

Advice to ESMA

SMSG advice to ESMA on its Consultation Paper on Technical Standards specifying certain requirements of the Markets in Crypto Assets Regulation (MiCA)

1 Executive Summary

The rise of crypto assets in the last few years – through ‘boom and bust’ cycles that are common in unregulated settings – highlights the potential of an innovation that may transform the financial system but also poses investor protection issues. The SMSG believes that regulation in this area should balance the need for investor protection with the need to create an environment that does not stifle innovation.

The SMSG also considers that entities active in the crypto space should be subject to the same regulation and oversight as intermediaries providing economically equivalent financial services. This is the case not only for reasons related to level playing field but indeed to insure financial stability and investor protection. In the long run, a sound regulatory framework coupled with a rigorous oversight would promote trust in the user base and ultimately the growth of the crypto ecosystem.

The ‘two-track approach’ (i.e., notification requirements for regulated financial entities largely following the authorisation requirements for other entities, without mirroring them fully) is understandable and appropriate. The SMSG welcomes the alleviated notification regime granted to the most highly regulated players, based on the assumption that such entities are considered generally suitable to provide crypto-assets services. The Advice provides some suggestions on specific aspects. For example, as crypto assets are not covered by Investors Compensation Schemes (ICSs), the SMSG suggests enriching the information package submitted to NCAs to explain the measures that will be put in place to make retail clients aware of the different levels of asset protection.

ESMA has identified various undesirable developments in the crypto ecosystem, some of which have led to the collapse of crypto-asset service providers, drawing lessons from these events. ESMA takes these undesirable developments into account in the definition of the information to be submitted with the application. The SMSG welcomes this approach, which seems necessary in the interest of effective investor protection.

The SMSG believes that the online marketing activity performed by so-called ‘Finfluencers’ deserves to be considered as it is a prominent aspect of the distribution of crypto assets and may lead to potential cases of false advertisements and price manipulation.

The SMSG welcomes the clarification from ESMA that conflicts of interests should either be prevented or managed, and the disclosure requirements are not an alternative to the prevention or management of conflicts of interests. The SMSG also believes that conflicts of interests should preferably be prevented, and managed only if prevention is not possible.

This Advice also provides the views of the Group on some general aspects related to the regulation of crypto-assets, based on the understanding that MiCA is designed as a building-block of a wider regulatory effort, which includes initiatives such as the Digital Operational Resilience Act (DORA), the DLT Pilot Regime and the Transfer of Funds Regulation (TFR).

As crypto markets are intrinsically global in nature, the SMSG highlights the need to have a cross-border coordinated approach to foster investor protection and minimize regulatory arbitrage. Cryptos amplify the need to clarify what conduct qualifies for solicitation or reverse solicitation due to the existence of multiple crypto-specific channels to approach clients like blogs and message boards.

MiCA Regulation is an entity-based set of rules. However, financial services may also be provided through Decentralized Finance (DeFi) settings. The SMSG understands that MiCA requires an assessment of the development of DeFi in markets in crypto-assets and of the necessity and feasibility of regulating DeFi by 30 December 2024. The SMSG highlights the need to start immediately monitoring the developments in the DeFi area and offering clarifications as to whether the MiCA Regulation applies to specific operations performed in a DeFi setting.

While MiCA Regulation provides fundamental safeguards, the SMSG also believes that investors should be in a position not to overrate the protection provided by MiCA. The SMSG considers that it would be useful to monitor the use that crypto-asset service providers make of the MiCA authorisation in their communication.

2 Background

1. On 20 July 2023, ESMA released the first MiCA consultation package as part of a series of three packages that will be published sequentially. This first consultation package covers the following aspects:
 - i. the notification by certain financial entities of their intention to provide crypto-asset services;
 - ii. the authorisation of crypto-asset service providers (CASPs);
 - iii. complaints handling by CASPs;

