REINFORCING EUROPEAN INNOVATION IN CRYPTO-ASSETS

A EUROCROWD Position Paper on Markets in Crypto-Assets Regulation Proposal (MiCA)

“ A publication of the Crypto Assets Working Group at EUROCROWD

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EXECUTIVE SUMMARY

The European Crowdfunding Network welcomes the initiative of the European Commission in facilitating with the proposal for Markets in Crypto-Assets (MiCA) regulation new frontiers in the financial system and beyond.

The Digital Finance Package with MiCA as its flagship piece of regulation has opened a new chapter in the efforts to legitimize the crypto-asset industry in the EU. Such legitimization was necessary to facilitate further advancement of blockchain innovation and to justify the dialogue and cooperation between the industry stakeholders and the EU regulators.

In general, this regulatory step has been very well received by crypto stakeholders, because once enacted, MiCA will bring a much-needed legal certainty not only to issuers but also to service providers of crypto-assets.

Nevertheless, what we perceive as a missed opportunity is that MiCA and the related regulation, including the amendment of MIFID II and PDMIR, do not completely resolve the legal uncertainty caused by the different qualifications of the crypto-assets or interpretation of their status. It is yet to be seen, whether the legislative process brings about some changes before the final version of these EU Regulations (and Directives) are accepted by the European Parliament.

The comparison and consolidation of the regulation related to crowdfunding and token offerings, which exhibit significant similarities and, in some aspects also overlap. It seems as if the evolution of the crowdfunding regulation was not taken extensively into account when MiCA was drafted.

Furthermore, we believe that regarding STOs, where the overlap between crypto-assets and crowdfunding for business under ECSP is more apparent, the combination of proposed regulatory changes may not resolve fundamental issues related to cross-border offerings such as differences stemming from different interpretation of EU regulation or additional requirements on securities imposed by national regulation.

Notwithstanding, the fact that the EU regulator is looking for ways to accommodate innovation in the crypto-asset space is positive and we fully support continued dialogue between EU officials, industry stakeholders, and associations to devise a workable and optimal regulatory framework.

To shed light on some of these matters we prepared the ECN Position Paper on MICA Regulation where we (i) assess the impact of this significant regulatory initiative, (ii) address several initial points of concern, (iii) explore the overlap between current forms of crowdfunding and blockchain-based fundraising methods, (iv) evaluate the possibility of their convergence in the future.
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# LIST OF ACRONYMS

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<td>DLT</td>
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<td>NFT</td>
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<td>PDMIR</td>
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<td>STO</td>
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About EUROCROWD

EUROCROWD, registered as the European Crowdfunding Network AISBL in 2013 in Belgium, is an independent, professional business network promoting adequate transparency, regulation and governance in digital finance while offering a combined voice in policy discussion and public opinion building.

We execute initiatives aimed at innovating, representing, promoting and protecting the European crowdfunding industry as a key aspect of innovation within alternative finance and financial technology, including crypto assets and distributed ledger technologies.

We aim to increase the understanding of the key roles that digital finance can play in supporting entrepreneurship of all types and its role in funding the creation and protection of jobs, the enrichment of European society, culture and economy, and the protection of our environment.

EUROCROWD maintains a dialogue with public institutions and stakeholders as well as the media at European, international and national levels.
CHAPTER 1

INTRODUCTION
On 24 September 2020, the European Commission adopted and published the Digital Finance Package, comprised of various legislative and non-legislative proposals including the EU’s Digital Finance and Retail Payments Strategies as well as legislative proposals on crypto-assets and digital resilience. The package consists of three legislative proposals. Each of which are significant in their own respect as well as collectively to the reforms to the EU’s regulation of digital assets, crowdfunding and digital operational resilience more generally. These proposals include a:

- Proposal for a regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology (hereinafter PDMIR); and
- Proposal for a regulation of the European Parliament and of the Council on digital operational resilience for the financial sector and amending regulations (EC) No 1060/2009, (EU) No 648/2012, (EU) No 600/2014 and (EU) No 909/2014 (hereinafter DORA). The MiCA proposal is, without a doubt, the centrepiece of the EU’s Digital Finance Package that triggered the most interest, not only across the EU-27 but also further afield. MiCA will effectively create the largest market for crypto-assets under the same regulatory framework. While this substantial piece of legislation is already on the table and will, in its final form, very likely enter into force at the beginning of 2024, the general public has still a rather narrow vision when it comes to the purpose and reputation of the crypto-assets. In this position paper, we would like to (i) assess the impact of this significant regulatory initiative (individually as well as collectively when taken together with PDMIR and DORA), (ii) address several initial points of concern, (iii) explore the overlap between current forms of crowdfunding and blockchain-based fundraising methods, (iv) evaluate the possibility of their convergence in the future.

1.1 THE EVOLUTION OF THE CRYPTO-ASSET MARKETS: BEFORE MICA

Arguably, the first modern crypto-asset, Bitcoin, emerged in 2009, as a project propelled by an anonymous individual or group of individuals under the alias Satoshi Nakamoto. The main purpose of Bitcoin was to implement a self-governing alternative payment system, with Bitcoin as its currency and its distributed ledger protocol, that would not rely on any centralized institution, which would determine its monetary policy. While Bitcoin slowly but surely gained a loyal following, other crypto-assets started to emerge as soon as in 2011. In 2013, J.R. Willet, initiator of the Mastercoin project launched the first-ever crypto-asset crowdfunding campaign, which would later become known as Initial Coin Offering (hereinafter ICOs). The main difference between the ICO and the crowdfunding campaign was the nature of the assets that were sold to the public and the absence of any intermediaries such as crowdfunding platforms. In 2014, a young programmer Vitalik Buterin, published a white paper with details on “Ethereum”, an alternative blockchain protocol, built to serve as an ultimate foundational layer for programming smart contracts, giving rise to many new applications built on top of the Ethereum network. Every such application could issue and use its native crypto-currencies, most commonly for payment for its services.

In a few short months, the crypto-asset market rapidly expanded from a handful of cryptocurrencies to hundreds of tokens that could not only be purchased but also actively traded on the secondary markets, primarily through so-called crypto-exchanges but also through brokered or otherwise intermediated (block) trading. Due to the steadily growing presence of active secondary markets, dubious price-discovery mechanisms and lack of regulation preventing market abuse, the value of crypto-assets has always been subject to significant fluctuation. From 2016 to 2018, the crypto markets experienced an unprecedented boom of ICO activity that expanded far beyond the initial blockchain community. As a comparison, in 2018, the value of the global crowdfunding market was roughly estimated to 89 billion USD (excluding China), while the ICO market has already reached 14 billion USD. The crypto-asset
Crowdfunding was one of the early successful applications of the crypto-industry, paradoxically more successful than the applications/services that these offerings were supposed to fund at the time. As expected, many of the projects either failed or never intended to succeed in the first place. This caused a palpable downfall of the ICO market after 2018, which persists until today.

