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Cryptocurrency: Opportunities and risks for investors

by Sam Birchall (/index.php/article/author/165) 19 March 2021

Overview

Despite increasing adoption, the regulatory landscape for crypto currencies and blockchain technology remains fragmented, limiting their potential for widespread use and presenting a challenge for investors seeking to scale their crypto portfolio companies. The EU's proposed

Markets in Crypto-Assets Regulation ("MiCA"), which was part of the comprehensive Digital Finance Package released by the European Commission on September 24th 2020, may change this dynamic by establishing a common set of crypto regulations across one of the world's largest trading blocs, making it much easier for crypto businesses to scale.

MiCA is a game changer for crypto businesses and for investors seeking to help them increase market share. However, it also proposes several new requirements that would make operating a crypto business more difficult and need to be taken into account by investors and other market participants. These include increasing regulatory compliance costs and making new Decentralised Finance ("DeFi") and Stablecoin projects much more difficult. We explore - these limitations in more detail below.

How does it work?

Asset Categories

MiCA proposes to regulate all crypto-assets that aren't covered by existing EU financial regulation. Importantly, this means that Security Tokens, which are tokens that function similarly to existing securities (e.g., shares or bonds), would continue to be regulated by MiFID II rather than MiCA. It creates new regulatory classes for other forms of crypto-assets per the following taxonomy: Crypto-assets (general catch-all); Utility Tokens (tokens that can be used to access various products or services); E-money Tokens (typically tied to a fiat currency; backed by a government); Asset Referenced Tokens ("ARTs") (value tied to one or more underlying assets; not government backed).

New rules for issuers

Issuers of crypto-assets must (subject to certain exemptions – e.g., small value issuances and issuances directed at qualified investors) publish a white paper at least 20 days prior to the proposed issuance and submit it to their national supervisory authority. MiCA prescribes the content and format of the white paper, putting a formal capital markets framework around new token issuances. The supervisory authority will have the opportunity to suspend or prohibit the offering or ask for additional information during the 20 day window. In addition, for E-money Tokens and ARTs the issuer will need to be based in the EU and for significant E-money Tokens and ARTs, meaning where the outstanding amount of such tokens exceeds EUR 5,000,000 over the preceding 12 month period, affirmative approval from the supervisory authority is required before the issuance can proceed. Depending on the type of crypto-asset, certain additional requirements may also be imposed, including in the case of ARTs to maintain reserve assets and have a set amount of cash on hand.

New rules for service providers

Providers of brokerage, custody, trading or investment advice in relation to crypto-assets ("crypto services"), which are not otherwise regulated as credit institutions under CRD IV or financial institutions under MiFID II, will require authorisation from their national supervisory authority before engaging in crypto services. In order to receive a license to provide crypto services, they will also need to comply with new regulatory requirements, including having adequate corporate governance, ensuring the suitability of their management board, maintaining initial capital reserves and having cyber-security measures in place. Existing European players in the crypto services space, that are currently following home country authorisation rules, can follow an expedited process to get licenses approved more quickly. Once approved, those providers benefit from the EEA passporting regime to provide their services in any member state.

Downsides of MiCA

The consequence of increased certainty in the regulatory environment is increased regulatory costs. MiCA raises potential obstacles to both new entrants and existing players in the blockchain/crypto market and could have the effect of making certain aspects of the crypto economy unfeasible in Europe. This includes:

- *Increased Regulatory Compliance Costs*: The EU estimates €35000-75000 in one-time costs for the whitepaper, €2.8-16.5 million in one-time compliance costs for unregulated entities to obtain authorisation, and €2.2-24 million in recurring annual compliance costs.
- *Chilling Effect on DeFi:* New de-centralised tokens (e.g., new variants of Etherium or Bitcoin) where there is no issuing entity will be unable to comply with the new standards. This would have a chilling effect on innovation in the crypto asset space and undermine one of the main drivers for this new asset class, which is meant to promote the democratisation of finance.
- *Stablecoins will struggle to be feasible:* Due to the various requirements imposed on ARTs and E-money Tokens, including reserve assets and cash holdings, as well as requirements that their issuers have additional authorisation as a credit or e-money institution, stable-coin issuers will find it incredibly difficult to meet the new requirements. This could mean the cessation of trading of existing stable-coins (e.g. DAI, Tether, etc.) on EU exchanges.

These increased compliance costs and regulatory hurdles will need to be taken into account in evaluating investment options in the EU crypto space if the regulation is ultimately adopted in its current form. However, it is likely that the initial proposal will evolve significantly before it is finally implemented. Investors in this space would be well-served in monitoring these developments as they will have a significant impact on crypto portfolio companies operating in the EU.

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