- iv. the identification, prevention, management and disclosure of conflicts of interests by CASPs;
 - v. the proposed acquisition of a qualifying holding in a CASP.
2. Additionally, in the last part of the paper – as this is the first public consultation following the publication of the final text of MiCA – ESMA asks for insights on key general aspects concerning entities that plan to offer services in EU jurisdiction(s) falling under the scope of MiCA. While the SMSG is not able to provide inputs in this respect, the Group still tries to contribute to the consultation process with some elements related to the regulation of crypto-assets.
3. The rise of crypto assets in the last few years – through ‘boom and bust’ cycles that are common in unregulated settings – highlights the potential of an innovation that may transform the financial system but also poses investor protection issues. The SMSG believes that regulation in this area should balance the need for investor protection with the need to create an environment that does not stifle innovation.
4. The SMSG also believes that entities active in the crypto space should be subject to the same regulation and oversight as intermediaries providing economically equivalent financial services. This is the case not only for reasons related to level playing field but indeed to insure financial stability and investor protection. In the long run, a sound regulatory framework coupled with a rigorous oversight would promote trust in the user base and ultimately the growth of the crypto ecosystem.
5. The SMSG understands that other topics – like market abuse or the qualification of crypto-assets as financial instruments – will be dealt with in the next consultation packages. Consequently, this Advice will not discuss such topics.
6. The rest of the Advice is organised as follows. Section 3 provides comments on aspects included in the draft RTS and ITS, listed in § 1, and Section 4 discusses other aspects that – although not included in the consultation paper – are relevant for the regulation of crypto-asset markets.

3 Comments on aspects included in the drafts RTS and ITS

7. As a general and preliminary remark, the SMSG notes that the Level 1 text and the related delegations provide a detailed framework, leaving limited room for changes.

3.1 Provision of crypto-asset services by certain financial entities: A notification procedure

8. MiCA provides that entities that already have a license to provide financial services and that already went through the authorisation process with the NCA of their home Member State (such as investment firms, credit institutions, etc.), do not need to go through the entire authorisation process again. Such entities are required to notify their relevant NCA that they intend to provide crypto-asset services, including the specific information relevant to the provision of such services.
9. The SMSG welcomes the alleviated notification regime granted to the most highly regulated players, based on the assumption that such entities are considered generally suitable to provide crypto-assets services.
10. In addition, the ‘two-track approach’ (i.e., notification requirements for regulated financial entities largely following the authorisation requirements for other entities, without mirroring them fully) is understandable and appropriate. For instance, if relevant information was already available to the NCA and the provision of crypto-asset services did not require any changes in the organisational structure, this information would not have to be submitted again. Tangible relief for notifying future CASPs could result, for example, from the fact that, unlike in the authorisation procedure, evidence of a sufficiently good reputation and appropriate knowledge, skills and experience of the business managers do not have to be provided again. Furthermore, it does not seem strictly necessary to impose the preparation of a detailed business plan for the following 3 years (Art. 1 of the draft RTS on the notification by certain financial entities) as well as extensive presentations on the IT concept and IT security (Art. 4 of the draft RTS on the notification by certain financial entities) on regulated companies that want to provide only, e.g., the services of investment advice, investment brokerage or portfolio management.
11. The likely development over time of new types of crypto-assets which were not yet known at the time of notification raises a point. Article 7 of the draft RTS on the notification by certain financial entities (Section 9.2.1) provides that the notifying entity should specify, among other things, which types of crypto-assets will not be admitted to trading on its platform and the reasons for this. It would be helpful to provide details regarding the procedure of potential future update and the meaning associated to the wording “types of crypto-assets” (e.g., whether it is sufficient to refer to the three types of crypto-assets defined by Article 3 of MiCA, ‘asset-referenced tokens’ vs. ‘e-money tokens’ vs. ‘utility token’).
12. In the context of the description of the trading system and market abuse surveillance (Art. 7 of the draft RTS on the notification by certain financial entities, Section 9.2.1), it should be described whether the final settlement of transactions is initiated on the Distributed

Ledger Technology (DLT) or outside the DLT. Additionally, a notifying entity intending to operate a trading platform for crypto-assets shall provide to the NCA the definition of the moment at which settlement is final (Article 7, § 1 (k) (vi)). In this respect, standardization or self-regulation may prevail. In the first option, the Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality is already in force for the traditional securities settlement systems, and would serve well the purpose of standardization. However, by nature, it does not deal yet with crypto-assets and their settlement. The second option may be preferred for the sake of the frequently postulated openness to technology. The SMSG acknowledges this option and welcomes the possibility of adopting the preferred solution at the choice of the provider.