Although short-lived, this initial boom in the fundraising activity had a significant two-fold impact. Firstly, ICOs brought blockchain technology to the attention of larger corporates, venture capital funds, industry associations, financial institutions, and governments, which began to explore the potential of blockchain technology and its application for mainstream use in many industries. Secondly, the inflow of capital into blockchain, enabled further R&D activities that accelerated the maturing process of this nascent technology. After the 2016–2018 boom, the ICO market began to quickly plummet due to many inefficiencies in this fundraising method. These included the inability to identify fraudulent offerings (the lemons), the lack of accountability or of auditability (including large-scale failings of ICOs and investor fraud), and significant information asymmetries between the ICO initiators and investors. The ecosystem stakeholders realized that the proper functioning of this fundraising mechanism requires a more robust framework that would decrease the information asymmetries and facilitate investor protection. Therefore, in 2019 there were various attempts to modify the initial ICO model to infuse the process with better reputation and selection safeguards. Especially in 2019, two variants of token offerings emerged, the Initial Exchange Offerings (IEOs) and Security Token Offerings (STOs). IEOs are token offerings of projects who are facilitated by the secondary market such as a crypto exchange. In these transactions, crypto exchanges take on the role of the gatekeeper, which conducts initial due diligence and pre-selection of the projects/companies and facilitate the issuance of the tokens on a technical level. In contrast, STOs, as the name already suggests, are offerings of transferable securities stored and transferred on the blockchain, which (largely but not always fully) must comply with relevant regulation related to the regulated financial instruments. The main advantage of STOs is the efficiency and transparency of the process and legal certainty of the status of the assets that are sold to the wider public (e.g. transferable securities). Despite this evolution, the token offerings activity is now nowhere near the peaks that we could observe in the 2018–2019 period (see Table I).

Furthermore, crypto-assets can be issued also without token offerings. Particularly, so-called stablecoins are a good example. Stablecoins are crypto-assets, which do not have a distinct utility function, but whose value is tied to an outside asset, usually one with a stable value over time, such as fiat currencies (such as USD or EUR) or precious metals (such as physical gold). The first stablecoin, Tether, emerged in 2014 and despite several financial scandals and litigations, remains to this day the most popular of its kind. Even more recent development involves so-called non-fungible tokens (hereinafter NFTs). NFTs are unique digital files which are recorded on the blockchain. The digital footprint facilitated by the blockchain enables to prove the authenticity of the asset in question and thus serve well in the context of one-of-a-kind assets such as works of art and collectibles. The market with crypto-assets is very dynamic and as our overview shows changes and evolves in a rapid pace. Hence, it is not a surprise that the regulators were compelled to introduce a new regulatory framework.

### Table I. Volume of token offerings in million USD (2016-2020)

![Volume of Token Offerings](image)

Source: Coinschedule
1.2 REGULATION OF CRYPTO-ASSETS: A NECESSITY OR RUSHED MOVE?

There are several compelling reasons for regulating crypto-assets:

- **Facilitation of innovation in financial services**
  
  Crypto-asset applications demonstrate the potential to generate efficiencies or democratize ownership of assets. While the industry is, in terms of value and volume of transactions, not large enough to destabilize the existing (traditional) financial system, it may not be ignored anymore. The advantages that tokenization brings to asset classes that have been previously constrained by the lack of tradability, fungibility and settlement finality are potentially scalable. The same applies in the case of the value add as well as cost-benefits, and, possibly efficiency, that a distributed ledger-based settlement can bring in terms of traceability (identity of holding levels and competing interests) and audibility, possibly with cost advantages, is attractive to institutions and financial services regulatory policymakers as well as the EU Commission more broadly. In essence, DLT technologies as well as tokenisation of financial assets can make the provision of financial services more efficient by unravelling the infrastructure of financial intermediaries and automating processes that are currently facilitated by them.

- **Legal certainty**

Arguably, crypto-asset services, including crypto-asset offerings, were, in its nascent stage, being developed in semi-obsccurity. Some of the reasons for this include that they were often perceived as mediums for illegal activities and speculation or as means (rightly or wrongly) to circumvent existing legal and regulatory requirements – including where they did not apply fully to crypto-asset services, products and providers thereof. From a legal perspective, it was often impossible to fit tokens and their sale or trading into an existing regulatory framework that applied to what the EU defines as “financial instruments” and subject to regulation as well as those crypto-assets that fall outside of that definition. The recognition of and certainty given to the legal status of crypto-assets and the operation of the professional service providing surrounding crypto-assets is thus a major step towards legitimizing their existence. We believe that this may compel the financial industry incumbents such as banks, various types of funds, and others to seriously consider the crypto-assets as a viable alternative investment option.

- **Investor/Consumer protection**

As mentioned in the MiCA’s explanatory memorandum, it is true that on many occasions, token-holders remained without any effective legal protection. They were exposed to suboptimal contractual arrangements and assumed most of the risks related to these assets. Defining ‘de minimis’ protection for the token-holders can thus improve the position and increase the trust of the mainstream investors/consumers. Although MiCA touches upon the protection of token holders (whether they are consumers or not) and gives them possibilities of recourse (for instance liability for irregularities in the white paper), it remains unclear how the consumer/investor protection contained therein relates to the existing rules and legal institutes facilitating such protection.

- **Combating market abuse**

Since markets in crypto-assets have been long perceived as unregulated, various illicit actors took advantage of the regulatory oversight and deployed...
several schemes that include fraud, insider trading, manipulation of the market price, or manipulation of the transaction data. These practices not only create a negative reputation of the crypto-asset markets but contribute to unjust and negative outcomes for the honest stakeholders.

- Preventing regulatory competition, arbitrage and market fragmentation across the EU

In the past two years, we have witnessed several attempts to spark the so-called regulatory competition (and thus potential for arbitrage) in crypto-assets regulation, among others by Malta, France, and Luxembourg. Each regulatory initiative however had a different approach and different extent and scope of regulating the crypto-asset markets. It became apparent that a supra-national approach is necessary to prevent further market fragmentation.

In contrast, there are also compelling reasons why a premature regulation of emerging phenomena, especially the ones which are technology-based, can become detrimental in the long run. For instance, Twigg-Flesner explains that the fear of regulatory uncertainty is not a sufficient reason to introduce a new regulation, we should rather first, based on functional equivalence, explore the possibilities within the existing legal framework or with slight modifications thereof. A hast regulatory activity can lead to suboptimal results in terms of efficiency of the regulatory framework. Oftentimes it may become obsolete very quickly if the technological development is not settled before the regulatory intervention. Notably, MiCA does not purport to regulate DLT (blockchain) technology itself, it only regulates new types of assets that are circulated and stored using this technology. The question is if this is a sufficient difference to justify a separate regulatory treatment, particularly distinct from the treatment of established financial instruments.
CHAPTER 2

CORE TOPICS OF MiCA
2.1 CRYPTO-ASSETS AS A SEPARATE ASSET CLASS

One of the most innovative features of MiCA is the legal status of the crypto-assets. Equipped with a bespoke definition, the crypto-assets effectively form a new asset class separated from the types of assets that the legal system knew before. In MiCA, crypto-assets are defined as ‘digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology’. Many commentators point out that the definition is somewhat broad and relies heavily on the technical nature of the assets (using distributed ledger technology or similar technology) and thus comes in at odds with the well-known principle of technology neutrality. It is questionable whether purely the nature of the asset’s form, e.g. the fact that the right or value is stored by using DLT technologies is a sufficient justification to create a completely new asset class. Furthermore, MiCA explicitly excludes financial instruments, even if in a tokenized form, from its scope. Moreover, MiCA does not specify what is the legal classification of these assets in the broader legal context. For instance, in the UK, The Law Commission is currently gathering evidence to determine whether digital assets could be legally qualified and treated as a property with all legal implications or if they should fall under a different legal category. Such determination is crucial to fully operationalize the concept of this new asset class.

