

April 26, 2024

VIA ESMA WEBSITE

The Honorable Chair Verena Ross
ESMA
201-203 rue de Bercy
CS 80910
75589 Paris Cedex 12, France

**Re: European Securities and Markets Authority; Consultation Response
(ESMA75-453128700-52)**

Dear Chair Ross:

Alchemy Insights, Inc. (“Alchemy”) appreciates the opportunity to respond to the European Securities and Markets Authority’s (“ESMA”) consultation paper on its draft guidelines on the qualification of crypto-assets as financial instruments for MiCA implementation, published on January 29, 2024 (the “Consultation Paper”).¹ We welcome opportunities to meet with ESMA staff, answer any questions that you may have, and discuss our comments below in more detail.

Alchemy provides the leading blockchain developer platform, offering software developers the fundamental tools they need to build the future of technology—i.e. blockchain applications that benefit users in the EU and around the world. We seek to empower developers similar to how Microsoft and Apple built operating systems that made it possible for developers to create applications such as word processors and image illustrators, or how Amazon built cloud hosting infrastructure that made it possible for developers to create applications such as Netflix and Uber. Alchemy supports some of the leading organizations in the space, including Web3 natives such as OpenSea, Circle, Ledger, and dydx, as well as Web2 companies such as Shell, Shopify, Stripe, Adobe, Gamestop, and many more.

At Alchemy, we believe the world needs an Internet that can foster competition and bring economic empowerment to individuals, unlock opportunities in the innovation economy, and enable people to take control of their digital information. The solution is web3 — the third wave of the Internet — a group of technologies that encompasses blockchains, digital assets, decentralized applications, decentralized finance, and decentralized autonomous organizations. Together, these tools enable new forms of human collaboration that can help

¹ ESMA, *On the draft Guidelines on the conditions and criteria for the qualification of crypto-assets as financial instruments* (Jan. 29, 2024), https://www.esma.europa.eu/sites/default/files/2024-01/ESMA75-453128700-52_MiCA_Consultation_Paper_-_Guidelines_on_the_qualification_of_crypto-assets_as_financial_instruments.pdf [Hereinafter: ESMA Consultation Paper].

communities make better collective decisions about critical issues, such as how networks will evolve and how economic benefits will be distributed.

I. Introduction

We support the overarching objectives of the Markets in Crypto-Assets (MiCA) regulation to create a single market for offering crypto-assets and the provision of related services across the EU, and we welcome ESMA's efforts to support the development of a common rulebook to foster consistency in approaches to supervision. Once finalized, ESMA's guidelines have the potential to reduce misunderstandings and misinterpretations of policy and regulatory intent, which will significantly strengthen the crypto industry in Europe. However, in order to achieve this result, we believe that ESMA should reconsider certain positions that it has taken in the draft guidelines. Our comments and observations are summarized below.

- Forms of staking that do not involve discretion, trust, and other qualities typical of financial transactions should not be treated as financial activities and, therefore, should not be covered by financial regulations, such as the Markets in Financial Instruments Directive 2014 (MiFID II).
- National competent authorities (NCAs) should use a principles-based approach for categorizing crypto-assets that involve rights typically associated with financial instruments (including utility and hybrid-type tokens), which focuses on how such tokens are intended to be used and how market participants predominantly use them. In general, the regulatory treatment of a given crypto-asset should be based on its risk profile. If the asset poses similar risks to traditional financial instruments, then regulatory classification as a financial instrument may be appropriate. However, if the crypto-asset obviates risks generally associated with traditional financial instruments, which tends to occur when the asset is sufficiently decentralized, it should not necessarily be considered a financial instrument solely because it involves a right commonly associated with a financial instrument.
- Given that non-fungible tokens (NFTs) are excluded from the scope of MiCA, ESMA should reconsider their inclusion in these guidelines. The EU's co-legislative bodies correctly agreed in the MiCA trilogues to exclude NFTs from MiCA because many NFTs, such as digital art NFTs and music NFTs, are not primarily financial instruments. Thus, any attempt to introduce criteria that could result in the inclusion of NFTs in the scope of MiCA may contravene the regulation, be disproportionate to its aims, create confusion in the marketplace, disrupt consumer activities, and stymie innovation.
- Outside of MiCA, NCAs should leverage a principles-based approach to classifying NFTs that emphasizes "look-through" analyses (i.e., closely examining their characteristics) to determine how an NFT is used in practice and its intended use. In general, when an NFT represents ownership in an underlying asset, the NFT should be treated as the underlying asset for regulatory purposes. NCAs should, however, note that NFTs are not separable from the good or service over which they represent ownership. Additionally, NCAs should be advised that an NFT's use can be manifold and may

