The Regulation of Cryptoassets

Response to European Commission Consultation—Part II

March 2020

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Financial Markets Law Committee

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1 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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1. EXECUTIVE SUMMARY AND INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In 2014, stakeholders recommended that the FMLC explore legal uncertainties arising from the proliferation of digital currencies such as Bitcoin. In response, the FMLC established the Virtual Currency Scoping Forum as a space for discussion and initiated an analysis of the legal character of virtual currencies and their development as a medium of exchange. As the pace of innovation poses challenges for regulators, the Committee decided in 2016 to widen the remit of the Virtual Currency Scoping Forum to include discussions on developments in regulatory technology and cybersecurity. Through the Forum—renamed the Finance and Technology Scoping Forum—and specialised Working Groups, the Committee has undertaken a broader evaluation of Financial Technology ("**FinTech**"). The FMLC has published papers analysing virtual currencies, questions about governing law in relation to distributed ledger technology ("**DLT**"), initial coin offerings and the application of anti-money laundering regulation to cryptoassets.[2]

1.3. In December 2019, the European Commission published a Consultation Document on an E.U. framework for markets in cryptoassets (the "**Consultation**").[3] The FinTech Action Plan, published in March 2018, had mandated the European Banking Authority ("**EBA**") and the European Securities and Markets Authority ("**ESMA**") to assess the applicability and suitability of the existing financial services regulatory framework to cryptoassets. ESMA provided Advice in January 2019, pointing out that while some cryptoassets fall within the scope of E.U. legislation, effectively applying it to these assets is not always straightforward.[4] At the same time, the EBA and ESMA have pointed out that most cryptoassets are outside the scope of E.U. legislation and hence are not subject to provisions on consumer and investor protection and market integrity, among others. The Consultation may be divided into three broad parts: (1) whether and how to classify cryptoassets; (2) cryptoassets that currently fall outside the scope of the

[2] For a complete list of the FMLC's work on FinTech issues, see: http://fmlc.org/Topic/fintech/

[3] European Commission, *Financial Services – EU Regulatory Framework for Crypto-Assets* (19 December 2019), available at: https://ec.europa.eu/info/law/better-regulation/initiatives/crypto-assets-2019/public-consultation_en.

[4] ESMA, *Advice: Initial Coin Offerings and Crypto-Assets*, (9 January 2019), available at: https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection,

E.U. financial services legislation; and (3) cryptoassets that currently fall within the scope of E.U. legislation. The FMLC has drafted a response to the Consultation in the form of two complementary reports. This Report comprises comments—gathered with the advice of members of the FinTech Scoping Forum—to the section of the Consultation dealing with cryptoassets which fall within the E.U. regulatory perimeter.

2. CRYPTOASSETS THAT ARE CURRENTLY COVERED BY E.U. LEGISLATION

2.1. Part IV of the Consultation deals with the application of existing regulation to, primarily, security tokens and e-money tokens. The Consultation clarifies that it uses the term "security token" to refer to cryptoassets issued on a DLT and that qualify as transferable securities or other types of financial instruments under Directive 2014/65/EU on markets in financial instruments ("**MiFID II**").[5] Activities concerning security tokens would qualify as MiFID II investment services/activities and transactions in security tokens admitted to trading or traded on a trading venue would be captured by MiFID II provisions. Financial instruments covered by MiFID II are also subject to Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories ("**CSDR**") and Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**"). Before delving into the specific questions regarding the application of existing financial services regulation to cryptoassets, however, the Committee would like to make a general observation.

2.2. The Consultation states that technology neutrality is one of the guiding principles of the European Commission's policies. This means that legislation should not mandate market participants to use a particular type of technology. Stakeholders have suggested to the FMLC that, especially in respect of existing regulation, a distinction should be drawn between two categories of legislation. The first category includes legislation which regulates the financial markets in general—such as MiFID II, Regulation (EU) 596/2014 on market abuse ("**MAR**") and Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (the "**Prospectus Regulation**"). The second category includes legislation which specifically concerns financial markets infrastructure—

[5] The FMLC published analysis on security tokens issued via initial coin offerings in July 2019. See: FMLC, *Report: Initial Coin Offerings*, (30 July 2019), available at: http://fmlc.org/report-initial-coin-offerings-30-july-2019/.

including, EMIR, CSDR, Directive 2002/47/EC on financial collateral arrangements (the "**FCAD**") and Directive 98/26/EC on settlement finality in payment and securities settlement systems (the "**SFD**"). The first type of legislation may indeed be considered technology neutral and can therefore encompass cryptoassets to the extent that they are functionally equivalent to financial instruments. The second type of legislation, however, contemplates an existing market infrastructure, in which activities such as clearing and settlement and actors such as intermediaries play a key role. These texts use notions and concepts which reflect the traditional market infrastructure of intermediated securities, such as "central securities depository", "account", "finality" or "portability", most, if not all, of which cannot readily be applied to a DLT context. As far as market infrastructure is concerned, it is likely that a new type of regulation will be needed rather than trying to shoehorn a new phenomenon into old concepts.