We believe that the Commission took a pragmatic approach with the main aim not to hinder the innovation that is currently occurring in the area of crypto-assets. In the explanatory memorandum, the Commission clarifies that creating a new asset class enables to regulate assets that would otherwise remain unregulated, because as the European Banking Authority (EBA) and the European Securities Market Authority (ESMA) contended ‘beyond EU legislation aimed at combating money laundering and terrorism financing – most crypto-assets fall outside the scope of EU financial services legislation and therefore are not subject to provisions on consumer and investor protection and market integrity, among others, although they give rise to these risks.’ Naturally, there are alternative approaches that could have been considered, such as a reform of financial services regulation that would better accommodate crypto-assets or provided extensive exemptions for crypto-assets, while they are in their nascent stage, but at the same time recognizing their financial character, when appropriate. We contend, however, that creating a separate regulation was a less contentious step since MiCA is a stand-alone piece of legislation that does not require systemic changes to the status quo of the financial industry. In that sense, MiCA creates a regulatory laboratory that will enable the evolution of the crypto-industry in a more controlled environment and under a thorough regulatory oversight. Nevertheless, in terms of their risk profile and potential damage particularly to retail investors and consumers crypto-assets pose similar, if not greater risks, as financial instruments. Therefore, we contend that MiCA may be an intermediary step, which will in the future lead to the further convergence or merge of the regulation on crypto-assets and traditional financial instruments.

2.2 A BESPOKE REGIME FOR THE PRIMARY AND SECONDARY OFFERINGS OF CRYPTO-ASSETS

In response to the wave of unregulated ICOs, MiCA sets forth the disclosure and compliance regime for the offerings and admission of these crypto-assets to trading on the secondary markets. The complexity of the obligations depends on the type of crypto-asset in question. MiCA distinguishes among three categories of crypto-assets, which can be further broken down into subcategories (See Illustration 1).

The three categories of tokens are defined as follows:

- “Asset-referenced token” is defined as a type of crypto-asset that purports to maintain a stable value by referring to the value of several fiat currencies that are legal tender, one or several commodities, or one or several crypto-assets, or a combination of such assets (hereinafter ART or A-R tokens).
- “Electronic money token” (“e-money token”) is defined as a type of crypto-asset, the main
purpose of which is to be used as a means of exchange and that purports to maintain a stable value by referring to the value of a fiat currency that is legal tender (hereinafter EMT or E-money tokens).

- “Crypto-assets, other than asset-referenced tokens or e-money tokens” are not specifically defined, however, they are defined by exclusion (e.g. neither ARTs, nor EMTs) and include the category of utility tokens. In essence, this all-catch category captures tokens that qualify as crypto-assets (according to the definition above), but do not fall under the definitions of EMTs and ARTs. Arguably, this category is by far the most prominent and heterogeneous.

- “Utility token” is defined as a type of crypto-asset which is intended to provide digital access to a good or service, available on DLT and is only accepted by the issuer of that token.

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Illustration I. Categories of crypto assets according to MiCA
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Notably, the most lenient regime is created for crypto-assets that do not qualify as ART or EMT but do fall under the generic definition of crypto-assets. Such offering requires the issuer to publish a disclosure document titled white paper, in case the offering is larger than 1 million EUR. The content of the white paper, the obligations surrounding its publishing, and any amendments are clearly defined by the regulation. In contrast with token offerings of ART or EMT, the white paper does not require any authorization from the national competent authorities, nor any post-offering ongoing compliance. As already alluded to, ARTs and EMTs are subsumed under a more stringent regime, where the authorization of the white paper is necessary before these can be offered to the wider public. Additionally, issuers of ART and EMT have other obligations, not only relating to the offering but also to the subsequent circulation of these assets and their administration.

### 2.3 Regulation of Crypto-Asset Service Providers

One of the most important issues that MiCA addresses is the operation of various types of service providers that emerged in the crypto industry and in many cases remained largely unregulated. MiCA defines seven different types of crypto-asset services, which to some extent create a mirror image to financial services as defined by Annex I of MIFID II. MiCA regulates the authorization of general obligations of every Crypto-Asset Service Providers (CASPs) (such as prudential and organization requirements, obligation to act honestly, fairly, and professionally), and specific obligations per type of CASP. Furthermore, the regulation ensures that once authorized in one member state, CASPs can operate across the Union through the so-called passporting option.

### 2.4 Addressing Market Manipulation

In title VI, MiCA defines undesired activities such as insider dealing, unlawful disclosure of insider information, and market abuse and prohibits them. The scope of the prohibition and the legal requirements extend according to Article 76 shall apply to acts carried out by any person and that concern crypto-assets that are admitted to trading on a trading platform for crypto-assets operated...
by an authorized crypto-asset service provider, or for which a request for admission to trading on such a trading platform has been made.’ MiCA also established a rather substantial set of sanctions in case of violations of the proposed rules. Concretely, competent authorities can decide to use monetary sanctions limited to 5m EUR or 3% of annual turnover on legal persons in violation, or 700,000 EUR for natural persons. Furthermore, other national sanctions, including those originating in civil or criminal liability for the above-mentioned acts, remain in place. Combating the market abuse and manipulation that frequently occurs in the crypto-markets is crucial in raising the credibility of these markets and the level of investor protection. While market manipulation is necessary for a correct and lawful operation of the crypto-markets, it is yet to be seen, what tools the authorities will use to monitor these markets and ensure that the rules and sanctions are effective and enforceable.

2.5 FOCUS ON SIGNIFICANT STABLECOINS

Many industry commentators openly discuss the obvious focus of MiCA on so-called stablecoins, which are in MiCA’s terminology coined as the asset-referenced tokens. The definition and rather intricate regulatory and compliance regime set them apart from the other types of tokens addressed by MiCA. In the Explanatory Memorandum, the Commission acknowledges increased risks of the stablecoins by stating that: ‘While the crypto-asset market remains modest in size and does not currently pose a threat to financial stability, this may change with the advent of ‘global stablecoins’, which seek wider adoption by incorporating features aimed at stabilising their value and by exploiting the network effects stemming from the firms promoting these assets.’ This statement is often perceived as a direct reference to Facebook’s DIEM project, formerly known as Libra. While the concept of stablecoins does not pose such a threat in and on itself, the massive customer base of Facebook and the likes combined with a well-prepared business case that DIEM has, could quickly challenge the existing payment services around the world, while providing Big Tech companies with additional sets of data on financial transaction of its users.
CHAPTER 3

FIRST RESPONSE: POINTS OF CONCERN
3.1 DEFINITIONS OF CRYPTO-ASSETS AS USED IN THE CURRENT DRAFT OF MICA

Article 3(1)(2)
‘crypto-asset’ means a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology; AND

Article 3(1)(1)
‘distributed ledger technology’ or ‘DLT’ means a type of technology that support the distributed recording of encrypted data;

Comment:
The definition of a crypto-asset heavily relies on the technological aspect or technological form of the asset in question. Although it would be difficult to remove such aspects from the definition and still capture the targeted group of assets, we contend that the definition of DLT should be more precise pointing to the functional value of the distributed ledger rather than to its technological execution. In view of this, we support the extended version of the DLT definition proposed by the European Parliament rapporteur with an additional adjustment (in bold), concretely

