and developing the crypto-asset. The document will also need to clearly outline the rights and obligations attached to the crypto-assets on offer, the reasons for the offering, planned use of the proceeds, and all risks related to the issuer, product, and project implementation. And finally, whitepapers should include further technical details regarding the underlying technology and mechanisms that allow the holding, storage, and transfer of tokens as well as the number of crypto-assets to be issued, their price, and subscription terms and conditions. Issuers should take great care in ensuring the truthfulness of all required information as they will bear legal liability for every statement made in such documents.

And third, crypto-asset issuers should notify their whitepapers to their respective national competent authorities (NCAs), such as the *Autoriteit Financiële Markten* in the Netherlands or *BaFin* in Germany, at least 20 working days before publication. The notification must explain why the tokens do not constitute financial instruments under MiFID II and may require that the NCA extends the notification to a list of Member State authorities where the issuer also plans to make the offering. Unlike prospectuses concerning the offering of financial instruments, crypto-asset whitepapers do not need to be approved by NCAs. Nevertheless, competent authorities will be tasked with certifying the compliance of planned crypto offerings with MiCA provisions and will have the power to prohibit or suspend trading in case of irregularities.

## 3. Additional Responsibilities

In addition to the three principal obligations outlined above, issuers must also adhere to principles of honesty and fairness when dealing with purchasers and must establish administrative systems to prevent internal conflicts of interests. Storing funds, collected as a result of the offering, with certified credit institutions or crypto custodians and maintaining security systems and protocols to protect the crypto ownership of investors are also the responsibility of issuing companies. And lastly, in order to ensure a maximum level of consumer protection, MiCA further mandates issuers to provide a 14 days right of withdrawal to token purchasers as long as the crypto-assets are not already admitted on a trading platform.





## 4. Exceptions

Following MiCA's adoption, whitepapers will become the most expensive component of crypto-asset public offerings due to the likely need to involve legal, financial, and IT experts in preparing such documents. However, the cost for issuers could be dramatically decreased if any of MiCA's exemptions from drafting, notifying, and publishing of whitepapers applies. According to the provisions in the Regulation, whitepapers are not required when crypto-assets are offered for free, as would be the case with crypto airdrops used to advertise new projects, when the public offering is considered small – available to less than 150 people per Member State or for a total consideration of less than EUR 1 million – and when the crypto-assets are offered solely to qualified (professional) investors. In addition to those instances, whitepapers will not be necessary for crypto-assets offered as reward for the maintenance of DLT networks, such as coins created through the process of validating transactions popularly known as "mining" or "staking". And finally, the distribution of unique, non-fungible tokens (NFTs), like the ones used to sell digital artworks online, will also fall under the exemptions, provided that they are truly unique and not-fungible, as mentioned in chapter 3. This latter category may prove to cover some of the most substantial crypto transactions, since NFT markets have exploded since its origin with pieces such as "EVERYDAYS: THE FIRST 5000 DAYS" by Mike 'Beeple' Winkelmann, selling for record-breaking $69.3 million and several "CryptoPunk" pictures, selling for over $7 million each. As stated in MiCA's preamble and accompanying EU Commission Impact Assessment, the exemptions are meant to introduce a degree of proportionality for public offers limited in value or reach and avoid discouraging startups and SMEs from engaging in small scale projects, which can often prove to be the drivers of innovation, due to heavy administrative costs.

## 5. Expected Effects

The rules on offering and admission to trading that MiCA introduces in relation to crypto-assets other than asset-referenced and e-money tokens, demonstrate best how the Regulation will increase consumer protection and contribute towards establishing the credibility of the crypto sector. Probably the biggest shift from current practice that MiCA causes is to attach civil liability to all statements and material omissions made in crypto-asset whitepapers. Issuers will need to be very careful in describing their products thoroughly, without including any misleading information or making claims about the future value of tokens while being unable to guarantee it. This should increase investor confidence in official marketing documents related to crypto offerings.