change over time, so classifications may need to be revised. When an NFT certifies authenticity and/or ownership of multiple associated rights, goods, or services, the “look-through” analysis should be paired with intended use and predominant purpose analyses.

- Lastly, several specific conditions and criteria pertaining to NFT series, value interdependence, and fractionalised NFTs should be revised.

Q4: Do you agree with the conditions and criteria to help the identification of crypto-assets qualifying as another financial instrument (i.e. a money market instrument, a unit in collective investment undertakings, a derivative or an emission allowance instrument)? Do you have any additional condition, criteria and/or concrete examples to suggest?

We are concerned that, without further guidance, the draft guidelines may lead NCAs to mistakenly classify all forms of staking as collective investment undertakings. We do not believe that collective investment undertakings or collective investment schemes (CIU/CIS) regulation would be fit for purpose with respect to forms of staking that do not involve discretion, trust, and other qualities typical of financial transactions. NCAs should not treat these forms of staking as financial activities and, therefore, they should not be covered by financial regulations.

Staking is a consensus mechanism used by Proof of Stake (PoS) blockchains to ensure network security and incentivise stakeholders to perform operational activities. Transactions are added to PoS blockchains by “validators,” who are similar to “miners” for Proof of Work (PoW) blockchains, but instead of performing calculations to “mine” new blocks, validators “stake” a certain amount of crypto-assets as a pledge that they will perform validation work honestly. PoS blockchains then distribute rewards to validators for performing validation services (i.e., confirming transactions), which are necessary for the network to function securely. “Stakers” are third parties that provide the necessary stake to validators and, in return, validators share rewards with stakers. Stakers often rely on “staking-as-a-service” providers, which allow users to benefit from staking activities without running validator nodes themselves. Most PoS blockchain networks (with the notable exception of Ethereum) do not commonly require stakers to transfer custody of their assets to staking-as-a-service providers; instead, stakers delegate their assets to providers, which typically removes the risk of token misappropriation. Further, as long as a validator does not contravene the standards of a blockchain, neither they nor stakers are at risk of losing their crypto-assets.

For the most part, financial regulation is ill-suited for a fundamentally technological process like staking.² As described above, the purpose of staking is to facilitate the security and technical operations of a blockchain network, not to engage in financial transactions. While it is true that stakers receive a financial reward from staking, the reward is collateral to the validation process. Validators and users who stake crypto-assets are not engaging in a financial transaction

² Relatedly, while this response is specific to Proof of Stake, ESMA should carefully consider the harmful consequences of recommending that NCAs apply financial regulation to other consensus mechanism processes that, like staking, are also fundamentally technological in nature.

unless they are empowering the third-party provider with discretion, trust, and other qualities that are more typical of financial activities. Crucially, other jurisdictions have already recognized that, generally, staking is a technological process, not a financial services activity. For example, in a recent UK consultation and call for evidence, HM Treasury asserts that “the specific process of operating a validator node using on-chain staked cryptoassets would generally constitute a technical function essential to the operational activities and security of a PoS blockchain, rather than a financial services activity.”³

More specifically, characteristics associated with CIU/CIS financial regulations are a particularly poor fit for forms of staking that do not involve discretion, trust, or other qualities typical of a financial transaction.⁴ First, staking participants possess a general industrial purpose: to validate transactions on a PoS blockchain in order to facilitate network operations and security. Second, many users that delegate assets to a validator for staking do so for the purpose of securing the network; their aim is not “investment with a view to generating a pooled return,” but rather facilitating the technical and operational needs of a PoS network.⁵ Finally, as aforementioned, with the exception of Ethereum, stakers do not typically need to transfer custody of their assets to staking-as-a-service providers and can instead delegate their assets to be staked by such providers, which means that stakers have day-to-day control of their assets.