“Distributed Ledger Technology” or “DLT” is a technology that refers to the protocols and supporting infrastructure that enables computers or other end-user devices in different locations to propose, validate, and immutably synchronize records over a network [they] create.124

3.2 DEFINITION OF UTILITY TOKENS AS USED IN THE CURRENT DRAFT OF MICA

Article 3(1)(5)
‘utility token’ means a type of crypto-asset which is intended to provide digital access to a good or service, available on DLT, and is only accepted by the issuer of that token;

Comment:
The last part of the utility token definition is rather confusing. Does ‘acceptance only by the issuer of the token’ mean that such a token cannot be traded on the crypto exchanges? If so, then the utility token would be a sort of a pre-order voucher that would form a closed loop, where it is sold to a customer and the customer then, once the service is available and she wishes to use it, pays the token back to the issuer in exchange for the services. However, in practice, the tokens, even utility ones, often change hands, for instance when being traded on crypto exchanges or tokens whose popularity evolved to such an extent that they are generally accepted for payment purposes such as Ether. In addition to that, due to interoperability issues between different blockchains, we often see so-called token swaps where assets stored on one blockchain network are swapped for assets on the other as they cannot be used directly due to the lack of interoperability between chains (for instance wrapped Bitcoin, an ERC-20 token that represents Bitcoin (BTC) on the Ethereum blockchain).

If the intention of MiCA is that utility tokens can be traded, then the last part of the sentence should be removed or an addition should be made to clarify the trading of the utility tokens. Upon closer look, we assume that the legislator intended to make utility tokens tradable, see for instance Annex I Part D, points 5 and 6, where utility tokens are mentioned in connection with the possibility to trade. If that is so, however, the regulatory requirements concerning utility tokens are too benevolent. It would be possible to launch a token offering to collect 25 million EUR worth of cryptocurrencies, or even more (as there is effectively no threshold for such tokens) and these tokens should be essentially a pre-order for a product or service that does not exist yet. In addition to pre-order, this token could be
traded, used for speculative purposes, without the existence of the underlying product or service. Considering the high risks of developing or deploying a functioning product or service, there should be a maximum threshold of a utility token offering, where a product is not yet developed. Alternatively, utility tokens could be excluded from trading until the product is launched. Nevertheless, we must point out that, as opposed to listing on regulated stock exchanges, the crypto-asset issuer does not have full control over listing on crypto-exchanges. Oftentimes tokens are listed/traded without the knowledge or explicit approval of the crypto-asset issuer, especially on decentralized exchanges.

3.3. FINANCIAL INSTRUMENTS OR CRYPTO-ASSETS? THE PERILS OF NATIONAL INTERPRETATION

According to Article 2(2)(a) of MiCA, MiCA does not apply to crypto-assets that qualify as:

(a) financial instruments as defined in Article 4(1), point (15), of Directive 2014/65/EU;

Comment

From our engagement with the stakeholders, it became clear that stakeholders think there still may be a grey area as to what is considered a crypto-asset and what qualifies as a “financial instrument” according to MiFID II. The reason is that while the definition of financial instruments is harmonized, the interpretation of the definition transposed into the national laws is done by Member States, which may come to divergent conclusions about a legal qualification of a particular crypto-asset as to whether it is really a “financial instrument” for purposes of the EU’s MiFID II Regime as transposed in the respective Member State. The MiCA Impact Assessment points out that, “while a majority of national competent authorities (NCAs) (16) have no specific criteria in their national legislation to identify transferable securities in addition to those set out under MiFID II, other NCAs (12) do have such criteria. This results in different interpretations of what constitutes a “transferable security”. Imagine that a crypto-asset issuer issues an asset that in its home state, Member State A, is not considered as transferable security but is considered as such by Member State B. Of course, MiCA enables the passporting option, therefore theoretically the crypto-asset issuer should be able to offer the crypto-asset throughout the whole territory of the EU, once it notifies (or once it is authorized) by the home state NCA. It is hard to pinpoint an alternative citation as this will, to some extent, interfere with the national law of member states. However, it could be emphasized by MiCA that the qualification of the crypto-asset by the home member state (based on the home member state interpretation of financial instruments) is the one that shall be accepted across the union for that particular asset. Nevertheless, such specifications could potentially trigger regulatory arbitrage, which MiCA aims to prevent in the first place. After many discussions, we believe that there is no other way, how to resolve the problem than for the regulator to provide further guidance on the interpretation of financial instruments.

3.4 UNLIMITED TOKEN OFFERINGS FOR TOKENS THAT ARE NEITHER ARTS, NOR EMTS

While most of the MiCA is focused on ARTs and EMTs, the third category, i.e. the category covering utility and other tokens, which lacks proper definition, often escapes the attention of commentators. Arguably, this category is at the same time most populous, as ARTs and EMTs form only a small minority of tokens currently in circulation. According to our analysis, many of the tokens that are regularly in TOP 100 of crypto-assets as per market
capitalization, would fall into this category, including crypto behemoths as Bitcoin and Ether. The process of issuance of these assets is very benevolent, besides publication of the white paper for offerings above 1m EUR and notification of the NCA in the member state, where the crypto issuer is based. Some commentators compared the 1 million EUR threshold to the threshold of an exemption from the threshold contained in the EU’s Prospectus Regulation regime, however, the prospectus and its content are starkly different from the requirements for a white paper. A white paper in our view essentially amounts to a basic disclosure document and not to an extended business plan and most likely would not require the involvement of attorneys, auditors, and/or fiscal specialists, as is the case of a prospectus. Nevertheless, the final standards for the white paper will be determined by technical standards introduced by ESMA after consultation with EBA. Considering the absence of any upper threshold for issuing tokens that are neither ARTs, nor EMT under MiCA, we contend that it would be legally possible to conduct a high amount of token offerings with little disclosure and supervision. Moreover, for these offerings, MiCA does not set forth any post-offering monitoring or compliance, which further aggravates potential damage.

3.5 HIGH BARRIERS FOR DECENTRALIZED FINANCE IN EUROPE

Decentralized Finance (hereinafter DeFi) is an emerging and booming crypto sub-industry that can be simply described as a growing alternative financial system with crypto-specific financial providers that vastly differ from regular financial institutions. Currently, the total value locked in smart contracts of DeFi protocols is around 50bn USD and further growing exponentially every month. Since DeFi is not precisely defined, there are many types of protocols/applications that are subsumed under it, amongst others:

- Stablecoins are crypto-assets, whose value (are aimed at being) is kept stable through a specific stabilization mechanism and that purport to maintain a stable price, usually following one of the fiat currencies such as USD, EUR, or others. An example would be Tether, USDC, and USDT.

- Decentralized exchanges are crypto exchanges that connect market participants directly to each other, utilizing smart contracts and without any facilitating intermediary in the middle. An example would be Uniswap, Kyber Network, and Bancor.