Of course, some of these improvements will come at the expense of decentralized finance (DeFi) projects. For example, the obligation of legal incorporation, which has the purpose of guaranteeing issuers' accountability, will essentially prohibit crypto-assets with unidentifiable offerors from EU trading platforms. Similarly, the compulsory drafting of whitepapers, necessary to increase transparency, will add to the administrative costs for issuers. Yet such expenses will be offset by the EU-wide passporting regime for crypto-assets, which will create efficiency by removing the need to seek admission separately in each Member State. Ultimately, MiCA's adoption is a balancing exercise that will sacrifice some of the freedom and flexibility associated with crypto projects in order to weed out illegal activities that such digital assets have enabled to proliferate.


# Offering and Admission to Trading of Asset-referenced and E-money Tokens

## 1. Setting the Scene

According to the MiCA Article 3 definitions, asset-referenced and e-money tokens are crypto assets primarily intended as means of exchange that purport to maintain a stable value by reference to other forms of capital. However, while asset-referenced tokens may refer to baskets of goods, including fiat currencies, securities, commodities and even other crypto assets, e-money tokens may refer only to a single fiat currency. E-money tokens bear a lot of resemblance to e-money under the Electronic Money Directive 2 (EMD2) and after MiCA enters into force, the two types of asset classes will be subject to analogous requirements. Whether an electronic representation of value falls under the scope of MiCA or EMD2 would depend on whether it relies on distributed ledger technology (DLT) for storage and transfer purposes. The offering and admission to trading of asset-referenced and e-money tokens is based on the same provisions applicable to other crypto assets. However, there are some key supplementary conditions, concerning issuers' licensing, reserve assets and own capital requirements, which complicate the procedure. According to a 2019 G7 Working Group report called 'Investigating the impact of global stablecoins', assets of this category have a great potential of becoming a viable alternative to fiat currencies and the traditional banking sector. This is reflected in the MiCA Regulation, which demonstrates a particularly careful approach towards asset-referenced and e-money tokens.

## 2. Whitepaper

When it comes to the public offering and admission to trading of asset-referenced and e-money tokens, whitepapers are mandatory. No exemptions apply regardless of the size, value or target of the offering. In addition to the information that must be disclosed in relation to crypto-assets other than stablecoins, asset-referenced and e-money token issuers must also include data regarding their asset reserves, such as the custody arrangements and investment policies related to them, as well as a description of the composition and professional qualifications of the issuer's management body. Issuers of asset-referenced tokens have to provide their coin purchasers with a permanent redemption right. The issuer has the possibility to redeem either by paying an amount of funds other than e-money equivalent to the market value of the assets referenced by the token, or by delivering the assets referenced by the token. The issuer should provide sufficiently detailed and easily understandable information to disclose the different forms of redemption available. E-money token issuers must also be ready to redeem holders completely at any moment. Holders of e-money-tokens should always be granted with a redemption right at par value with funds denominated in the official currency that the e-money-token is referencing. The whitepaper should explicitly indicate that holders of e-money-tokens are provided with a claim in the form of a redemption right. Liquidity fees can be imposed on the redemption.



## 3. Authorization

Besides having to register as legal entities, issuers of asset-referenced and e-money tokens must also obtain authorization from their designated NCAs. Exceptions are allowed only if issuers are already licensed as credit institutions, their offering is made solely to qualified (professional) investors, or the total annual value of their tokens does not exceed € 5 million. The licensing process for asset-referenced tokens includes assessment of the issuer's own capital, draft whitepaper, business model soundness, token features, and security protocols. It also involves checking issuers' conformity with other key MiCA requirements, such as the prohibition of granting interest to token holders or the obligation to appoint credit institutions as reserve assets custodians. NCAs will have the final say in the matter and could issue a refusal on grounds that issuers appear likely to fail to meet MiCA's requirements or that their management body or business model pose a threat to the legitimate interests of clients, financial stability, and monetary policy. With regards to issuers of e-money tokens, they will have to be authorized as credit or e-money institutions. It suffices to say that if such entities stick solely to the issuance and distribution of stablecoins, they need to follow the same procedure for authorization as already described above. However, if they wish to engage in other activities related to the business of e-money institutions, such as the provision of payment services, additional capital requirements will apply.

