Cryptocurrencies from the Perspective of the EU Financial Market Regulation

Martin Hobza, Aneta Vondráčková[1]

DOI: 10.36250/00749.16

JEL Classification: O39, G19

Abstract

During the last two years, cryptocurrencies became a new social, economic, as well as legal phenomenon. In this context, many open questions arise. The paper deals with the issue how cryptocurrencies interact with the current European financial market regulatory framework. The following key issues will be particularly mentioned: cryptocurrency derivatives, ICO's and investment services regulation under MiFID II and possible relation of an ICO to the regulation of collective investment undertakings/investment funds under UCITS/AIFMD.

Keywords

cryptocurrencies; financial market regulation; MiFID II; ICO, financial instrument

1 Introduction[2]

During the last two years, cryptocurrencies became a new social, economic, as well as legal phenomenon. In this context, many open questions, including the legal ones, arise. These questions are often related to the very nature of cryptocurrencies from a legal perspective. It seems evident that it is the somewhat unclear nature of cryptocurrencies which presents a huge challenge not only for civil law, but also for financial law, including financial market regulation.

[1] JUDr., PhD, Department of European Law, Faculty of Law, Czech University, the Czech Republic. The author specialises in European financial market regulation. Contact email: hobza@prf.cuni.cz. JUDr., PhD, Department of European Law, Faculty of Law, Czech University, the Czech Republic. The author specialises in European law. Contact email: vondrac@prf.cuni.cz.

[2] The research was supported by the Charles University, project PRIMUS HUM/17 "Europeanization as a determiner of legal regulation of financial services and taxation" and University Research Centers (UNCE), project HUM/028 implemented at the Faculty of Law, Charles University in 2018.

Hobza, M. and Vondráčková, A. Cryptocurrencies from the Perspective of the EU Financial Market Regulation. In: Hulkó, G. and Vybíral, R. eds., *European Financial Law in Times of Crisis of the European Union*. Budapest: Dialóg Campus. 2019. pp. 169–175. DOI: https://doi.org/10.36250/00749.16

The present paper deals with one of these questions, namely, how cryptocurrencies interact with the current European financial market regulation, especially concerning cryptocurrency derivatives and the so called Initial Coin Offering process (hereinafter: ICO). Thus, the research purpose of the paper is to address particularly the following issues.

Firstly, the question whether cryptocurrencies could be considered eligible underlying assets of financial instruments under MiFID II will be examined. Secondly, the relation of ICOs and investment services regulation under MiFID II, especially the possible classification of cryptocurrencies/tokens as a financial instrument will be analysed. Finally, possible regulatory aspects of ICOs under collective investment undertakings under UCITS or investment funds regulation under AIFMD will be shortly mentioned.

As a hypothesis, the authors would like to prove the fact that although regulatory aspects of cryptocurrencies are still not very clear in some respects, it seems that in many cases ICOs, tokens, financial instruments and services related to cryptocurrencies/tokens could fall into the scope of the actual European financial market regulation. To verify the above hypothesis, the analytic and comparative scientific method will be used.

Despite the overall recency and due to the dynamic development of the present issue, several resources has been available across Europe so far. In addition to regulatory notices of the ESMA (European Securities and Markets Authority[1] and certain national supervisory authorities, particularly BaFin,[2] AMF[3] and FINMA,[4] the research from the other EU member states scholars, especially the German ones, and preceding research of one of the co-authors (Vondráčková, 2016) could be used.

2 Cryptocurrencies and General Legal Issues

Regulatory issues arising from the interaction of cryptocurrencies and the financial market regulatory framework are by far not the first legal questions discussed regarding cryptocurrencies. The first wave of attention was brought to the question by the general legal classification of cryptocurrencies. In the field of financial law, the related issues included anti-money-laundering measures and evaluation of cryptocurrencies, namely Bitcoin, from the perspective of monetary law, especially payment services regulation.