- Lending platforms (including yield farming) are lending markets that connect borrowers to lenders of cryptocurrencies. As opposed to traditional lending, loans in the DeFi space are standardly collateralized by putting up cryptocurrency into a smart contract as collateral. Therefore, from a perspective of a lender, it resembles a savings account with a decent interest rate. On top of that, lenders, during the time their crypto-assets are borrowed, receive a native token of a DeFi application that is usually of a stable value (soft-peg to a fiat currency), which they can use and/or trade; and example is Compound or Curve Finance. Particularly lending platforms utilize models that in the context of traditional finance strongly resemble the so-called margin lending

- Prediction markets: Markets for betting on the outcome of future events, such as elections. The goal of DeFi versions of prediction markets is to offer the same functionality but without intermediaries. There are several friction points between MiCA and DeFi applications. For instance, the governance of these
protocols is at least to some extent decentralized through governance tokens, where the community of governance holders votes and makes strategic decisions for the application. Furthermore, the operations of the application are bestowed upon a set of smart contracts that execute them without further interference from the creators, e.g. they operate as a decentralized automated organization (DAOs). MiCA, on the other hand, formulates and allocates liability and obligations to centralized entities, such as issuers or service providers. Such friction is rather fundamental, and it is difficult to suggest an alternative approach by proposing a simple regulatory amendment. Furthermore, many products of DeFi applications, particularly stable coins and lending protocols would most likely fall under the definition of an asset-referenced token, the issuance of which would be subject to rather strict regulation. This could significantly increase the barriers to entry for newcomers in the DeFi space. Last but not the least, Article 36 and Article 45, respectively prohibit issuers of ARTs and EMTs, and CASPs from providing ‘interest or any other benefit related to the length of time during which a holder of asset-referenced tokens holds asset-referenced assets’. This is counter-effective to the intention of fostering innovation, one of the main goals of MiCA. The provision could be problematic especially for DeFi applications, involving lending and borrowing of crypto-assets. The financial incentive to lock crypto-assets in the smart contract and thus provide liquidity is usually awarded by fees and/or governance tokens that also can be traded on the crypto exchanges.

As mentioned before, the ART category was designed to address a rapid emergence of stablecoins by established players, which could, within a short time frame, challenge the traditional financial system, particularly the traditional monetary system. The concerns related to projects such as Diem (formerly LIBRA) are of course relevant, however, the regulation should also create space for the emergence of new financial models that are often to be found in the DeFi space. As an example, MiCA, in building upon the sandbox concept of PDMIR, could introduce a further sandbox regime for ARTs and EMTs which would enable the regulator to not apply the full extent of MiCA’s requirements and at the same time observe DeFi applications in a controlled environment and under limited conditions (such as limited value and volume of transactions per protocol). For the time being, however, we believe that the prohibition of interest should be in any case reconsidered, possibly removed, and if it proves problematic, reintroduced, at the first revision of MiCA.
CHAPTER 4

CROWDFUNDING AND TOKEN OFFERINGS
4.1 CROWDFUNDING VS. TOKEN OFFERINGS

Since the very first token offering, it was clear that it resembles crowdfunding in many aspects, especially with the financial types of crowdfunding. The engagement of the crowd, including retail and professional investors, the possibility of small contributions from many investors, and online campaigning are all fundraising attributes brought to life by the crowdfunding industry. While some projects initially tried to disguise their offerings as donation- or reward-based\(^4\), it was clear that there was more to the functionality of crypto-assets than a symbolic consideration. In the financial types of crowdfunding, the crowdfunding investors purchase rather traditional financial instruments such as shares or bonds or enter a contractual arrangement such as a loan agreement. While the method of financing is rather innovative, the legal nature of the relationship between the crowdfunded companies and crowdfunding investors is not. However, the legal nature of tokens sold in these campaigns is not so straightforward. In most of the cases, the token gives its holder access to a certain service that the initiator of the token offering offers or will offer in the future. These types of tokens are commonly known as utility tokens, e.g. they have a consumption value. In that sense, we could compare these offerings to a pre-order crowdfunding campaign. Nevertheless, tokens may not be limited to this function, they may possess a wide range of rights, including voting rights, loyalty discounts, or a right to receive a reward for certain desired behaviour on the platform. Therefore, it would be incorrect to dismiss them purely as pre-paid vouchers for future services. Moreover, many of the tokens can be listed on the crypto exchanges and traded with a financial gain. In this part of their life-cycle tokens indeed behave more like financial assets and the token-holders are driven by the financial incentives instead of motivation to consume the services. On most occasions, it is virtually impossible to determine, whether token-holders purchase the tokens for consumption or speculative purposes. This hybrid nature of tokens made it difficult to define their legal nature and appropriate legal regime with the existing legal framework. Nevertheless, functionally token offerings and crowdfunding overlap to a large extent, therefore it is prudent to compare them especially in the context of (retail) investor protection.

4.2 THE DISCLOSURE OBLIGATION: KEY INVESTMENT INFORMATION SHEETS VS. WHITE PAPER VS. PROSPECTUS

While crowdfunding campaigns involving financial instruments are formally not limited, most of them set their maximum targeted amount below the threshold that triggers the obligation to publish a prospectus. In the EU, this threshold varies per member state but must be set between 1 and 8m EUR. Offerings below 1m EUR are automatically exempted from the prospectus obligation. Furthermore, the EU’s Prospectus Regulation regime requires the issuer to address a broad range of topics and provide a very extensive and audited financial snapshot of the company. It is unlikely that a company conducting a crowdfunding campaign would decide to surpass the threshold set by the EU’s Prospectus Regulation regime, considering the costs and disclosure requirements of a prospectus.

Besides the prospectus, the bespoke crowdfunding regimes of several member states require disclosure documentation, although considerably less elaborated, also for the offerings that do not trigger the obligation to publish a prospectus. For instance, in Germany, §§ 13, 14
CHAPTER 4 - CROWDFUNDING AND TOKEN OFFERINGS

Investment Act requires an issuer to prepare a so-called investment information sheet (Vermögensinformationsblatt – VIB). Such a sheet must contain essential information on the type of investment, investment strategy, debt to equity ratio, risk warnings, repayment under different market conditions, and fees claimed by a crowdfunding platform. A very similar light prospectus is also required in France. In contrast, the UK regulator is satisfied with a general rule of disclosing sufficient information about the investment opportunity in a clear and non-misleading manner combined with appropriate information related to the nature and the risks of investments in this type of securities. The recently enacted European Crowdfunding Service Provider (ECSP) regulation emulates the need for a disclosure document and stipulates the obligation for a key investment information sheet (hereinafter KIIS). Correspondingly, MiCA establishes the disclosure obligation in form of a so-called white paper, which is in terms of content similar to the key investment information sheet of the ECSP regulation. While both regulations are currently not applied (even though ECSP already has been enacted), we do not expect that composing one or the other document would be financially challenging, in stark contrast with the prospectus. Most notably, a prospectus requires the issuer to disclose an extensive amount of financial information that is audited. Such documentation requires extensive involvement of professional service firms and significantly drives up the costs of compiling the prospectus. In contrast, KIIS and white paper are in general much ‘lighter’ in nature and require minimum help from professional service providers (lawyers, accountants, and auditors).