Moreover, we urge ESMA to reckon with the potential unintended consequences of regulating staking as a CIU/CIS. Any jurisdiction’s decision to regulate forms of staking that do not involve discretion or trust as financial activities is likely to impose a prohibitively expensive and undue regulatory burden on web3 start-ups, given the widespread use of staking by blockchain protocols that employ PoS mechanisms. As such, the regulation of staking would hamper innovation. Regulating staking may also risk blockchain protocols favoring other less environmentally-friendly mechanisms, such as PoW mechanisms. While staking raises novel policy considerations, it is a marked improvement over other blockchain consensus mechanisms such as PoW with respect to environmental sustainability. When developers first introduced blockchains more than a decade ago, the networks consumed significant electricity because they relied on PoW. But this is generally no longer necessary because the industry has developed newer consensus mechanisms, including PoS, that do not require significant energy expenditure. PoS blockchains, like Ethereum, consume an extremely low amount of energy relative to comparable products and industries. For example, Bitcoin, and the traditional banking system

³ His Majesty’s Treasury, *Future financial services regulatory regime for cryptoassets: Response to the consultation and call for evidence* (Oct. 2023), https://assets.publishing.service.gov.uk/media/653bd1a180884d0013f71cca/Future_financial_services_regulatory_regime_for_cryptoassets_RESPONSE.pdf.

⁴ CIU/CIS are not defined under MiFID II, but Paragraph 44 of the Consultation Paper suggests certain characteristics that would qualify an entity as a collective investment undertaking, including “the absence of a general commercial or industrial purpose of the entity, the pooling together of capital raised from investors for the purpose of investment with a view to generating a pooled return for those investors, and the absence of day-to-day control of the unitholders or shareholders over the entity.” See ESMA Consultation Paper, at 14.

⁵ *Id.*

annually consume 100x, 53,000x, and 92,000x more energy than Ethereum, respectively.⁶ Therefore, ESMA should refrain from imposing financial regulations on forms of staking that do not involve discretion, trust, and other qualities typical of financial transactions.

Q5: Do you agree with the suggested conditions and criteria to differentiate between MiFID II financial instruments and MiCA crypto-assets? Do you have concrete conditions and/or criteria to suggest that could be used in the Guidelines? Please illustrate, if possible, your response with concrete examples.

We welcome ESMA's efforts to support the development of a common rulebook to foster consistency in approaches to supervision. However, we are concerned that ESMA's suggested conditions and criteria to differentiate between MiFID II financial instruments and MiCA crypto-assets could result in the misclassification of crypto-assets, which could lead to regulatory fragmentation and, in turn, undermine consumer protection and reduce innovation by EU crypto-asset businesses. Ultimately, it could also result in crypto businesses and organizations leaving the EU for jurisdictions with clearer regulatory frameworks. It is, therefore, important that ESMA clarify its approach.

In particular, we disagree with ESMA's assertions that "a utility token should give neither financial rights that would be related to a company's profits, capital, or liquidation surpluses – and thus representing an ownership position in a company's capital (e.g. unit of equity ownership in the capital stock of a corporation)," and that, in general, rights conferred by utility tokens "should not replicate the rights attached to financial instruments."⁷ Many crypto-assets, including utility tokens, confer multiple rights on their holder, some of which could replicate the rights attached to financial instruments. Thus, as a starting point, ESMA should explain what types of financial rights it is referring to and clarify whether a utility token replicating a single such right would be considered a financial instrument, or if categorizing it as such would require multiple associated financial rights. Without further clarification, the authority's guidance could create significant uncertainty for businesses and consumers alike.