As a general outcome of the above-mentioned discussions and with respect to the scope of the present paper, it could be just shortly advised, that although a certain level of legal uncertainty regarding classification of cryptocurrencies remains, within

1 European Securities and Markets Authority.
2 Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority) as a supervisory authority of Germany.
3 Autorité des Marchés Financiers (Financial Markets Regulator) as a supervisory authority of France.
4 Eidgenössische Finanzmarktaufsicht FINMA (Swiss Financial Market Supervisory Authority FINMA).

the EU, cryptocurrencies are generally being considered as intangible movable property[5] possessing neither the status of currency nor money (including electronic money)[6] under the monetary law. With regard to the increasing use of cryptocurrencies as an investment or speculation opportunity on the one hand, or as a means of raising capital through ICO process on the other, issues related to financial market regulation are becoming more and more important.

3 Cryptocurrency Derivatives

The first question relates not directly to the cryptocurrencies itself, but to the increasing use of cryptocurrencies as an underlying asset of derivatives in the meaning of MiFID II [Art. 4 par. 1 (49) of the Directive 2014/65/EU], for example contracts for difference. In order to determine whether such cryptocurrency derivative could be considered a financial instrument under Annex I Section C MiFID II, it is necessary to clarify whether cryptocurrency is or is not one of the eligible underlying assets under MiFID II, i.e. financial underlying [Derivatives under Annex I Section C (4) MiFID II] or non-financial underlying [Derivatives under Annex I Section C (5) – (7), (10) MiFID II].

Since the issue has already been dealt with in detail elsewhere,[7] only brief theses follow. In case of contract for differences, MiFID II lays down no requirements on the underlying assets.[8] Hence it seems that cryptocurrency contract for differences may fall within the definition of financial instruments under MiFID II.[9] In case of other categories of derivatives, a further determination is necessary. It seems to be clear that cryptocurrencies will not fall within the category of financial underlying in most cases but can fall into the category of non-financial underlying as indices and measures not otherwise mentioned in Section C Annex I MiFID II. If it is the case and if the derivative contract has the characteristics of other derivative financial instruments, namely, if the contract (the price difference) is settled in cash or may be settled in cash, that means in another way than physical delivery of the underlying asset, such a cryptocurrency derivative can be considered a derivate and consequently a financial instrument under MiFID II.[10] Providing services to such a cryptocurrency derivative, such as for example investment advice, would be subject to regulatory measures under MiFID II.

5 Cf. e.g. AMF, 2018.
6 Cf. e.g. ESMA, 2018.
7 In detail Cf. e.g. AMF, 2018.
8 Cf. Annex I Section C (9) MiFID II.
9 Cf. AMF, 2018.
10 Cf. Annex I Section C (10) MiFID II in connection with Art. 7 par. 3 of the Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

4 ICOs and Its Regulatory Aspects: Tokens as Securities?

The issue of classification of cryptocurrencies under the financial market regulation became crucial namely in relation to ICOs. An ICO is a process of raising capital (typically in form of cryptocurrencies) from investors through blockchain-based units, usually called tokens. Not only the shortcut ICO, but the process itself shows parallels to the initial public offering (IPO) process. While IPO relates to standard transferable securities, namely shares, in an ICO, a business or individual searching for capital needed for its economic activities issues tokens and puts them for sale in exchange of traditional currencies, or more often cryptocurrencies.[11]

The tokens issued by the ICO organiser can possess different economic purposes, features or transferability. Although no generally recognised economic or legal categorisation of tokens is available yet, whether in the EU, or worldwide, the tokens can be divided into the following groups based on their economical essence.[12] Furthermore, some tokens may share characteristics of more groups mentioned below, others may not.

