Crypto regulation in the EU

Last updated in July 2022

Introduction

At the moment, there is still no harmonised framework on the regulation of crypto–assets at the EU level. In the absence of a common approach, ever since the ICO bull run of 2017, individual EU Member States have been trying to create national frameworks that would address the gaps in regulation and supervision of the crypto industry in their respective jurisdictions.

As part of this process, different EU Member States have been taking different approaches, from those trying to bring the crypto industry under the scope of existing financial regulations (like Germany for example) to those that have tried creating designated crypto–friendly regulatory frameworks with the aim of becoming crypto hubs (like Malta).

Aiming to bridge these divergences in national frameworks and create a level playing field for all crypto businesses willing to explore the potential of the EU single market, as part of its Digital Finance Package, the European Commission has published on 24 September 2020 two legislative proposals designed to shape the new EU regulatory framework on crypto–assets:

- Proposal for a Regulation on Markets in Crypto–Assets (MiCAR) which aims to create a harmonised regulatory framework for issuers of crypto–assets and crypto–asset service providers operating in the EU. On 30 June 2022 the European Parliament and the Council have reached a provisional agreement on MiCAR that is still to be officially adopted by both institutions in the coming months.

- Proposal for a Regulation on a pilot regime for market infrastructures based on distributed ledger technology (DLT–Pilot Regime) that introduces an EU–wide regulatory sandbox within which entities willing to operate DLT market infrastructures may be exempted from certain requirements that prevent deployment of DLT in securities trading. This regulation (Regulation (EU) 2022/858) was recently adopted by EU lawmakers and officially published in the EU Official Journal on 2 June 2022.

In addition to these two proposals, on 21 July 2021 the EU Commission also proposed a proposal for a regulation which aims to implement the FATF Travel Rule for the crypto industry in the EU through the revision of the existing Regulation on information accompanying transfers of funds (Regulation 2015/847/EU) that currently applies to payment service providers. This proposal will complement the already applicable AML/CTF regulatory framework on crypto–assets that was introduced back in 2020 through the 5th EU AML Directive under which a large number of crypto–asset service providers are already deemed as obliged entities for AML/CTF purposes.

Authored by:

Dr. Verena Ritter–Döring, Partner
v.ritter–doering@taylorwessing.com

Miroslav Đurić, LL.M, Associate
m.duric@taylorwessing.com

1. Markets in Crypto–Assets Regulation (MiCAR)

Intended to become a backbone of the EU regulatory framework on crypto–assets, MiCAR creates a common set of rules applicable to issuers of crypto–assets as well as service providers such as crypto wallet providers and crypto exchanges operating in the EU. For this purpose, MiCAR firstly introduces a common taxonomy of crypto–assets by differentiating between three groups of crypto–assets, to which different regulatory requirements apply.

1. Asset–referenced tokens

Crypto–assets that purport to maintain a stable value by referring to the value of several fiat currencies, one or several commodities or one or several crypto–assets, or a combination of such assets.

2. E–money tokens:

Crypto–assets whose main purpose is to be used as a means of exchange and that purport to maintain a stable value by referring to the value of a fiat currency that is legal tender (for instance EUR or USD).

3. Other crypto–assets:

A catch all category that aims to cover all other crypto–assets such as crypto–currencies (Bitcoin, Ether etc.), various types of investment and utility tokens provided that they do not qualify as asset–referenced or e–money tokens.

Crypto–assets that by their features qualify as other regulated instruments under existing financial regulations in the EU, such as transferable securities, structured deposits, e–money or securitisations, will remain outside the scope of the new regime and remain subject to existing sector–specific regulations.

Requirements on the issuers

Before offering crypto–assets to the public under the new regime, the issuers will be required to comply with a number of regulatory requirements.

First, they will need to be entities incorporated in the EU that will need to prepare and publish a whitepaper (investor information document similar to the securities prospectus) which clearly describes relevant information about the issuer, the crypto–asset, risks associated with the investment as well as information around the underlying technology.