Moreover, for crypto-assets that do involve a right generally associated with financial instruments, ESMA should guide NCAs to use a principles-based approach for categorizing assets that focuses on how the asset is intended to be used and how it is predominantly used. Importantly, just because a utility token (or any crypto-asset for that matter) involves a right typically associated with financial instruments does not mean that regulators should automatically categorize it as a financial instrument. Instead, NCAs should carefully consider the crypto-asset's intended use and predominant purpose to adequately classify it. To that end, a "look-through" analysis is a reasonable approach. For example, if a utility token provides its

⁶ a16z crypto policy & regulatory teams, *State of Crypto 2023: Spotlight on crypto policy* (Nov. 16, 2023), https://a16zcryptofrz.wpenginepowered.com/wp-content/uploads/2023/11/State-of-Crypto-2023_Policy-Spotlight.pdf.

⁷ ESMA Consultation Paper, at 19.

holder with access to a good or service, while also involving rights generally associated with financial instruments, ESMA should direct NCAs to carefully consider how the crypto-asset is used in practice. If its use is more akin to a consumer good, then it should not be subject to financial regulation, if however its use mirrors that of a traditional financial asset, it may be appropriate to treat it as such.

Moreover, in general, the regulatory treatment of a crypto-asset should be based on its underlying characteristics and risk profile. Crucially, if the crypto-asset obviates risks typically associated with traditional financial instruments, it should not necessarily be considered a financial instrument solely because it involves a right typically associated with a financial instrument. More specifically, if the characteristics of a crypto-asset are similar to those of a transferable security, and if they pose similar risks, it may be appropriate to treat the crypto-asset in the same manner as a transferable security. However, these are not the only possible examples and merely because a crypto-asset involves a right generally associated with a financial instrument does not mean it necessarily poses the same risk as a traditional financial instrument. For example, art, sneakers, and other collectibles have a financial component, but that does not necessarily mean that they pose the same risks as traditional financial instruments. Similarly, tokens designed to facilitate the accumulation of value in a reality game should not be treated as tokenized forms of securities simply because the game tokens have value in a marketplace. Marketplace value and liquidity can be critical to the utility and functioning of game tokens, but the financial value of those tokens does not mean they should be regulated in the same way as instruments designed to provide an investment return.

Decentralization is the primary characteristic that is relevant for determining the risk profile of a given crypto-asset. For example, because most blockchains are transparent, comprehensive information about crypto-assets can typically be found on-chain, meaning that all potential holders of such assets have access to the information necessary to value and trade them on a level playing field. This feature of web3 can eliminate many information asymmetries, mitigating the risk that insiders take unfair advantage of material nonpublic information when transacting with others.

Therefore, policymakers and regulators should focus on developing rules tailored to the unique nature of blockchain networks that are capable of achieving critical regulatory outcomes, such as ensuring robust consumer protection, preserving market integrity, and fostering innovation. We thus urge ESMA to revise its guidelines on the suggested conditions and criteria to differentiate between MiFID II financial instruments and MiCA crypto-assets to reflect that, with respect to crypto-assets that involve a right commonly associated with a financial instrument, NCAs should use a principles-based approach that categorizes an asset based on how the asset is intended to be used, how it is predominantly used, and what risks it poses.

Q6: Do you agree with the conditions and criteria proposed for NFTs in order to clarify the scope of crypto-assets that may fall under the MiCA regulation? Do you have any

additional condition and/or criteria to suggest? Please illustrate, if possible, your response with concrete examples.

We disagree with ESMA's proposed criteria for NFTs and are concerned that they could have detrimental consequences for the crypto-asset industry and its users in the EU. As an initial matter, given that NFTs are excluded from the scope of MiCA, ESMA should reconsider their inclusion in these guidelines. The EU's co-legislative bodies rightly agreed in the MiCA trilogues to exclude NFTs from MiCA because many NFTs, such as digital art NFTs and music NFTs, are not primarily financial instruments. This exclusion is clearly stated in MiCA,⁸ whereas ideas referenced in the Consultation Paper such as an "indicator of [...] fungibility" only appear in a suggestive form in the recitals of the regulation.⁹ Thus, any attempt to introduce criteria and indicators of fungibility that could result in the inclusion of NFTs in the scope of MiCA may contravene the letter and the spirit of the regulation.