The most straightforward group of tokens are the payment or currency tokens. Currency tokens have typically no further functions than means of payment (now or in the future) for acquiring goods or services or as a means of value transfer and are in fact synonymous with cryptocurrencies. Then, there are the utility tokens that provide digital access to a product (usually an application) or service, developed by the issuer using the capital acquired by the ICO. In such a case, the investor buys a right to use a product or service in the form of token issued during ICO. Finally, the asset or investment tokens represent an asset such as participations in physical underlying, shares on companies and related obligations and rights, including voting rights, entitlement to dividends or interest payments, or participation on earnings streams. Such tokens are analogous to shares, bonds or derivatives in terms of their economic purpose.[13]

The analogy of investment tokens to existing financial instruments gives rise to question, whether under the European law, at least some of the tokens could be regarded as financial instrument under Annex I Section C MiFID II. Due to individual specifics of the ICOs and issued tokens, no over-all answer can be given, and a case-by-case analysis should be undertaken. As follows from the EMSA statement[14] as well as available academic research,[15] it seems clear that at least some of the tokens might fulfil the criteria of financial instrument under MiFID II. Such an opinion was recently supported by the statement of the German BaFin (BaFin, 2018) and, among the non-EU countries, Swiss FINMA (FINMA, 2018).

11 Cf. ESMA, 2017.
12 In detail cf. Zickgraf, 2018.
13 Cf. ESMA, 2017b and FINMA 2018.
14 Cf. ESMA, 2017a.
15 Namely Hacker and Thomale, 2017: 37 or Zickgraf, 2018: 307.

Since BaFin classifies the tokens not only under the German law, but in relation to MiFID II as well, its view could be inspiring in the context of the whole EU financial market regulation. According to BaFin (BaFin, 2018: 2), besides the role of cryptocurrencies or tokens as underlying asset of a derivative mentioned in Chapter 3 above, based on a case-by-case analysis of the token's specific design and features, it can be classified as (transferable) security[16] or a unit in a collective investment undertaking[17] under MiFID II.

In order to classify tokens as a security under the EU law, the following criteria need to be fulfilled:

1. Transferability.
2. Negotiability/tradability on the financial or capital market. According to BaFin, cryptocurrency trading platforms might be in principle considered financial or capital markets in terms of the definition of a security.
3. The rights embodied in the token, in particular shareholder or other equity rights or debt claims.
4. The token is not an instrument of payment under Art. 4 par. 1 (44) of MiFID II.

The identified decisive factor is the specific structure of the rights embodied in the token, irrespective of the labelling of the token as for instance utility token. Apparently, the token should be materially assessed according to its economical purpose and in case the investment purpose prevails, such a token should be considered a security under the EU financial market regulation. This applies in case of hybrid tokens or utility tokens with prevailing investment element, as well.[18]

If a token presents a financial instrument under MiFID II, the related regulation, in particular provisions governing investment services will apply. Nevertheless, it is important to stress that there is no explicit ESMA statement yet and therefore it is possible that national regulators will not follow the example of BaFin, partly because of the differences of national legislation regarding securities.[19] In order to avoid regulatory arbitrage, it seems necessary for ESMA to take initiative and come out with a clarification of the legal nature of the tokens in relation to the European financial market regulatory framework.

---

16 Under Art. 4 par. 1 (44) MiFID II. Transferable securities mean those classes of securities which are negotiable on the capital market, with the exception of instruments of payment.

17 Under point (3) Section C of Annex I MiFID II.

18 For the same conclusion, cf. Zickgraf, 2018: 304.

19 For example, the Czech national bank stated, that Bitcoins are neither securities, nor derivatives under the Czech legislature. It is important to mention though, that the statement of the Czech national bank relates exclusively to Bitcoins and was published in 2014 (ČNB, 2014).

5 Conclusion

The above-mentioned issues are just a brief introduction to and an example of how cryptocurrencies might interact with the current financial services regulatory framework. Further research is needed. For instance, regarding the relation of cryptocurrencies and collective investment undertakings/investment funds regulation, it seems that under certain circumstances, ICOs, tokens and issuers might be subject to the respective regulation. In short, if the material essence of the activities of an issuer is further investing of funds (irrespective of its form, whether cryptocurrencies or "standard" currencies) acquired by means of ICO from the public or a limited number of investors and further criteria are met, such an issuer could be, with respect to the activity deemed in an analogous position, a collective investment undertaking/investment fund manager under UCITS/AIFMD. In such a case, the tokens issued in the ICO could be classified as units in a collective investment undertaking under Annex I Section C (3) MiFID II and therefore financial instruments[20] and the UCITS/AIFMD rules will also apply.[21]

With regard to the above analysed issues it could be concluded, that the research purpose of the paper was reached, and that the hypothesis was confirmed. In other words, it is apparent that although regulatory aspects of cryptocurrencies are still not clear in some respects, in many cases ICOs, tokens, financial instruments and services related to cryptocurrencies/tokens could fall and will fall into the scope of the actual European financial market regulation.