Further, the issuers will need to comply with certain minimum marketing requirements, liability limitations as well as to grant their investors a mandatory 14–day withdrawal right.

After following the predefined notification procedure, issuers located in one EU Member State will also generally be able to offer crypto–assets to investors located in other EU Member States on a cross–border basis. On the other hand, MiCAR will not allow offering of crypto–assets issued by entities from outside the EU to the European investors in accordance with the proposed regime.

Requirements on crypto–asset service providers

By mirroring the basic principles of the existing financial regulatory framework based on the Second Markets in Financial Instruments Directive (Directive 2014/65/EU 'MiFID II'), EU lawmakers have designed specific authorisation, conduct and operational requirements that providers of crypto–asset related services such as crypto wallet providers and operators of crypto exchanges will need to comply with.

Prior to starting with the provision of crypto–asset related services, they will need to apply for authorisation with the national competent authority (NCA) in the Member State of their establishment.

Once authorised, providers of crypto–asset related services will also have a chance to benefit from the so–called EU Passport, by providing crypto–asset related services across the EU on a cross–border basis based on a single licence obtained in their home EU Member State.

Due to the fact, that the requirements that will apply to crypto–asset services providers are rather less onerous than the ones that apply to financial institutions in the EU, MiCAR provides for an equivalence regime for existing authorised investment firms under the MiFID II framework who, where they decide to provide crypto–asset related services, will generally not be required to apply for an additional licence under the new regime.

Bespoke regime for stablecoins

Issuers of two types of stablecoins defined under MiCAR, asset referenced and e–money tokens, will be subject to some additional requirements aimed at ensuring proper regulation and supervision of this evolving subfield of the crypto industry.

Whereas only authorised credit and e–money institutions will be allowed to issue e–money tokens, issuers of asset–referenced tokens will be able to obtain a special authorisation for this activity, subjects to compliance with minimum organisational, capital and governance requirements.

Further, issuers of asset–referenced and e–money tokens will be subject to strict requirements on the maintenance of reserve assets underlying their value, will need to have a clear stabilisation mechanism in place and will need to include some additional information in the whitepaper regarding the reserve assets, custody arrangements used, the stability mechanism etc.

In relation to certain significant stablecoins, whose daily transactions and/or market value exceed certain thresholds, additional requirements will apply and they will be subject to a special supervisory framework within which the European Banking Authority (EBA) will have some direct supervisory powers in relation to their issuers.

In the light of recent developments in the stablecoin market (ie the **Terra/Luna** collapse and the rising concerns around the use of stablecoins), it is possible that regulators in other jurisdictions may decide to follow the footpath of EU lawmakers when approaching this topic.

ESG considerations and the way ahead

For quite some time now, the EU has aimed to create a comprehensive regulatory framework on sustainable finance that enables more funds to be channeled towards financing sustainable economic activities.

This rising sustainability awareness in the EU policy making circles, led EU lawmakers to consider including certain additional requirements in the MiCAR proposal, that would bring the emerging regulatory framework on crypto–assets in line with the Union's sustainability policy.

Against this backdrop, on 14 March 2022 the European Parliament has adopted its negotiation position on MiCAR that includes additional requirements on issuers of crypto–assets that would need to include information about sustainability aspects of the crypto–asset (consensus mechanism used, associated electricity consumption etc.) in the white paper as well as special disclosure requirements on crypto–asset service providers that will be required to publish information related to the environmental and climate–related impact of each crypto–asset for which they offer services.

On 30 June 2022 the European Parliament and the Council have reached a provisional agreement on MiCAR which puts the end of the two year long legislative making process on MiCAR in clear sight.

Besides the aforementioned ESG-related requirements that were implemented on the initiative of the European Parliament, the final version of MiCAR is expected to clearly exclude non–fungible tokens (NFTs) from the scope of its application however only as long as they clearly lack the fungibility element. Further, issuers of stablecoins will likely face stricter requirements than originally planned, especially when it comes to requirements on redemption rights, maintenance of reserve assets as well as the possibility for the issuers to grant token holders interest on their holdings in their stablecoins.