13. MiCA states that crypto assets are not covered by Investors Compensation Schemes (ICSs) under Directive 97/9/EC¹. This provision creates a situation in which regulated entities like banks and investment firms will be providing the same service (i.e., custody or portfolio management) to the same retail clients and, however, only part of the relevant assets will be covered by an ICS in case of insolvency² of the institution while some other assets will not. This set up implies a change from the perspective of retail investors: an entity that was previously thought to be covered by an ICS will no longer be a covered entity for the full scope of the investments, as it will be a covered entity for some investments and not for others.
14. Against this background, the SMSG considers that possible investors disappointments and reputational issues may arise, leading to serious concerns on investors awareness and investors protection. The Group suggests to include – in the information package that a bank or an investment firm has to send to the NCA before providing services on crypto assets – an explanation of the measures that will be put in place in order (1) to make retail clients aware of the different levels of asset protection and (2) to let them know at all times what investments are protected by an ICS and what are not.

3.2 Provision of crypto-asset services by other entities: An authorisation regime

15. ESMA has identified various undesirable developments in the crypto ecosystem, some of which have led to the collapse of CASPs, drawing lessons from these events. Specifically, ESMA criticised (i.) the lack of basic information on the corporate structure of the service provider and its financial resources, (ii.) the lack of transparency regarding the characteristics and scope of entities associated with the service provider, and (iii.) the

¹ Articles 6, 19, 51 and 81 of MiCA.

² The term insolvency is used to express that the conditions required to compensate the investors are met in accordance with article 2.2. of Directive 97/9.

offering of various services related to crypto-assets that were not subject to (sufficient) regulation and supervision.

16. ESMA takes these undesirable developments into account in the definition of the information to be submitted with the application. The SMSG welcomes this approach, which seems necessary in the interest of effective investor protection. This applies in particular to the measures for the segregation of clients' crypto-assets and funds (§ 39). For example, the lack of such measures was a major cause of the collapse of FTX, a case in which investors suffered considerable losses. Against this background, it looks reasonable that the information provided by a legal entity or other enterprise that intends to provide crypto-asset services in the future (Art. 62 MiCA) in order to apply for permission to the competent NCA should be more comprehensive than for a notification, as the NCA has to gather appropriate information.
17. The SMSG believes that the online marketing activity performed by so-called 'Finfluencers' deserves to be considered as it is a prominent aspect of the distribution of crypto assets. Regulation and enforcement of rules and liabilities are required to protect investors and markets from false advertisements and price manipulation. Social media platforms should have an incentive to moderate the activity of Finfluencers, as they may cause damages to investors through incorrect assertions of facts. In the past, prominent figures have apparently used their fame to raise the prices of some crypto assets and then sell them, resembling classical "pump and dump" schemes which are illegal. It is important to ensure that these rules apply to crypto markets as well. On a general basis, the advices that are provided by Finfluencers should be regulated as the advices provided by financial advisors and monitored to control the spread of sharp practices in the dissemination of promotional information about crypto assets.

3.3 Complaints handling by crypto-asset service providers

18. The SMSG understands that the approach adopted by ESMA is different from the one adopted by the EBA for its mandate under Article 31(5) of MiCA, regarding complaints-handling procedures for issuers.
19. The SMSG notes that it would be desirable that the rules on complaint management are uniform within a regulatory framework such as MiCA, as it can be assumed that some companies act both as issuers and as CASPs. Therefore, further harmonisation and standardisation of the rules on complaint management should be undertaken.

3.4 Conflicts of interests

20. Article 72 of MiCA provides that crypto-asset service provider “shall implement and maintain effective policies and procedures [...] to identify, prevent, manage and disclose” conflicts of interest.
21. The consultation paper clarifies that conflicts of interests should either be prevented or managed and the disclosure requirements of Article 72(1), as further detailed in paragraph 2 of Article 72, are not an alternative to the prevention or management of conflicts of interests. The SMSG welcomes this clarification from ESMA. Additionally, the SMSG believes that conflicts of interests should preferably be prevented, and managed only if prevention is not possible.
22. The SMSG welcomes that ESMA has closely followed the Delegated Regulation on MiFID II on conflicts of interests. Other regulatory frameworks would have indeed resulted with overburdening the financial institutions that are already regulated under MiFID.