2.3. By extension, the fundamental question in this context remains which properties of DLT need to be regulated from a market infrastructure perspective, and how this should be done. This question can only be answered by starting from the specific risks associated with the technology, its peculiar functioning and its particular weaknesses. Consideration might again need to be given to the multiple types and features of cryptoassets described in the FMLC's publication on a cryptoasset taxonomy.

Centralised and permissioned vs decentralised and permissionless platforms

2.4. In the Consultation, the European Commission states that it appears that existing requirements in the trading and post-trade area would largely be able to accommodate activities related to security tokens *via* permissioned networks and centralised platforms, which hold the cryptoassets on behalf of their clients and wherein trades are settled off-chain. For the development of permissionless networks and decentralised platforms where activities would not be entrusted to a central body or operator but would rather occur on a peer-to-peer basis, the European Commission is concerned that existing legislation would need to be adjusted. The European Commission proposes a gradual regulatory approach, focusing initially, for example, on providing regulatory guidance or legal clarification regarding permissioned centralised solutions.

2.5. Whilst an approach which addresses permissioned, centralised solutions first seems sensible, further thought may need to be given to the concepts of centralisation and permissioning as set out in the consultation paper. For example, the Consultation distinguishes between centralised and decentralised platforms according to whether or not the platform holds cryptoassets on behalf of its clients and the settlement takes place on-chain. Further consideration may be required as to whether these are the appropriate criteria for distinction. In practice, there is not always a sharp dichotomy between centralised and decentralised platforms, but rather the degree and type of "permissioning" can determine how centralised or decentralised a platform may be. The concept of "permissioning" can encompass many things, including permissioned access (i.e. permission to access the system), permissioned governance (i.e. some form of overriding rulebook/legal framework, agreement to which is a key component of the underlying protocol) and permissioned nodes (i.e. the inclusion of master nodes that have editorial rights over some entries on the distributed ledger). Legal certainty may be maximised if the regulatory treatment is distinguished on the basis of a more precisely defined governance structure—considering, for example, whether there is a "master node", the operator of which is responsible for overseeing the operations and taking regulatory responsibility.

Financial instruments under MiFID II

2.6. Section C of Annex I of MiFID II specifies financial instruments. These are *inter alia*, "transferable securities", "money market instruments", "units in collective investment undertakings" and various derivative instruments. There is currently no legal definition of security tokens in E.U. financial services legislation; where security tokens meet necessary conditions to qualify as a specific type of financial instruments, however, they are regulated as such. Whether or not a cryptoasset is a financial instrument is a determination to be made by each individual Member State's National Competent Authority ("**NCA**"). Whilst this consideration will be based on the definition of "financial instrument" in Section C of Annex I of MiFID II, NCAs have taken differing approaches as to whether a particular instrument cryptoasset would be considered a "financial instrument" under MiFID II, leading to a lack of consistency in the application of MiFID II across Member States.[6] This creates uncertainty and gives rise to the risk of regulatory arbitrage. In this context, the Consultation asks, in Question 58, whether the absence of a common approach on when a security token constitutes a financial instrument is an impediment to the effective development of security tokens.

2.7. The absence of a common approach as to the characteristics that lead a security token to constitute a financial instrument is not only a barrier to development, it gives rise to

[6] In January 2019, ESMA published a paper, outlining the findings from a survey conducted among NCAs on how they would qualify specific cryptoassets. One example of divergence outlined in the paper is that of a utility token (i.e. a token that grants access to a service) in which there is a secondary market (which may cause individuals to purchase the tokens for investment or speculative purposes), NCAs take different approaches as to whether such a token should qualify as a transferable security. See: ESMA, *Annex 1 of Legal Qualification of Cryptoassets—Survey to NCAs* (January 2019), available at: https://www.esma.europa.eu/sites/default/files/library/esma50-157-1384_annex.pdf.