Following the adoption of this provisional agreement, EU lawmakers still need to officially adopt the final text of the Regulation, and given that the original proposal provided for an 18–month transitional period, it is unlikely that MiCAR will become fully operational before the end of next year.

2. DLT Pilot Regime

Alongside MiCAR, the EU Commission has also published a Regulation on a pilot regime for market infrastructures based on distributed ledger technology (the so called 'DLT Pilot Regime') that aims to create an EU–wide regulatory sandbox for DLT–based market infrastructures.

With this proposal, the EU Commission plans to open the door for deployment of DLT in securities markets for authorised financial institutions, who will be able to benefit from targeted exemptions from existing requirements that represent potential impediments to the development of DLT–based market infrastructures.

On 2 June 2022 the Regulation on DLT Pilot Regime **(Regulation (EU) 2022/858)** was officially published in the EU Official Journal and it will start to apply as of 23 March 2023.

DLT market infrastructures

The proposed Regulation introduces a pilot regime for three types of DLT market infrastructures:

- The DLT multilateral trading facility (**DLT MTF**) which is a multilateral trading facility, operated by an investment firm or a market operator, that only admits to trading DLT financial instruments.
- The DLT securities settlement system (**DLT SS**) which is a securities settlement system, operated by a central securities depository (CSD), that settles transactions in DLT financial instruments.
- The DLT trading and settlement system (**DLT TSS**) which refers to a DLT MTF or DLT SS that combines services performed by a DLT MTF and a DLT SS operated by an investment firm, market operator or alternatively a CSD.

The scope of application of the DLT pilot regime is limited to DLT market infrastructure serving the trading or settlement of financial instruments within the meaning of MiFID II that are issued, recorded, transferred and stored using a DLT (the so called **DLT financial instruments**).

In order to enable tokenisation of financial instruments, the EU Commission has also separately proposed the extension of the definition of a financial instrument under MiFID II which shall now include financial instruments issued by means of DLT as well.

Limitations

The operation of DLT market infrastructures shall be limited to the following groups of financial instruments:

- shares, the issuer of which has a market capitalisation, or a tentative market capitalisation, of less than EUR500 million
- debt securities (bonds, money market instruments, securitised debt excluding instruments that embed derivatives or have complex structure) with an issue size of less than EUR1 billion
- units in collective investment undertakings, the market value of the assets under management of which is less than EUR500 million.

In addition, the aggregate market value of all the DLT financial instruments that are admitted to trading on a DLT market infrastructure shall not exceed EUR6 billion. Where this threshold is surpassed, the operators of the DLT market infrastructure will be required to activate a special transition strategy with the aim of reducing the trading activity on their platform.

Exemptions from existing requirements

The Regulation allows NCAs to exempt operators of DLT MTFs, DLT SSs and DLT TSS from certain regulatory requirements applicable under existing regulations that would represent potential impediments to deployment of DLT in securities markets.

Operators of DLT MTFs will be able to apply for exemption from requirements on transaction reporting under Markets in Financial Instruments Regulation (MiFIR) as well as to apply for a temporary derogation from the obligation to hold securities on an intermediated basis (ie by authorised investment firms) with the aim of granting retail clients a direct access to DLT–based trading venues.

CSDs operating DLT SSs will be able to apply for an exemption from the book entry requirement under Article 3 of the Central Securities Depository Regulation (CSDR) which would enable admission to trading of securities that are not registered with a CSD, but instead automatically recorded on the DLT–based ledger.

Further exemption will also be possible from requirements on mandatory cash settlement which is intended to use of settlement coins or e–money tokens for securities settlement purposes. Operators of DLT TSSs will be able to request the same exemptions as those available to operators of DLT MTFs and of DLT SSs.