## 4. Reserve Assets and Own Capital Requirements

Issuers of asset-referenced and e-money tokens will be obliged to create and maintain asset reserves in order to guarantee the stable value of their cryptocurrency. These reserves will be subject to prudential governance requirements, ensuring that they are invested only in highly liquid financial instruments with minimum market and credit risk. This will be verified through mandatory independent audits conducted every 6 months at the expense of the issuer. MiCA further imposes a set of rules regarding the custody of reserve assets, which will need to be separated from the issuer's own funds, will not be available for securitization purposes, and will have to be entrusted to a credit institution. Lastly, NCAs will demand that issuers enter into and maintain contractual arrangements that guarantee the proceeds of the reserve assets are paid out to token holders in case the issuer ceases operations, becomes subject to a wind-down, or loses its authorization. In addition to asset reserves, issuers of asset-referenced and e-money tokens will need to comply with own capital provisions which stipulate that they should have in place funds equal to or higher than either € 350,000 or 2% of the average amount of their reserve assets. This capital pool must consist of Common Equity Tier 1 items or in other words the most reliable and liquid forms of capital, such as common stock and subordinated loans. Essentially, all measures related to reserve assets and own capital funds aim to mitigate the potential economic harm that token

holders may suffer should their asset-referenced or e-money tokens cease trading.

### 5. Significant asset-referenced and e-money tokens

At the point of authorization, the NCA reviewing the application will make a determination as to whether the crypto offering should be considered significant. If this is the case, issuer supervision will be carried out by the European Banking Authority (EBA) under a heightened set of standards. According to MiCA, the factors that suggest significance are as follows:

- Customer base exceeding 10 million people;
- Total value of issued tokens of more than € 5 billion;
- Execution of more than 2,500,000 transactions per day;
- Daily transactions value exceeding € 500 million.

Offerings that meet three or more of these thresholds will be classified as significant. To reflect the increased responsibility owed to customers, issuers of significant tokens will have to implement internal remuneration policies that promote effective risk management, ensure that their stablecoins are accessible to different crypto-service providers (CASPs) on a fair, reasonable and non-discriminatory basis, establish liquidity management policies in relation to their product, and comply with a higher own capital requirement threshold set at 3% of the amount of reserve assets.

### 6. Expected effects

As is the case with all types of crypto-assets that MiCA sets out to regulate, MiCA will radically improve transparency and investors protection with regard to asset-referenced and e-money tokens, although at an increased cost for issuers. Measures requiring the continuous disclosure of information, such as the monthly publication of data regarding the number of tokens in circulation as well as the mandatory commissioning of independent reserve asset audits, will serve to reassure investors of the true value of their assets, discrediting ungrounded public speculations. Yet, auditing services, for example, could prove to be quite expensive given the small number of firms that currently specialize in reviewing such assets. Similarly, provisions stating that all profits and losses resulting from price fluctuations of the reserve assets must be borne by the issuers as well as the additional own capital requirements, will serve as a guarantee for investors that their crypto assets would not lose value even during times of financial instability. However, compliance with those requirements may create a barrier to entry for small and medium-sized entities, which will need to source more initial funding and expend additional resources to ensure they are properly managing their underlying capital, especially in the current financial climate with negative interest rates.

Another point to consider is the reserve assets custody provisions that require funds received in exchange of tokens to be stored by third party credit institutions. While such arrangements will contribute to increased levels of security, they may be at odds with some of the current crypto projects in circulation. For instance, DAI is a stablecoin pegged to the US dollar, which can be obtained by users when they deposit collateral on the Ethereum network. Smart contracts then track a predetermined collateral to token value ratio threshold, falling under which triggers automatic liquidation of the position, destroying the tokens and paying out the deposit. Obviously this setup is inconsistent with the proposition that reserve assets should be stored only with credit institutions. Thus, MiCA's implementation may necessitate that some existing stablecoin crypto projects change their underlying propositions accordingly or exit the EU market.

And finally, the prohibition of granting interest to holders of asset-referenced and e-money tokens warrants a discussion. It is a clause that may undermine the ability of issuers to attract capital. However, according to the Commission Impact Assessment the prohibition is necessary to limit the risks of "shadow banking", which is a term that refers to financial activities, such as lending, taking place among non-banking institutions. The purpose is to counter the practice of collecting money from crypto investors in exchange for a fee and then using it to grant loans to the wider public outside the scope of regulatory frameworks.