4 Other aspects

23. The SMSG understands that MiCA is designed as a building-block of a wider regulatory effort, which includes initiatives such as the Digital Operational Resilience Act (DORA), the DLT Pilot Regime and the Transfer of Funds Regulation (TFR). The SMSG is aware of the possibility that some of the points that are raised in this opinion might imply changes at Level 1 or require the involvement of other ESAs or be covered in other parts of the EU’s overarching initiative to regulate digital assets. Still, it is deemed as potentially useful to share the SMSG view on these points.

4.1 Non-EU entities and cross-border crypto-asset services

24. Crypto markets are intrinsically global in nature. Investors located in the EU might have access to crypto-assets regulated in different jurisdictions. Several exchanges are located in other jurisdictions. To protect EU investors, the challenge is to bring crypto services into the scope of EU regulation when EU citizens are involved. The SMSG highlights the need to have a cross-border coordinated approach to foster investor protection and minimize regulatory arbitrage.
25. MiCA waives the requirement for authorisation where an EU client initiates at its own exclusive initiative the provision of crypto-asset services (‘reverse solicitation’, Article 61.1). Paragraph 2 of Article 61 clarifies that the client’s own initiative does not entitle a third-country firm to ‘market’ new types of crypto-assets or crypto-assets services to that client. However, there is legal uncertainty as to the boundaries of reverse solicitation and there is a risk of solicitation cloaked as reverse solicitation.

26. Although the discussion on the boundaries of reverse solicitation is not unique to the crypto ecosystem, the SMSG highlights that cryptos amplify the need to clarify what conduct qualifies for solicitation or reverse solicitation due to the existence of multiple crypto-specific channels to approach clients like blogs, message boards, newsletters, referral programmes and partnership programmes.

4.2 Decentralized finance

27. MiCA Regulation is an entity-based set of rules (e.g., the CASP authorisation process or the CASP conflicts of interests). However, financial services may also be provided through decentralized applications running on permissionless networks like Ethereum with minimal or no intermediaries' involvement. This setting is usually referred to as Decentralized Finance (DeFi)³.

28. The SMSG understands that, based on Article 142 of MiCA Regulation, by 30 December 2024 and after consulting EBA and ESMA, the Commission shall present a report to the European Parliament and the Council on the latest developments with respect to crypto-assets, including an assessment of the development of DeFi in markets in crypto-assets and of the necessity and feasibility of regulating DeFi⁴.

29. Given the dynamic nature of these technologies and the semantic difficulties associated with the interpretation of the related concepts, the SMSG highlights the need to start immediately monitoring the developments in the DeFi area and offering clarifications as to whether the MiCA Regulation applies to specific operations performed in a DeFi setting. Recital 22 of MiCA states that partially decentralized services are in scope of MiCA, whereas fully decentralized services in crypto-assets are not in MiCA scope⁵. However, ascertain whether a service is provided in a partially decentralised manner or in a fully decentralised manner is not straightforward⁶. Additionally, the risk of malpractices is

³ Decentralized applications (or "protocols") are set of smart contracts which do not need to be operated by a clearly identifiable corporate entity. Developers may create and distribute governance tokens, which confer rights – e.g. related to the governance of the protocol – to their owners, to be exercised within novel forms of organization such as Decentralized Autonomous Organizations (DAOs). Decentralized finance emerges when the protocols provide users with financial services on a decentralized network.

⁴ MiCA requires that the report is also expected to contain an assessment of the necessity (and feasibility) of regulating lending and borrowing of crypto-assets, an assessment of the treatment of e-money tokens, where not addressed in the review of the Payment Services Directive (PSD2), an assessment of the development of markets in non-fungible crypto-assets (e.g., Non-Fungible Tokens, NFTs) and of the appropriate regulatory treatment of such crypto-assets.