As evident from the table below, the disclosure obligations differ per type of offering. In the context of MiCA we distinguish between three types of offerings depending on the type of token being offered. Token offerings of neither ARTs, nor EMTs tokens, for instance, utility tokens, are the least demanding in terms of disclosure and they do not require authorization from national competent authorities. The issuer is required to compile and publish the white paper for the offerings that surpass 1m EUR in value over a 12-month period. It must be noted that most of the token offerings during the ICO boom would most likely fall into this category of tokens. Putting this into context, it would be possible to conduct 200m EUR token offerings of a multitude of utility tokens in compliance with MiCA regulation that requires only publishing of this light disclosure document. Token offerings of ARTs and EMTs, on the other hand, require authorization from competent authorities and additional information in the white paper in case the offerings surpass 5 million EUR, which is more consistent with increased requirements in case of offerings of transferable securities. Regarding the disclosure and authorization requirements (see Table III), it becomes apparent that there is slight inconsistency for token offerings of non-AR and non-EM tokens, which could be exploited. Based on functional equivalence with crowdfunding, we believe there should be a financial threshold also for offerings of tokens that are not ARTs or EMTs, surpassing of which would trigger an adequate authorization procedure and potentially also ongoing compliance requirements.
4.3 RETAIL (NON-SOPHISTICATED INVESTORS’ LIMITATIONS

Similarly, to crowdfunding, token offerings are open to retail investors, who are particularly vulnerable to losses. Arguably, the potential damage in the case of crypto-assets might be even greater, since retail investors are exposed to both, primary and secondary markets. On the other hand, due to active secondary markets, crypto-assets present a much more attractive alternative for retail investors. As opposed to crowdfunding, MiCA does not contain any significant limitations or hurdles for retail investors. Investor protection is primarily based on the disclosure of information and liability for such a disclosure. In terms of post-investment protection, MiCA emphasizes that the burden of proof lies on the shoulders of the token holders. In contrast, ECSP regulation poses some softer hurdles for retail investors that should in the first instance raise awareness and enable retail investors to understand the risk profile of their investment and its potential financial consequences for the overall financial situation of the investor. ECSP regulation focuses on the platforms and facilitates offerings that are conducted through this financial intermediary. The fact that the platform is present in the investment process enabled the regulator to put this process on the shoulders of this financial intermediary.

For instance, crowdfunding platforms shall in any individual case, “assess whether and which crowdfunding services offered are appropriate for the prospective non-sophisticated investors.”20 To make such an assessment, the platform must ask for information and review the investor’s experience (with loans and transferable securities in the context of crowdfunding), investment objectives, financial situation, and basic understanding of risks involved in investing. Even if a retail investor does not provide requested information or receives a negative assessment from the platform, it does not prevent her from investing in the offered products, it only prescribes a more extensive set of warnings and explicit acceptance of risk for every offering. However, crowdfunding platforms have also an educational role and they operate as
important gatekeepers between investors and campaign owners. Token offerings, on the other hand, were largely conducted without the presence of an intermediary equivalent to the platform in crowdfunding.

In contrast, MiCA does not prescribe any additional methods of awareness-raising or at least soft hurdles to investing. We believe that in the case of token offerings that do not necessarily involve a platform, additional requirements like those imposed on the platforms in the context of crowdfunding could be assigned to the issuers, who would have to inform potential token-buyers more profoundly. Currently, the only requirement is to publish a white paper, the content of which is prescribed by MiCA and include a set of standard boilerplate warnings.

4.4 PLATFORM REGULATION

While there are some significant common themes and overlaps of topics tackled by MiCA in the context of crypto-assets and the EU’s ECSP regulation in the context of crowdfunding, the focus of both regulations is different. The ECSP regulation is focused on the regulation of the financial intermediary, e.g. the crowdfunding platform with some caveats for the regulation of the crowdfunding process (for instance crowdfunding thresholds and investor protection). In contrast, MiCA has a triple-focus, it regulates crypto-assets, the process of token offerings, and crypto-asset service providers. On one hand, it is understandable that platforms are not specifically mentioned in MiCA, as they were not commonly a stakeholder in the token offering process. On the other hand, the decreasing volume and value of token offerings indicate that the previous model did not work optimally and introducing platforms into the token offering formula may be one of the ways to mitigate information asymmetries between token offering initiators and investors/token-buyers. To facilitate this process, MiCA could at least indicate, which category of CASPs such platform would fall under and therefore what type of authorization is needed to conduct such activities. Based on the definition of crowdfunding services in ECSP regulation, we found some similarities with two types of crypto-asset services as defined by MiCA, namely:

‘Placing of crypto-assets’ defined as the marketing of newly issued crypto-assets or of crypto-assets that are already issued but that are not admitted to trading on a trading platform for crypto-assets, to specified purchasers and which does not involve an offer to the public or an offer to existing holders of the issuer’s crypto-assets.

This type of crypto-asset service would include placing crypto-assets to professional investors (sophisticated investors), which is often the first (private) phase of the token offering.

‘Reception and transmission of orders for crypto-assets on behalf of third parties’ defined as the reception from a person of an order to buy or to sell one or more crypto-assets or to subscribe for one or more crypto-assets and the transmission of that order to a third party for execution.

Nevertheless, none of the two definitions is optimal and the policy-maker could further clarify, which category of services is the most suitable for the compliant operation of platforms for token offerings.
4.5 WHAT ABOUT SECURITY TOKEN OFFERINGS?

Security token offerings are in essence offerings of securities that have a form of a crypto-asset. The question of the applicable regulation usually has to be answered on a case-by-case basis by analysing the rights that every such token carries. As mentioned before, a crypto-asset is in MiCA defined purely by its technological form, as a digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology. Nevertheless, MiCA also states that the regulation shall not apply to financial instruments as defined in Annex I C of MiFID. Such wording means that MiCA leaves out DLT-based transferable securities from its scope and they remain regulated under the partially harmonized EU capital market laws. Tokens conferring equity or debt-like rights on its holder could qualify as transferable securities. The intention of EU regulators to include DLT-based securities in the definition of financial instruments is demonstrated by the proposed amendment to the definition of financial instruments that is included in the Digital Finance Package, too. Concretely, the directive proposing MiFID II amendments states that:

‘financial instrument’ means those instruments specified in Section C of Annex I, including such instruments issued by means of distributed ledger technology.

If passed, this amendment could come into force at the same time as MiCA. Until then, the issuers and facilitators of STOs will have to face various obstacles presented by respective regulations and authorities in member states. It is important to mention that capital market laws are harmonized to a certain degree and there are still many differences that stem from the different application or interpretation of the rules by authorities in the member states. Hence MiCA and the MiFID II amendment may still not resolve all the issues of how transferable securities that happen to be stored and transferred utilizing DLT technologies, shall be treated. Simply put, despite the clear acknowledgment of DLT-issued securities in MiFID II, the EU’s Member States still possess tools to practically prevent their issuance or even sale on their territory.