Any questions? Please contact **Eline Janssen** of Watsonlaw.



# Regulation of Crypto-asset Service Providers

### 1. Crypto-Asset Service Providers

Crypto-asset service providers (CASPs) are companies that help users control, trade or store their crypto-assets. Examples include Luxembourg based Blockchain.com, a virtual cryptocurrency wallet provider responsible for facilitating 28% of global bitcoin transactions, Bitpanda, an Austrian based exchange enabling the purchase and sale of crypto-assets as well as providing payment services with such assets, and Bitstamp, a Luxembourg based trading platform allowing fiat to crypto exchange and offering institutional clients liquidity, order executions and real-time data streams to enable banks, brokers and fintechs to incorporate crypto-trading services for their clients. These and more are the types of companies that the MiCA CASP provisions encompass.

### 2. Authorization Procedure Overview

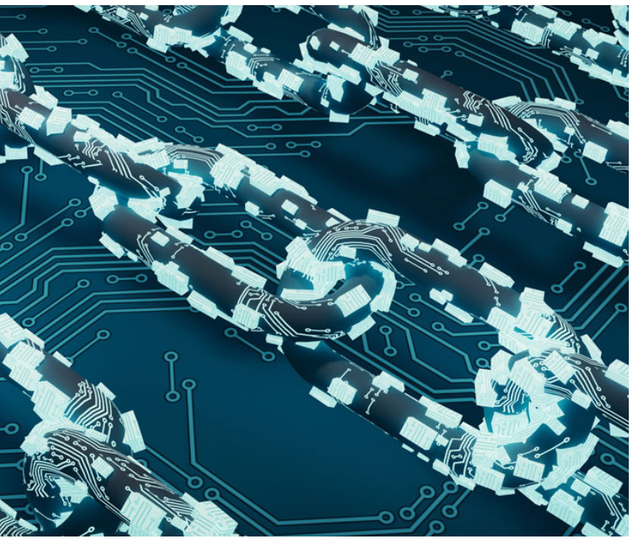
CASPs perform an important function within the crypto industry. Whether these entities take on the role of providing custody for clients' digital assets, operating crypto trading platforms, or offering investment advice on DLT products, CASPs deliver the means for investors to obtain and exercise control over their crypto holdings. Therefore, it will be no exaggeration to state that CASPs are the 'gatekeepers' to crypto markets. As such they will be subject to authorization under MiCA and will have to ensure that they deal solely with issuers who comply with the upcoming Regulation.
In order to be granted authorization, service providers will need to be registered as a legal entity with offices in at least one Member State and draw up an application, demonstrating sufficient capital, good governance arrangements capable of preventing market manipulation and abuse, and internal control systems that guarantee services will be provided in a manner that promotes the best interest of their clients. As is the case with token issuers, CASPs' authorization under MiCA will carry 'passporting' rights, meaning that their licenses will be legally recognizable throughout the Union.

## 3. Capital Requirements

One of the big changes that MiCA introduces is imposing prudential requirements on CASPs, in which case CASPs have to demonstrate to national competent authorities (NCAs) that at any time they have own funds in place ready to absorb losses. The capital size necessary to satisfy NCAs will be the higher of either a minimum amount adjusted for each crypto-asset service as set out in Annex IV, ranging between € 50,000 and € 150,000, or one quarter of the service provider's fixed overheads for the preceding year, such as office rental charges and staff salaries. CASPs' own capital must be held separate from investors' assets and consist of either Common Equity Tier 1 items (e.g. common stock and subordinate loans) or an insurance policy with coverage against a number of carefully detailed risks, such as loss of documents, misrepresentations, and errors leading to breach of duties owed to clients as well as gross negligence in safeguarding crypto-asset funds. The rationale behind this measure is to protect investors and the stability of the overall financial system during economic downturns, by ensuring that CASPs can afford to sustain operating losses, while still honoring withdrawal requests.