A. Background on NFTs

Before providing further feedback on ESMA's proposed conditions and criteria for classifying NFTs, we offer background information on NFTs. Though early in their development, NFTs already have a wide range of use cases. NFTs typically have unique token IDs that link to a URL containing metadata in JSON format. This metadata may also include one or more URLs to a digital file, such as an image. If the NFT links to an image, it is usually the "face" of the NFT, and is displayed by applications that assist users in discovering NFTs. As the NFT "lives" on a blockchain, its provenance and history are recorded, and if the blockchain is public, then this information is transparent to the public. NFTs can be transferable or non-transferable. The NFT metadata and any linked digital file are populated by the NFT creator. Together, they can certify authenticity, convey ownership or licensing rights, serve as a credential or identity verification, provide redemption rights for intangible or tangible things, and more. As with crypto-assets in general, NFTs can have both financial and non-financial uses. Likewise, an NFT's uses may change over time. The potential categories and use cases for NFTs are endless, much like a blank piece of paper carries almost infinite possibilities. For example, NFTs can be used to certify authenticity of art or music, enable identity verification or credentialing, or serve as concert tickets or badges for customer loyalty programs.

Given the early stage of NFT development, and because no one can predict how this vibrant corner of web3 will evolve, it is crucial that policy and regulation not stymie innovation by prematurely pigeonholing this broad category of innovation into overly narrow categories. Indeed, as described below, many NFTs are linked to goods and services that are not, in and of themselves, directly subject to regulation. NFTs related to goods and services for which strong consumer protections already exist may not require additional regulation. Thus, in general,

⁸ MiCA, Article 2(3).

⁹ MiCA, Recital 11.

policymakers should carefully consider whether any regulation is appropriate for a category of NFTs based on the factors discussed below.

B. A principles-based approach to NFTs

Outside of MiCA, rather than adopting prescriptive approaches to categorization, NCAs should be directed to use a principles-based approach to classifying NFTs. Principles-based approaches are especially important with emerging technology, which evolves so rapidly and is often so complex that regulators cannot prescribe their way to pragmatic outcomes; principles-based approaches can best help regulators achieve their goals in quickly changing, dynamic spaces.

For the purpose of token classification, a principles-based approach should focus on assessing the intended use of the NFT and how market participants predominantly use it. Specifically, when an NFT represents ownership in a good or service, the NFT should be regulated as the good or service would typically be; identifying an asset as an NFT should not alter its regulatory treatment. To that end, a “look-through” analysis is a reasonable approach. For example, if an NFT provides its holder with access to a membership club with the NFT acting as a membership card or personal identifier — the regulatory treatment would focus on the club membership. Importantly, unlike utility tokens, NFTs provide *unique* (hence non-fungible) access — in the case of the membership club NFT, for a specific member to a unique club. In this example, a single right is associated with the NFT.

In the case that an NFT has multiple associated rights, goods, or services, we suggest that NCAs be advised to apply the “look-through” analysis with intended use and predominant purpose approaches. For example, it is possible that the membership club NFT could provide the holder of the NFT not only with access rights to a club, but also with a right to attend an exclusive event. In this case, a “look-through” analysis without a predominant purpose or intended use approach would require rules to determine how to value the NFT based on an allocation among the different associated rights or assets, which could result in costly appraisals. But a “look-through” analysis paired with these approaches reduces complexity while enabling innovation. Finally, NCAs should be advised that an NFT’s use can be manifold and may change over time, so classifications may need to be revised.

