Digital assets regulation in the EU, UK and France – working with industry towards a fundamentally different approach to traditional financial services regulation

The discussion on crypto-currencies and digital assets has until recently been a feature of the broader technology focused discussion on distributed ledger technology (DLT), blockchain and fintech. During this early phase of the policy discussion, the various risks and opportunities, and the concern of various authorities and regulators, were broad and industry oriented. In the UK for instance, DLT, and specifically blockchain and digital assets, were considered in the Digital Strategy of 2017 of the Department for Digital and Creative Industries, and the Consumer Green paper on Blockchain by the department responsible for business and industry. In the European Union, DG Connect in the European Commission, and the committees on industry (ITRE) as well as international trade (INTA) in the European Parliament considered the technological and market implications for industry and consumers.

More recently, crypto-currency and digital assets policy has become one of the clear priorities for traditional financial services authorities. HM Treasury, the FCA, ESMA, the European Commission's DG FISMA, and the ECON Committee of the European Parliament, have been considering the risks and policy implications. Notably, in France, the AMF has set out its own preliminary regime as a forerunner to a prospective EU regime.

Against the background of increased market and media attention on crypto-currencies and the evolving market focus to security '*tokenisation*', a first point to note is that risks have been the focus as opposed to opportunities. This has led to authorities at times appearing disconnected in their analysis and uncoordinated in their proposed approaches as different regulatory approaches determine risk priorities. In this article we consider what the main authorities in Europe have identified as priority concerns and the approaches to dealing with them.

European Union, focus on custodian and settlement risk

In the EU, including the UK and France, an initial discussion about the regulatory treatment of crypto-currencies and digital assets and tokens has focused on identifying instruments and services and activities that can be recognised as falling within the existing financial services regulatory regime. At the UK's FCA this has been led by a categorisation exercise, which we will consider later, but for the moment it seems reasonably prudent to provide clarity on the demarcation line between instruments and services and activities that attract regulatory obligations as things stand today, leaving questions about amending the existing regime to take account of new and emerging risks as a further step.

In the EU progress has been slow, except to say derivatives on crypto and digital assets are treated as financial instruments, and that certain market integrity legislation is therefore applicable, mainly existing anti-money laundering legislation.

ESMA has carried out an initial exploration of the market for crypto-assets/digital assets and it is comfortable that where there is an identifiable financial instrument and service, a substantive suite of regulation is applicable. Consumer protection, market integrity and stability concerns are dealt with through the application of prospectus directive, AMLD, transparency directive, as well as securities depositaries and settlement finality and market abuse directives.

A few difficulties are worth highlighting at this point. One, due to the different ways in which member state competent authorities have implemented MiFID, there remains a substantial body of activity in the EU that is not caught. In the least, there is a good deal of uncertainty across the EU. Two, a more significant difficulty arises when new technology brings into one firm what in the scheme of existing business

models and markets might have been in several separately regulated entities. Three, applying financial regulation directly in this area creates difficulties for firms and regulators. Finally, a major preoccupation of existing and new exchanges is in dealing with issues associated with surveillance. Traditional financial markets surveillance techniques may be able to deal with some of the challenges in time, such as fractionalized assets, lack of standardization, 24/7 trading and fundamentally different nature of the data. However, industry and regulators are struggling to make traditional surveillance approaches fit for purpose in this area.

ESMA has most notably focused on highlighting concerns around the issue of custodianship and settlement of digital assets, giving rise to identifiable risks to be addressed in a potential substantive regime for the asset class. Industry developments in this area are attracting attention from regulators and investors. Staking, a market led solution and offer from service providers appears on face value to deal directly with concerns around custodianship. It is however still likely this will require agreed standards with regulators. Settlement issues on the other hand are less easy to deal with. Traditional financial services regulation to settlement risk may be too expensive for a developing sector. The alternatives, such as divulging to regulators for testing the viability of algorithms associated with settlement may be too creative and commercially prohibitive. More traditional financial services participants have been strongly opposed to any requirements associated with private disclosure of so called ‘secret sauce’, giving rise to commercially risk. Settlement remains an important area of work going forward, not just operationally but also because of the data requirement regulatory implications.