Currently, there are several market players and platforms, which issue or have issued security tokens in the EU. For instance in Germany, pioneering debt-based crowdfunding platform Kapilendo facilitated the issue of token-based bonds for the L’Osteria, a “gastronomy concept” by using the Stellar blockchain network. Exporo, a leading real estate-focused platform also from Germany, has been issuing security tokens (concretely bonds) for almost two years, bringing the STOs to their regular base of investors. Both examples represent platforms that initially operated as more traditional crowdfunding platforms and moved into the STO space, once it became viable. These platforms of course must ensure that STOs are attractive for their investor base, which may or may not be familiar with how to use blockchain-based applications. Another group represented in the STO space perceives STOs as their unique selling point (USP) and does not directly combine it with traditional forms of crowdfunding. First movers in the EU in this respect are STOKR, based in Luxembourg and Fintelum, based in Latvia. The platforms encountered some problems or lack of regulatory understanding when they attempted to offer the securities on a cross-border basis. In order to prevent conflicts with local authorities the easiest way is to put in place so-called geo-fencing, e.g. restricting the offering only those jurisdictions, which interpret the law (or enacted national law) favourably towards STOs.
In regulatory terms (very much ahead of MiCA), EU Member States have somewhat different approaches to the facilitation of STOs. One may argue that even the starting point of the member states’ regulators is not the same, since the differences in the financial regulation, despite partial harmonization of rules, persist. We have uncovered several fundamental and some practical inefficiencies. For instance, Germany has currently finalised the legislative process for a new piece of legislation, Electronic Securities Act (eWpG)\textsuperscript{6} that will regulate electronic securities (initially only bonds and certain debt instruments) and alleviate certain civil law restrictions that effectively prevent storage and transfer of securities on DLT networks\textsuperscript{27}. However, in the meantime, German financial markets authority BaFin decided to enable STOs on a case-by-case basis by qualifying them as ‘sui generis' securities, which to some extent omits the civil law restriction imposed on their issuance and transfer.\textsuperscript{29} For the time being, it is clear that German authorities focus on enabling DLT-based debt-like instruments rather than equity. Authorities in Luxembourg\textsuperscript{29} and France\textsuperscript{30}, on the other hand, have focused their legislative efforts on ensuring that the settlement of such DLT-based securities can occur outside of traditional securities settlement and trading infrastructure represented by central depositories. In Latvia, the regulators do not have extensive requirements on the form of DLT-based securities, however, in the past, they required the involvement of financial intermediaries in every public offering of securities, regardless of the value of the offerings (even when the prospectus was not required).\textsuperscript{31}

The above-mentioned examples are only a limited selection of obstacles that may occur or occurred in the past when conducting STOs. They point, however, to the fact that the reality of conducting STOs, especially cross-border, is much more complex than expected.

Could ECSP resolve the issues with STOs?

The market players that facilitate STOs could indeed qualify as crowdfunding service providers under ECSP regulation, however that to large extent depends on how different member states assess the legal status of security tokens in question (and on a case-by-case basis). The STO facilitators could however benefit from the ECSP regime, having the passporting option and guaranteed opportunity to conduct offerings up to 5m EUR regardless of the member state of issuance. The situation will indeed become slightly clearer once the amendment of the definition of financial instruments that explicitly legitimizes their DLT format comes into force.

4.6 SECONDARY MARKETS IN CROWDFUNDING AND TOKEN OFFERINGS

One of the most perplexing differences between crypto-assets and financial instruments offered through a crowdfunding campaign is the possibility for trading on the secondary markets. For years, the crowdfunding industry has been pleading with regulators to allow for more extensive secondary trading for instruments used in crowdfunding. Nevertheless, the regulators were always hesitant to enable secondary trading on a larger scale and through automated means. In this context, ESMA again clarified that equity crowdfunding platforms mostly operate in the primary markets; thus, they facilitate offerings through which one party (an issuer) is selling securities to multiple parties (crowdfunders).\textsuperscript{32} ECSP explicitly addresses and regulates the extent to which platforms can facilitate secondary trading through so-called bulletin boards. However, the crowdfunding
market has a significant interest in developing secondary markets beyond what the regulation enables today. In case platforms develop trading venues, where multiple sellers would offer securities to multiple buyers under non-discretionary rules, they would be qualified as MIFID-regulated multi-trading facilities (hereinafter MTFs). Trading venues that operate as bulletin boards that merely list parties interested in selling and buying securities are, in their opinion, not fully operationalized secondary markets and thus fall outside of the MTF definition. In stark contrast to crowdfunding’s focus on primary offerings, token offerings are much more often connected to the possibility of selling tokens on the secondary markets. Not only MiCA does not prohibit or limit secondary trading, but it also directly regulates crypto-exchanges as one of the crypto-asset services and thus facilitates primary offerings and fully automated secondary markets in one piece of regulation. Notably, the conditions for authorization and provision of such services are significantly lighter than operating an MTF under MiFID II. We believe that if the policy-maker enables secondary trading of crypto-assets, which pose similar financial risks as assets offered through crowdfunding campaigns, there is no reason why the secondary trading in crowdfunding should not be afforded similar treatment, e.g., more comprehensive facilitation of the secondary markets in crowdfunding, outside of the scope of MiFID II. Unfortunately, such option was not introduced with the recently enacted ECSP regulation and the idea will not be reintroduced until the said regulation is up for a review after 2 years.

4.6.1. DLT Pilot Regime Regulation

Although often standing in the shadow of MiCA, the DLT Pilot Regime Regulation (PDMIR) proposal conveys the message that the traditional financial industry will surely not remain untouched by the rise of crypto-assets, even though financial instruments and traditional financial providers remain regulated by the same set of rules. In essence, the PDMIR creates a regulatory sandbox regime that enables the introduction of a DLT-based secondary market infrastructure where tokenized financial instruments could be traded. In its impact assessment, the Commission recognizes that a DLT-based secondary markets infrastructure ‘can lead to increased financing for companies through securities token offerings (STOs) and efficiency gains throughout the value chain, by reducing the need for intermediaries and the automation, resulting in faster, cheaper and frictionless transactions. However, certain conditions present in the current regulation prevent the market players from testing and implementing such DLT-based infrastructure. For instance, regular crypto-asset exchanges are accessible to retail investors directly as opposed to traditional financial markets where retails investors participate through financial intermediaries. Furthermore, DLT-based infrastructure offers efficiencies because the transactions can be conducted and settled instantaneously, which contrasts with the current setting where trading and post-trading (settlement) activities are conducted by different market infrastructures (MTFs or regulated markets and central security depositories respectively). In contrast to MiCA, this proposal leaves the primary offerings of financial instruments (initial issuance and sale of DLT-based transferable securities) to existing regulations (such as the EU’s Prospectus Regulation, Transparency Directive regime etc.) and focuses on the facilitation of trading of DLT-based financial instruments.

The most important points of the proposed regulation are:
The proposal enables market participants to apply for authorization to operate DLT-based market infrastructures;

Two novel market infrastructures are DLT Multilateral Trading Facilities (trading) and DLT Central Security Depositories (CSD) (settlement);

It removes regulatory obstacles that prevent DLT-based solutions or reduce the efficiency gains that could be achieved with these infrastructures in place;

The legal requirements to apply for an authorization accompanied by exemptions are identical to those necessary for standard MFT or CSD authorizations under MIFID II directive;

DLT CSDs (DLT MFT where they also conduct settlement) may record and settle transferable securities in the total value of 2.5bn EUR.

DLT MTFs can accept for trading only: shares of companies with a total market capitalization of 250m EUR or bonds with the total value of the issue not more than 500m EUR.

The DLT Pilot regime has a sunset clause, after 5 years, the regulator will decide whether it shall become a permanent regulation, whether it should be amended or terminated in its entirety.

Apparently, the EC decided not to address certain fundamental issues such as different interpretation of transferable securities, additional rules of member states related to securities, or the fact that prospectus ’as is’ may not be an adequate disclosure document for issuance of DLT-based securities, even though some of these are directly acknowledged in the explanatory memorandum of the proposal and/or the impact assessment accompanying the proposal.