Application for exemptions

Prospective operators of DLT market infrastructures will need to apply with their NCA for permission and will need to fulfill some additional requirements aimed at ensuring that the risks related to the use of distributed ledger technology or the way in which the DLT market infrastructure would operate, are properly avoided.

For this purpose, prospective operators of DLT market infrastructures will need to demonstrate that they possess:

- comprehensive documentation describing their systems and processes
- designated operational risk management procedures
- specific and robust IT and cyber arrangements related to the use of distributed ledger technology.

Specific permissions and exemptions will be granted by the NCA on a temporary basis, for a period of up to six years from the date on which the specific permission was granted, and will be valid only for the duration of the pilot regime.

By 24 March 2026 ESMA shall prepare a report on how the pilot regime is functioning, based on which the EU Commission shall make recommendations to the EU Parliament and the Council on whether the regime shall be extended for an additional period of up to three years, made permanent, amended, extended to other types of financial instruments or eventually terminated.

3. AML/CTF framework for crypto–assets

Right after the initial surge in popularity of crypto–assets in 2017 and 2018, the EU took necessary steps to bring the providers of crypto–asset related services under the scope of the existing AML/CTF regulatory framework.

By following the **FATF Guidance on Virtual Asset Service Providers** from June 2019, the fifth EU AML–Directive has added virtual asset service providers (VASPs), such as custodian wallet providers and operators of crypto exchanges, to the list of obliged entities that are required to ensure compliance with the applicable AML/CTF regulatory requirements in the EU.

That being said, currently all in–scope VASPs operating in the EU are subject to AML/CTF requirements regardless of whether the provision of crypto–asset–related services currently requires authorisation or not in the Member State of their establishment.

With the aim of implementing the FATF Recommendation No. 16 (also known as 'the Travel Rule') for crypto–asset related transactions, on 21 July 2021 the EU Commission has also proposed a **Regulation** on transfer of funds and certain crypto–assets which shall repeal and recast the **Regulation 2015/847** ('the Wire Transfer Regulation') that applies to payment service providers facilitating conventional transfers of funds.

The proposed Regulation aims to impose obligations on crypto–asset service providers (CASPs) to collect and transmit payer and payee data (such as name, address, public key) with respect to all crypto–asset transactions including transactions with unhosted wallets that exceed the de–minimis threshold of EUR 1000.

In this process, CASPs will be required to verify the accuracy of the transmitted information for their own customer from a reliable and independent source and will also need to have effective monitoring policies and procedures in place in order to ensure that the required information is available for each transaction.

While the proposed Regulation is still undergoing the EU legislative making process, some EU Member States like Germany decided to go a step ahead and already implement the Travel Rule at the national level through amendments of existing national regulations on AML/CTF.

Conclusion

With its comprehensive Digital Finance Package and key legislative proposals that come as part of it, the EU shows unequivocally its readiness to embrace application of new technological solutions in finance and open the door for more innovation in the financial services sector.

However, by being aware of its importance as one of the wealthiest markets in the world, the EU remains focused on ensuring a proper level of investor protection when designing its comprehensive regulatory framework on crypto–assets which will be based on strict rules that all crypto businesses willing to gain access to European investors will be required to play by.

2000+ people
1100+ lawyers
300+ partners
29 offices
17 jurisdictions

Austria	Klagenfurt | Vienna
Belgium	Brussels
China	Beijing | Hong Kong | Shanghai
Czech Republic	Brno | Prague
France	Paris
Germany	Berlin | Düsseldorf | Frankfurt | Hamburg | Munich
Hungary	Budapest
Netherlands	Amsterdam | Eindhoven
Poland	Warsaw
Republic of Ireland	Dublin
Slovakia	Bratislava
South Korea	Seoul*
UAE	Dubai
Ukraine	Kyiv
United Kingdom	Cambridge | Liverpool | London | London TechFocus
USA	New York | Silicon Valley

* In association with DR & AJU LLC

Taylor Wessing statistics published are correct as of 1 September 2021.

TaylorWessing