## 4. Governance Arrangements

In addition to sufficient capital reserves, service providers will also have to demonstrate that they meet certain organizational standards. One of the key conditions to satisfy is the appointment of a management body with sufficient integrity, professional qualifications, and experience for the performance of its duties. CASPs' shareholders who have qualifying holdings in the applicant CASP must also prove that they are of good repute and have never been convicted of financial offences, such as money laundering, terrorist financing, etc. Besides assembling a team of individuals without a criminal record, service providers will need to prepare a business continuity plan aimed at ensuring that the performance of their services would not be disrupted due to external interferences and that even in worst case scenarios there are systems and procedures in place to safeguard the confidentiality of sensitive information. Records of all orders and transactions must be stored and be readily available for NCAs that will need such information in order to perform their supervisory functions. And finally, CASPs will have to establish mechanisms for monitoring and detecting instances of market abuse committed by clients. Measures that could be taken in that regard shall range from soft policies like promoting better education on what types of behavior are likely to constitute market abuse and manipulation to the implementation of market surveillance systems, such as trade pattern analysis tools. These latter policies, often automated, metrics for tracking abnormal price movements must be customized to the parameters of the particular crypto markets under review. The range of expected volatility need to be taken into account, or the built-in alert triggers might produce impractical results.



## 5. Internal Controls

As part of their 'gatekeeping' role, CASPs will have to not only protect the integrity of the financial system, but act in regard to the best interest of their clients at the same time. To this effect, MiCA stipulates that service providers have to have internal control systems in place that can detect and prevent the misuse of data regarding clients' standing orders. Anyone with access to delicate information, including employees, could exploit this information for the purposes of market abuse and market manipulation. A CASPs' ability to demonstrate that they can effectively isolate such risks is crucial for their authorization. By the same logic, service providers must take measures and adopt appropriate policies to avoid conflicts of interest arising between their shareholders, managers, staff members and even between different clients. Establishing a designated oversight committee and internal channels for anonymous reporting to encourage whistleblowing are all good starting points. And lastly, CASPs will be obliged to create and maintain complaint handling procedures available to clients free of charge. The information contained in all communications released to the public must be clear, accurate and non-misleading, containing warnings of the risks related to purchasing digital property.



In addition, CASPs must publish their pricing policies on their websites so that investors are fully aware of any fixed costs and applicable calculation methods for adjustable expenditures. Complaints handling procedures aim to ensure that such requirements are never neglected and that any disagreements arising with customers can be investigated internally and be resolved without interference from the judicial system.

## 6. Service Specific Provisions

Outside of its authorization regime, MiCA will establish a legal framework tailored around the various activities that service providers may engage in. For instance, in relation to the offering of custody and administration for crypto-assets, MiCA's provisions stipulate that CASPs will have to regularly send out balance statements to clients, keep their own capital segregated from client funds, and bear full liability for any loss of crypto-assets as a result of malfunctions or hacks, which essentially gives rise to a statutory guarantee that investors who store DLT assets with a licensed provider will never lose the market value of their property. In the interest of keeping crypto markets operational and functional, operators of crypto trading platforms must admit only crypto-assets that have a published whitepaper, reject all tokens with inbuilt anonymity functions that prevent identifying holders and tracking their transaction histories, and ensure that crypto-asset trades are settled and recorded on the DLT network, following their execution on the exchange. CASPs engaged in exchange of crypto-assets on their own account will have to publish in advance a non-discriminatory commercial policy in advance, indicating the conditions that clients must meet in order to be accepted and informing about the method employed in determining the price of crypto-assets. As to providing investment advice or portfolio management, MiCA obliges such entities to assess the compatibility of crypto-assets with prospective clients' objectives, the ability to bear losses, client's past investing experience and their knowledge of crypto markets. Service specific provisions of this nature will necessitate some compliance customization by CASPs, depending on their business, but would add to the overall level of consumer protection offered by MiCA.