The most obvious disadvantage of the proposal is that it primarily facilitates the incumbent players who already obtained or have the capacity to obtain necessary authorization for the operation of MFT or CSD. These market players are in a unique position to extend their business lines to crypto-asset markets (namely security tokens) even if they did not have such intentions in the first place. In contrast, some younger innovative market players that could have the know-how to deploy more efficient or innovative solutions will be prevented from entering the sandbox due to its high entry requirements. It is questionable whether such an approach will lead to the most optimal results. Many incumbent market players will have to search for external expertise in the DLT domain, which may lead to acquisitions of innovative DLT companies that in other circumstances and under the more lenient sandbox regime could develop these infrastructures on their own or in the context of joint ventures with incumbents. Furthermore, the proposal imposes a rather low limit on the total market capitalization of financial instruments that are recorded by DLT CSDs, concretely only 2.5bn EUR. We expect that in most cases the market players making use of this pilot regime, would like to use the opportunity to combine the two market infrastructures, hence the threshold for DLT CSDs would apply also to the DLT MFTs who fulfil the role of DLT CSDs. The limitation in our view decreases the attractiveness of these market infrastructures even for the incumbents.

Does the PDMIR facilitate the secondary markets for instruments in the scope of ECSP (at least those in the DLT format)?

This sandbox regime has no impact on the requirements imposed on financial instruments that can be admitted to trading on the regulated secondary markets. For instance, such admission requires publication of the prospectus, unless one of the exemptions in Article 1(5)
of the Prospectus Regulation applies. This means that the
given market infrastructure may be interesting for
companies that wanted to do the primary offering and
secondary offering in a traditional way, not necessarily
through means of crowdfunding. For the time being, it
seems that even platforms or service providers that
facilitate STOs of SMEs will rather use the bulletin
boards regulated by ECSP than engage with DLT-based
market infrastructures for trading.

4.7 ARE TOKEN OFFERINGS A NEW BUSINESS
OPPORTUNITY FOR CROWDFUNDING
PLATFORMS?

The simple answer to the question, would be yes, if
crowdfunding platforms decide to allocate resources to
developing their blockchain-based business line. The
general concept of crowdfunding campaigns and token
offerings is similar. In both cases, the campaign owners
exert substantial effort into promoting their venture to
potential investors and gathering sufficient funds for the
execution of their plan. Both types of campaigns,
however, differ in nuances that distinguish crowdfunding
offerings and token offerings as potentially distinct
business lines for the crowdfunding platform. In practice,
these two fundraising options are not directly
interchangeable, meaning that a company that is suitable
for an equity crowdfunding campaign may not be a good
fit for a token offering and vice versa. In this respect, we
must distinguish between offerings of utility tokens and
security token offerings. In the case of the latter, the
issuer offers digitized securities to the crowd (stored and
transferred on the DLT network), while in case of the
former, non-financial assets are offered to the crowd,
which are often designed as a means of accessing the
service or a product itself and thus facilitate and
operationalize the business model of the issuer. Hence,
STOs are from the legal perspective not substantially
different from equity crowdfunding campaigns, only the
underlying technology used to transfer and store the
securities in question is different and potentially more
efficient. Nevertheless, we already discussed that in many
EU member states there still exist legal hurdles for STOs,
stemming from rather rigid methods of issuance and
transfer of financial instruments. In the case of utility
tokens, the issuer must consider whether a utility token
with a consumption value is properly integrated into their
business model, what rights it conveys on its holder.
Nevertheless, there is no reason why platforms would not
be able to offer a broad range of financing options,
including traditional crowdfunding campaigns, STOs, and
token offerings of utility tokens. The costs of such
diversification, however, can be substantial.

Moreover, the investors that form the current base of
crowdfunding investors of an existing platform may not
be interested in token offerings and vice versa, token-
holders may not be interested in traditional crowdfunding
campaigns. Furthermore, when offering tokens to
traditional crowdfunding investors, the platforms must
develop a very user-friendly interface, which would not
make it less convenient for the investors to engage in the
offering. For instance, investors in a token offering must
create their digital wallets and safely store their private
keys (unique passwords to their wallets). Therefore, it is
likely that a platform would have to exert extra effort in
attracting a new group of investors, who would be familiar
and interested particularly in token offerings.


3 For instance, Namecoin or Litecoin were early examples of so-called altcoins.


5 Cambridge Center for Alternative Finance report 2019


9 See Article 3(2) MiCA

10 For more information see https://www.lawcom.gov.uk/project/digital-assets/

11 FSB Chair’s letter to G20 Finance Ministers and Central Bank Governors, 2018.


13 On the EU level, margin lending is regulated by Regulation (EU) 2015/2365 of November 25, 2015—known as the Securities Financing Transactions Regulation (“SFTR”). Although the assets in question are of course different, the strong resemblance of crypto-lending and margin lending of poses a question if the approach of regulating the crypto-lending should not be analogous to the current regulation.
For instance, in case of Tezos, the contractual arrangement between the token buyers and the offering initiator claims that the transaction between them has a nature of a donation. Most of the token-buyers were however not aware of it. Lars Klöhn, Lars Hornuf and T Schilling, ‘The Regulation of Crowdfunding in the German Small Investor Protection Act: Content, Consequences, Critique, Suggestions’ (2016) 13 European Company Law 56,62-64

§14 Investment Act

See Art.325-38, 314-106 AMF Regulation

See Conduct of Business Sourcebook, Chapter 4, section 4.2.

Article 4 MiCA

Article 21(1) MiCA

Given statement applies to the issuance of crypto-assets, which are not ARTs or EMTs.


For more information about Exporo, see https://exporo.de/

For more information, see https://stokr.io/

For more information, see https://www.fintelum.com/

For more information see https://www.bmvd.de/SharedDocs/Gesetzgebungsverfahren/DE/Einfuehrung_elektr_Wertpapiere.html

German law posits that securities (Wertpapiere) must remain a physical document in accordance with the German Civil Code.

BaFin, ‘Guidance Notice: Second advisory letter on prospectus and authorisation requirements in connection with the issuance of crypto tokens.’ Available at https://www.bafin.de/SharedDocs/Downloads/EN/Merkblatt/WA/dl_wa_merkblatt_ICOs_en.html?jsessionid=4409C34C42490287A297231B8C4188971_cid500?nn=9866146

Law of 1 March 2019 amending the Law of 1 August 2001 concerning the circulation of securities

Ordinance No. 2017-1674 of Dec. 8, 2017 related to the use of a shared electronic recording system for the purpose of representing and transferring securities


Ibid.

Ibid.

In article 3(1)(11) MiCA defines operating a crypto exchange as ‘the operation of a trading platform for crypto-assets’ means managing one or more trading platforms for crypto-assets, within which multiple third-party buying and selling interests for crypto-assets can interact in a manner that results in a contract, either by exchanging one crypto-asset for another or a crypto-asset for fiat currency that is legal tender’

Proposal for a Regulation of the European parliament and of the Council on a pilot regime for market infrastructures
based on distributed ledger technology

37 Regulatory sandbox is a legislative tool that removes certain legal obstacles preventing development of innovative solutions. In essence, the regulator determines exemptions for the stakeholders accepted to the sandbox and enables them to develop their novel solution in a controlled and limited environment in order to prevent or significantly reduce the possibility of harmful effects and at the same time observe the novel solution in market of close-to market conditions. Sandboxes are often focused on innovative startups.

38 These exemptions are usually relevant for companies, whose shares were already previously admitted to the trading on regulated markets and thus not relevant for companies that conducted a crowdfunding campaign that is identical only to a primary offering.