significant legal uncertainty. Central to that legal uncertainty is the definition of "transferable security" (and related guidance from the European Commission), in respect of which there is a lack of clarity and commonality in implementation across the E.U.[7] This is problematic given that these are important definitions in the regulatory perimeter for several key pieces of E.U. legislation. For example, transactions in "transferable securities" which take place on a trading venue are required to be recorded in book-entry form in a central securities depository ("**CSD**") under Article 3(2) of the CSDR. The definition of "transferable securities" under Article 4 of MiFID II is, however, opaque and circular. It refers to "those classes of securities" which are "negotiable" on the "capital market", with the exception of "instruments of payment", but the meaning of those terms is not at all clear in this context and they are interpreted differently across Member States. For example, there is no exhaustive definition of "securities" and, often, they are not distinguished from the definition of transferable securities itself. Similarly, there is uncertainty as to what is meant by "capital market" and the European Commission's guidance provides little clarity as to its meaning. The meaning attributed to the term "instruments of payment" differs across Member States and it is often not clear when a token, which is exchanged for (other) assets or goods and services, would qualify as an "instrument of payment". This uncertainty means that it is unclear whether various novel token structures would qualify as transferable securities and whether the same approach to categorisation would be taken across the E.U. As CSDR is directly applicable in Member States, a clearer definition and harmonised approach to interpreting the meaning of "transferable securities" would be helpful. This is particularly the case as a CSD currently needs also to ask the preliminary question as to which law to look to in order to determine whether a particular token is a transferable security (for example, the law of the jurisdiction of the CSD, the jurisdiction of the issuer, the jurisdiction of the account holder, etc.).

2.8. The definition of "transferable securities" is, however, used pervasively in E.U. legislation and any attempt to clarify its meaning/interpretation would need to be considered very carefully to avoid unintended consequences. A clarification purely for the purposes of accommodating cryptoassets would not be desirable. Likewise, the definition of other terms for the purpose of cryptoasset regulation risks unintended consequences.

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7 In the paper mentioned above, ESMA surveys the ways in NCAs interpret the types of "transferable securities". *Survey to NCAs* (n. 6), pp. 12-16.

2.9. In a similar vein, Question 64 asks whether the current scope of investment services and activities under MiFID II is appropriate for security tokens. Clarification as to how investment services should be understood in the context of a distributed network of nodes would be helpful. For example, it remains unclear whether a wallet provider's node would be considered to be providing the investment service of "reception and transmission of orders in relation to one or more financial instruments" or "execution of orders on behalf of clients" if it inputs a client order for security tokens directly onto the distributed ledger of an exchange platform.

Hybrid cryptoassets

2.10. Question 61 focuses on the treatment of hybrid cryptoassets which display the characteristics of multiple types of tokens. As stated above, this is an important consideration to ensure consistency and to avoid a high degree of discretion, resulting in an uneven application of regulation across the financial markets. For clarity and consistency, we would expect that any tokens that have the features of financial instruments would need to be regulated as such (in addition to complying with any further requirements that may be relevant). Clearer harmonised guidance as to precisely which features would cause a token to meet the definition of a financial instrument (e.g. whether a utility token in which there is a secondary market would meet the definition) is needed to address the current legal uncertainty.

The Central Securities Depositories Regulation

2.11. The CSDR aims to harmonise the timing and conduct of securities settlement in the European Union and the rules for central securities depositories which operate the settlement infrastructure. In general terms, the scope of the CSDR refers to the 11 categories of financial instruments listed under MiFID. Various requirements of the CSDR, however, refer only to subsets of categories under MiFID.

2.12. Question 88 asks whether the use of various terms as defined in the CSDR in a cryptoasset context may lead to legal, operational or technical uncertainty. The FMLC would like to draw attention to complexities which may arise in respect of the following:

- *Whether records on a DLT platform can be qualified as securities accounts and what can be qualified as credits and debits to such an account*: It would be helpful for there to be clarification as to how these concepts are to be understood particularly in the context of a DLT implementation which keeps records of transactions only and does not maintain a separate record of account balances.

- *What could constitute delivery versus payment ("**DvP**") in a DLT network*: It may be helpful to have guidance as to whether requirements for DvP can be satisfied through the delivery of a cryptoasset provided that the other requirements of the DvP definition are met, considering that the fiat cash leg is not processed in the network (although, there are platforms on which one cryptoasset is exchanged for another where both legs may be on-chain). Some platforms have incorporated the use of smart contracts which enable "automatic" DvP or analogous arrangements. Consideration may also need to be given to how DvP may be satisfied in the event of "forking"—i.e., a radical change to a network's protocol that makes previously valid blocks and transactions invalid, or vice versa.

- *Outsourcing*: It would be helpful to have clarification as to how validator nodes in a distributed financial network should be treated in relation to the CSD. This includes, for example, clarity on what circumstances (if any) in which the CSD would be considered to be outsourcing the validation function to the validating nodes. As a general matter, the Consultation provides insufficient analysis of the role of validator nodes. The lack of guidance on this point gives rise to unnecessary legal uncertainty, which could be resolved by providing for the regulatory treatment of validator and other nodes to be based on the activity undertaken in connection with the node. This activity may fall legitimately outside the regulatory perimeter (for example, if the node is providing a purely technical service of running the protocol), while it may appropriately fall within the regulatory perimeter in other circumstances.