## 7. Expected Effects

The 'passporting' effects of authorization under MiCA will eliminate the need for cross-border service providers to apply for licensing separately in each Member State with a bespoke crypto regime. Although the authorization requirements entail one-off as well as on-going compliance costs that may initially impact CASPs' profit margins, MiCA's implementation deals with regulatory fragmentation and enhance

compliance efficiency. Furthermore, the increased investors' confidence, resulting from prudential requirements and governance standards imposed on CASPs, is expected to attract more capital to the crypto industry in the long run. As competition among providers intensifies at the European level, the benefits of improved services and lower costs will be passed down to EU consumers. The measures discussed throughout this whitepaper will also safeguard the stability of the overall financial system if and when crypto markets grow exponentially in the future, which is a very likely scenario given the great potential they have demonstrated so far. While most crypto-assets in circulation today operate on the premise of enabling digital peer-to-peer exchange of value without the need for financial intermediation, the majority of their users rely on the 'gatekeeping' function fulfilled by CASPs. Hence, through the regulation of service providers, financial authorities will be able to monitor the points at which traditional financial systems interact with emerging crypto markets and address the risks associated with digital finance prior to their spill over into the regulated economy.

Any questions? Please contact **Camiel Vermeulen** of Watsonlaw.

# Market Abuse Prevention under MiCA

## 1. Background

Market integrity has long been considered a key aspect of investor protection in traditional finance. Measures guaranteeing equal access to information and fair price formation regarding financial instruments have been the subject of EU wide harmonization since 2003, which has resulted in the Market Abuse Regulation (MAR). As a new type of asset class, crypto products that do not qualify as financial instruments fall outside the scope of MAR, yet the markets that have grown around them have exhibited many of the same market abuse practices as observed in traditional finance. In light of this, MiCA introduces rules for preventing market abuse and market manipulation that closely resemble the legal framework established by MAR. Their scope encompasses all persons who carry out actions that concern crypto-assets admitted to trading platforms authorized under MiCA or crypto-assets that have requested admission to trading. One of the major differences between the market abuse regime under MAR and its corresponding counterpart under MiCA is that the latter has been adapted to take into account the relatively smaller size of issuers and service providers operating within the crypto industry, refraining from the imposition of measures that would cause a disproportionate administrative burden on such entities. The following paragraphs will examine the provisions contained in the Regulation, drawing parallels with MAR where appropriate in order to give a perspective on the extent of leniency afforded to crypto markets by legislators.

## 2. Disclosure of inside information

One of the pillars of preventing market abuse and manipulation is ensuring that all market participants have access to equal information. In order to achieve this, MiCA will require crypto-asset issuers to publicly disclose inside information regarding their company and tokens as soon as possible and in a way that guarantees its quick and widespread distribution among the public. According to MiCA all data concerning issuers that is likely to have a significant impact on the value of their crypto-assets falls under the definition of inside information. In some cases issuers can choose to delay the disclosure of inside information but only in circumstances in which acting otherwise would prejudice the company's legitimate interests. In order to be lawful, delays should not be likely to mislead the public and the confidentiality of the information concerned must be guaranteed. Some illustrative examples of the legitimate interests of issuers can be sourced from the ESMA MAR Guidelines, which mention situations where issuing companies are in the process of negotiating some type of restructuring or reorganization, such as mergers, acquisitions or splits, the outcome of which may be jeopardized by immediate disclosure as well as instances when the financial viability of an issuer is at stake and immediate disclosure could threaten the successful conclusion of recovery negotiations. Information regarding such events may cause frenzy buying or market panic that would fundamentally change the circumstances surrounding a planned corporate transaction.

## 3. Prohibition of insider dealing and unlawful disclosure of inside information

Insider dealing occurs when a person who possesses undisclosed inside information regarding an asset uses it to complete trades for his own benefit or recommends investment actions to another person. As already mentioned, information asymmetries within markets may put some investors at a disadvantage, which is why trading crypto-assets on the basis of undisclosed inside information is prohibited by MiCA. For that reason, the disclosure of inside information to third parties regarding DLT products, outside of the normal procedures and channels established for public dissemination will also become illegal following the entry into force of MiCA. It is in relation to these rules that we notice some divergence between the upcoming MiCA Regulation and the already established MAR. In order to ensure better monitoring and enforcement of market abuse rules, MAR requires issuers of financial instruments to prepare and maintain insider lists, identifying all persons who have access to inside information by virtue of their occupation within the company. Under MiCA, however, crypto-asset issuers will have no such obligations. Likewise, entities falling within the scope of MiCA will not need to notify competent authorities whenever members of their management bodies conduct transactions on their own account with crypto-assets issued by their employer, while that is already a requirement for issuers of financial instruments under MAR. In the spirit of proportionality, MiCA applies a shortened set of market abuse rules to crypto-asset issuers, alleviating the ongoing compliance costs that such companies will face.