United Kingdom, a broader perimeter and consumer detriment

In the UK the FCA has started its analysis of the market by categorising

the various types of crypto-assets and digital assets and tokens identifying those that fall within the existing regulatory perimeter. It is currently considering a proportionate application of the existing rules to that part of the market. In CP19/3 the FCA identified and defined security tokens as financial instruments under MiFID, and as such activities and services in relation to security tokens should attract the full suite of financial services regulatory regime. The FCA was clear however that it is possible for other categories of digital-assets, such as exchange and in particular utility tokens to be used as financial instruments. To deal with this uncertainty, and the broader issue of scope, HM Treasury is set to consult in 2019 on a proportionate and effective regime for a potentially broader regulatory perimeter. It will be important to watch this space.

A further feature of the UK regime is the FCA's approach to consumer detriment. The FCA has been far more aggressive in recent times in its approach to protecting consumers from loss. Earlier this year we saw that in the case of binary options and CFDs the FCA took steps to ban in the case of binaries, and restrict use of leverage in the case of CFDs for retail consumer participation based on loss rates. The market failure identified seems to have not been focused on conduct of firms, but rather the overall outcome, in this case high levels of losses to clients based on a lack of understanding of how instruments are priced. The FCA has been clear this analysis is relevant to the markets for digital-assets, and the clear implication is that the market may only be open to the most sophisticated participants in the medium to long term. Such action holds potentially significant liquidity implications for this growing market and potential asset class. According to the Digital Assets Industry Association (DA-IA), it may be that the market experience to date is too short, and data required to carry out the kind of extensive analysis the regulator based its conclusion on in relation to binaries and CFDs is not yet available for digital-assets. The Association points to the fact the FCA's work in relation to CFDs for instance can be tracked back to many

years.

France, optionality followed by Pan-European regulatory regime

In France the AMF has taken an initial approach that is also risk sensitive. The AMF's approach like the UK FCA's is also based on the recognition of exchange, utility and securities tokens, with the latter automatically attracting financial regulatory requirements. The AMF does however stress the need to consider if the existing financial regime is appropriate, even more so than the UK's FCA does, which may indicate the size and proportion of the markets for tokens displaying features of financial instrument. Notably the AMF considers only 6% of its market for tokens would fall within the financial services regulatory perimeter.

Specifically the AMF regime offers a regulatory disclosure based opt-in to acquire visa approval for ICOs and also a crypto asset service providers license. This "white list" approach is intended to provide some degree of certainty and safety for consumers while enabling development of the sector. The regulator is clear of its view of the need for further consideration at international level for dealing with settlement and settlement finality, calling for EU legislation in this area. Regulations are traditionally detailed and intrusive, which would be a big departure from the approach of the new French regime.

Data

Data concerns arise from several perspectives in relation to digital assets. The EU is currently considering the substantive implications for DLT in view of the GDPR's requirements associated with data immutability and the right to be forgotten, as well as data minimization. The work of the European Commission's Data Protection Working Party, an internal group of technicians, and the EU Blockchain Observatory, is understood to feature the implications for the digital assets markets. Then there are

the broader implications of the GDPR in terms of recognition of third countries, including a post Brexit UK. Recognition while expected is not a foregone matter as equivalence and recognition decisions are expected to involve more than just technical assessments, but more political.

Conclusion

Participants in markets for digital assets are currently dealing with significant uncertainty from a regulatory perspective. Lack of clarity about scope and definitions, as well as the different approaches and focus of authorities is complicating the environment of the sector at a time it should be considering development. However, one thing is increasingly certain – policy makers and politicians do not consider self-regulatory codes setting market standards as the answer to identified risks to the sector, the broader financial markets and consumers and investors. Recalling the experience of other sectors when substantively entering the regulatory perimeter for the first time, the process involves intensive education, both on the part of industry and regulators alike. There is after all mutual interest in working together to find optimum solutions to realistic risks in a proportionate and effective way.

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