2.13. Similarly it would be beneficial to have clarity as to whether the book-entry requirements under CSDR can be met through the use of DLT (for example, in relation to security tokens).

The Settlement Finality Directive

2.14. The SFD is designed to reduce systemic risks by minimising the disruption to a system caused by insolvency proceedings against a participant in that system. Question 96 of the Consultation asks whether the effective functioning and/or use of DLT solution is limited or constrained by any of the SFD provisions. It is likely that certain DLT implementations will be incompatible with the requirements for designation under the

SFD. As the Consultation Paper points out, the list of persons authorised to take part in a designated system under the SFD excludes natural persons, so those implementations that provide for direct access to retail customers are unlikely to qualify.[8] This supports a conclusion that the SFD is more likely to be compatible with a centralised and permissioned system than a decentralised and permissionless one.

2.15. Question 94 asks if the conflicts of laws rules in the SFD need to be clarified when applied in a DLT context. The conflicts of laws provision in Article 9(2) of the SFD refers to the law of the Member State in which the securities register, account or centralised deposit system is located. It is unclear how this provision would apply in the context of securities which are issued, held and transferred on a multi-jurisdictional distributed ledger. The notions of register, account or deposit system do not align well with DLT applications, which operate without a central register, accounts or deposits. In addition, depending on the precise implementation, local copies of the ledger may be stored or reproduced in any of the jurisdictions in which a data-sharing node is being run and so it may not be clear in which jurisdiction the register, account or system is "located". One solution may be for the location to be pinned to the jurisdiction of the operator of a "master node" in a centralised system.[9] This would, however, require redrafting Article 9 of the SFD which does not currently refer to the operator. This is also unlikely to be applicable to decentralised ("permissionless") systems, which do not have any central operator, and for which a completely new rule would have to be crafted.

E-money tokens

2.16. E-money has been defined in Article 2(2) of Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions (the "**E-Money Directive**") as

> electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions as defined in point 5 of Article 4 of Directive 2007/64/EC, and which is accepted by a natural or legal person other than the electronic money issuer

8 The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 ("**SFR**"), which implement the SFD in the U.K., also includes provisions in which a system operator and an easily ascertainable group of participants are necessary.

9 The FMLC has considered questions around governing law in the context of DLT in a 2017 Paper. FMLC, *Report: Distributed Ledger Technology and Governing Law*, (27 March 2018), available at: http://fmlc.org/report-finance-and-technology-27-march-2018/.

E-money includes pre-paid cards (like oyster cards) and pre-paid accounts online (as Paypal can be) and on electronic devices (such as mobile telephones). Some virtual currencies—and, in particular, those which are pegged to a sovereign fiat currency—may be considered to be e-money. In the E.U., issuers of those cryptoassets which qualify as E-Money must have the relevant authorisations and follow requirements under the E-Money Directive. In the U.K., the FCA has adopted a taxonomy of cryptoassets which includes the category of "E-money tokens", which it defines as any token which reaches the definition of e-money. Such tokens are subject to the E-Money Regulations 2011 and firms must ensure they have the correct permissions and follow the relevant rules and regulations.

2.17. The definition of e-money under the E-Money Directive is not sufficiently clear. Questions arise as to the meaning of a "claim" on the issuer and of "accepted", especially in the context of the complex ways and means of holding and transferring cryptoassets. The current definition may capture many cryptoasset structures that are not intended to be regulated as e-money. Equally, the current lack of clarity in interpreting the term "instruments of payment" (which are carved out from the definition of "transferable securities" under MiFID II) leaves a residual technical risk that something could be e-money *and* a transferable security (noting that the fact that something is accepted for payment (see the definition of e-money) does not necessarily turn it into an instrument of payment. As a related point, there is also a lack of clarity as to the circumstances in which a payment token could constitute "cash", for example, under EMIR and the FCAD.

3. CONCLUSION

3.1. In this part of the response to the European Commission's Consultation on regulating the market in cryptoassets, the FMLC has provided comments on uncertainties which may arise in the application of existing financial services regulation to cryptoassets. The FMLC has observed that, at least as far as market infrastructure is concerned, it is likely that a new type of regulation will be needed rather than trying to shoehorn a new phenomenon into old concepts. It has then drawn out specific uncertainties in respect of centralised and permissioned vs decentralised and permissionless platforms, as well as several definitions in MiFID II, the CSDR, and the E-Money Directive.

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