## 4. Market manipulation

Market manipulation is a term that lacks regulatory definition due to the complex combination of factors necessary to establish its presence. Sometimes a perfectly legal action may comprise market manipulation if it was committed by a person who is in a position in which they need to understand the misleading impact of their conduct. Therefore, in order to prohibit such practices, both MAR and MiCA resort to generalized descriptions of behavior that may give rise to market manipulation. One broad category of activities that could comprise market manipulation is entering into transactions or placing orders that distort signals regarding demand and supply of a particular crypto-asset, setting its price at an abnormal or artificial level. Examples of this behavior include 'pump and dump' schemes, which involve significant crypto-asset purchases that artificially push up prices and encourage other unsuspecting investors to buy as well as unfair trading techniques such as 'spoofing' and 'layering', whereby fraudsters place multiple transaction orders to seemingly boost trading volumes but then cancel them right before execution. The other major approach to market manipulation is the outright public distribution of false or misleading information that is likely to deceive market participants about the genuine supply and demand for a particular crypto-asset. Unfortunately, due to the novelty of the distributed ledger technology, price volatility and often high ownership concentration of crypto-assets, markets in those instruments are especially vulnerable to manipulative practices.

Despite using the same indicators to identify market abuse as MAR, MiCA's provisions will apply solely to crypto-asset transactions that require input from crypto-asset service providers (CASPs). Adopted in 2014 against the backdrop of the 2008 financial crisis, MAR sets out to regulate not only financial instruments admitted to regulated trading venues, but also derivatives of such instruments traded over-the-counter (OTC), as abusive practices in those markets were found capable of influencing the underlying assets. MiCA deviates from this approach, making no mention of crypto-asset peer-to-peer trading in its tailor-made market abuse regime. This was probably done because of the small number of token holders who engage in crypto exchange without any assistance from CASPs. However, this omission is still peculiar given the high potency of peer-to-peer trading to exert direct influence over the market value of the DLT assets concerned.

## 5. Sanctions

Finally, the market abuse regimes in respect of financial instruments and crypto-assets will differentiate regarding the types of sanctions they impose. To better understand this point it is important to note that unlike MiCA, MAR is part of a sequence of legislative acts, one of which, the Criminal Sanctions for Market Abuse Directive (CSMAD), is still in force. CSMAD, as the name suggests, called on Member States to adopt a harmonized framework of criminal sanctions for market abuse, which was later supplemented by the detailed infringement definitions and administrative sanctions introduced by MAR. MiCA, on the other hand, while not excluding the right of Member States to establish criminal penalties, mentions as an absolute minimum that competent authorities must only have a list of administrative sanctions at their disposal. Among these rudimentary powers are orders requiring restitution of profits gained or losses avoided due to infringements, suspension or withdrawal of CASPs' authorizations, temporary or permanent bans on members of CASPs' management bodies held individually responsible for infringements, a maximum administrative sanction of at least EUR 5 000 000 for natural persons and a maximum administrative sanction of at least EUR 15 000 000 or 15% of their total annual turnover for legal persons. Member States are further authorized to provide their NCAs with additional powers and increase the maximum amount of pecuniary sanctions in respect of both natural and legal persons.

# Questions?

## Feel free to ask our specialists.






This paper is written by the blockchain experts of Watsonlaw. Whether you have questions regarding your crypto-oriented company, or have specific questions regarding the implementation of MiCA, do not hesitate to contact us. Watsonlaw is your partner in blockchain, tokenization and the crypto-market in the Netherlands and abroad, with a broad network of collaborating law firms throughout various countries to provide national as well as international advice. Not only do we possess extensive knowledge regarding the new MiCA regulation, we can also guide your company every step of the way to becoming a leading blockchain enterprise.

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