References

AMF [online]. 2018. *Analysis of the legal qualification of cryptocurrency derivatives.* Available at: www.amf-france.org/en_US/Reglementation/Dossiers-thematiques/Marches/Produits-derives/Analyse-sur-la-qualification-juridique-des-produits-d-riv-s-sur-crypto-monnaies [Accessed 13 Sept. 2019].

BaFin [online]. 2018. *Initial coin offerings: BaFin publishes advisory letter on the classification of tokens as financial instruments.* Available at: www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2018/fa_bj_1803_ICOs_en.html;jsessionid=22CF92E3E0324E5AA76B492170074673.2_cid298 [Accessed 13 Sept. 2019].

ČNB [online]. 2014. *Je k obchodování s bitcoiny nebo k jejich směně potřebné povolení ČNB?* [Is the ČNB Permission Necessary for Trading or Exchanging Bitcoins?] Available at: www.cnb.cz/miranda2/export/sites/www.cnb.cz/cs/faq/stanoviska_a_odpovedi/pdf/obchodovani_s_bitcoiny.pdf [Accessed 13 Sept. 2019].

ČNB [online]. 2018. *Regulace investičních fondů a tzv. initial coin offerings (ICOs)* [Regulation of Investment Funds and So-called Initial Coin Offerings (ICOs)]. Available at: www.cnb.cz/

[20] Cf. BaFin, 2018: 3, and Hacker and Thomale, 2017: 15.

[21] The Czech supervisory authority, the Czech National Bank, draws attention specifically to the possible use of the investment fund regulation. Cf. ČNB 2018.

miranda2/export/sites/www.cnb.cz/cs/faq/stanoviska_a_odpovedi/pdf/regulace_investicnich_fondu.pdf [Accessed 13 Sept. 2019].

ESMA [online]. 2017a. *ESMA alerts firms involved in Initial Coin Offerings (ICOs) to the need to meet relevant regulatory requirements.* Available at: www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms [Accessed 13 Sept. 2019].

ESMA [online]. 2017b. *ESMA alerts investors to the high risks of Initial Coin Offerings (ICOs).* Available at: www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms [Accessed 13 Sept. 2019].

ESMA [online]. 2018. *ESA warning on virtual currencies.* Available at: www.esma.europa.eu/document/esa-warning-virtual-currencies [Accessed 13 Sept. 2019].

FINMA [online]. 2018. *FINMA publishes ICO guidelines.* Available at: www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/ [Accessed 13 Sept. 2019].

Hacker, P. and Thomale, Ch. Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law. *15 European Company and Financial Law Review,* (645–696) 2018. DOI: https://doi.org/10.2139/ssrn.3075820

Vondráčková, A. [online]. 2016. *Regulation of Virtual Currency in the European Union.* Charles University in Prague, Faculty of Law, Research Paper No. 2016/III/3. Available at: https://ssrn.com/abstract=2896911 [Accessed 13 Sept. 2019].

Zickgraf, P. Initial Coin Offerings – Ein Fall für das Kapitalmarktrecht? [A Case for Capital Market Law?] *Die Aktiengesellschaft. Zeitschrift für deutsches, europäisches und internationales Aktien-, Unternehmens- und Kapitalmarktrecht* [The Public Company. Magazine for German, European and International Stock, Corporate and Capital Market Law], (9) 2018, pp. 293–307. ISSN 0002-3752. DOI: https://doi.org/10.9785/ag-2018-630903