⁵ 'This Regulation should apply to natural and legal persons and certain other undertakings and to the crypto-asset services and activities performed, provided or controlled, directly or indirectly, by them, including when part of such activities or services is performed in a decentralised manner. Where crypto-asset services are provided in a fully decentralised manner without any intermediary, they should not fall within the scope of this Regulation.'

⁶ Even where crypto platforms pose as DeFi *stricto sensu*, it is far from certain whether they are, in fact, fully decentralized in MiCA's sense. Some type of legal entity is often related to fully decentralized platforms. See Zetzsche/Buckley/Arner/van Ek, *Remaining regulatory challenges in digital finance and crypto-assets after MiCA*, publication for the Committee on Economic and

present with decentralisation as well. For example, when decentralized applications act as market makers (i.e., Automated Market-Makers, AMMs) the underlying code should be made available to regulators for possible scrutiny in order to prevent market abuse.

4.3 Risk of misunderstanding MiCA scope and implications

30. MiCA Regulation provides operational, organisational and prudential requirements at Union level applicable to crypto-asset service providers to address potential risks that the provision of crypto-asset services poses to investor protection.
31. While MiCA Regulation provides fundamental safeguards, the SMSG also believes that investors should be in a position not to overrate the protection provided by MiCA. The no-endorsement statement⁷ on the first page of the crypto-asset white paper is fully consistent with this approach.
32. Along the same lines, the SMSG believes that it would be useful to monitor the use that CASPs make of the MiCA authorisation in their communication. A potential risk is in the misuse of the authorisation received by NCAs to convey the idea that the crypto-assets are less risky thanks to this authorisation.

4.4 Market stability and prudential requirements of CASPs

33. MiCA provides prudential and conduct requirements for CASPs, including back-up systems and risk controls. The SMSG notes that such requirements address the resilience of CASPs while a different – although interconnected – dimension of market stability refers to excessive volatility. This second dimension also deserves attention, for investor protection purposes and market abuse prevention, as issuers may limit the supply, pushing upwards the market price for the crypto asset. This practice - which essentially leads to 'positioning' the market price at an artificial level - is similar to a market corner or squeeze.
34. With respect to prudential requirements, the SMSG understands that the introduction of a prudential regime for CASPs is intended to ensure consumer protection (Recital 80). To create a level playing field between CASPs and regulated financial entities, prudential requirements should be subject to a test of functional equivalence, namely they should be similar to those of regulated institutions undertaking same functions.

Monetary Affairs (ECON), Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg, May 2023. This document is available on the internet at: <http://www.europarl.europa.eu/supporting-analyses>.

⁷ 'This crypto-asset white paper has not been approved by any competent authority in any Member State of the European Union. The issuer of the crypto-asset is solely responsible for the content of this crypto-asset white paper' (Articles 6(39) and 51(3)).

35. According to Article 67 of MiCA, CASP shall have prudential safeguards equal to an amount of at least the higher of the following two items: an amount of permanent minimum capital requirements – that ranges from EUR 50,000 to EUR 150,000 depending on the type of the crypto-asset services provided – and 25% of the fixed overheads⁸.

36. While the SMSG understands that prudential safeguards have been set by the Level 1 text and prudential regulation is not explicitly in ESMA remit, the SMSG notes that prudential requirements – which may have an impact on market stability – do not appear to be fully related to the potential riskiness of CASPs as they do not take into account, e.g., the value of the assets in custody or the value of the crypto-assets placed or traded⁹.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 6 October 2023

[signed]

Veerle Colaert
Chair
Securities and Markets Stakeholder Group

[signed]

Giovanni Petrella
Rapporteur

⁸ The prudential safeguards may be complied with own funds of the CASP or an insurance policy.

⁹ Annex IV of MiCA provides minimum capital requirements for CASPs offering, among others, execution of orders on behalf of clients, providing custody and administration of crypto-assets on behalf of clients, exchange of crypto-assets for fund, operation of a trading platform for crypto-assets. The exchange of crypto assets for funds, as defined by Article 3.1.(19), is a market making activity where the CASP buys and sells contracts concerning crypto-assets with clients for funds by using proprietary capital.