C. Additional changes to the conditions and criteria proposed for NFTs

In addition to the foregoing comments, we also recommend several changes to ESMA’s suggested conditions and criteria to differentiate between MiFID II financial instruments and MiCA crypto-assets. Specifically, we propose changes to ESMA’s guidelines with respect to NFT series, value interdependency, and fractionalised NFTs.

As an initial matter, we are concerned about ESMA’s guidelines regarding NFT series and interchangeability, particularly with ESMA’s suggestion that NFTs “that are issued ‘in a large series or collection’ may be considered fungible and thereby covered by MiCA.”¹⁰ Fungibility is a nuanced concept and one that deserves more clarification if regulators are going to create prescriptive rules around it. Further, fungibility is a hallmark of many assets, notably commodities, which have financial value and are not regulated as financial instruments. In general, NFTs in a series can retain their non-fungibility: trading card NFTs (representing, for instance, a football team) may be issued in a large series or collection, but each individual NFT can retain its non-fungibility by, for example, representing different team-members or different years of the team. The misclassification of NFTs in such a series as being fungible could be avoided with the principles-based approach, outlined above, which would assess each NFT in a series on its own merits. While it is conceivable that bad actors could attempt to circumvent MiCA regulations by issuing fungible assets in the guise of an NFT series, we believe that a principles-based approach to classifying NFTs would uncover this and preserve the integrity of the NFT market.

Likewise, value interdependency is a weak indicator of fungibility. It is true that NFTs in a series have interdependent value because as the perceived value of a collection rises or falls, so does the value of each individual NFT within it. However, buyers and sellers commonly value different traits, attributes, or types of NFTs within a collection differently, much like buyers of the same artist’s unique works, and such valuations often change over time as the tastes and interests of individuals change. Another analog from the art world is the concept of limited edition prints or series. When an artist like LeRoy Neiman creates a series of lithographs in a subject area such as the Olympics or golf, his offering multiple copies of prints within that topic area does not convert his artwork into a security. This is true even though there may be a deep market for such work and some purchasers may view their purchase as having the potential to appreciate. In addition, some traits may provide special or additional utility, so while a given NFT’s value may be interdependent on a larger series, the NFT itself may still be unique. For example, the value of one NFT in the aforementioned series (e.g., an NFT representing the goalie) may be interdependent on the value of another NFT in that series (e.g., NFTs representing the midfielders), but that does not mean that these NFTs are fungible. Indeed, value interdependence should have little, if any, bearing on whether assets are fungible. Here too, a principles-based approach is crucial.

Lastly, we are also concerned about ESMA’s conditions and criteria related to fractionalised NFTs. In paragraph 73 of the Consultation Paper, ESMA states that “Fractional parts of a unique and non-fungible crypto-asset should not be considered unique and non-fungible.”¹¹ However, in paragraph 140 of the Consultation Paper, ESMA implies that “fractional parts of a unique and non-fungible crypto-asset, when considered separately” may be

¹⁰ ESMA Consultation Paper, at 37.

¹¹ *Id.* at 21.

“deemed unique and non-fungible.”¹² As a starting point, we strongly recommend that ESMA clarify these apparently contradictory statements. In line with our foregoing comments, we also urge ESMA to guide NCAs to avoid an overbroad position with respect to fractionalised NFTs, but rather to use the aforementioned principles-based approach for appropriately categorizing them based on how they are intended to be used and how they are predominantly used.

Q7: Do you agree with the conditions and criteria proposed for hybrid-type tokens? Do you have any additional condition and/or criteria to suggest that could be used in the Guidelines? Please illustrate, if possible, your response with concrete examples.

In reference to paragraph 141, we strongly disagree with the notion that “if the hybrid token displays features of a financial instrument, this characteristic should take precedence in its classification.”¹³ This approach risks classifying hybrid tokens that have a small, non-primary, or potential feature that mirrors those of financial instruments as financial instruments, although the primary intended use case of the token may not be financial. The resulting classification may subject new hybrid tokens to an unsuitable regulatory regime – MiCA is tailored to tokens and related activities and services and MiFID/R is not – and create market distortion for investors and service providers of existing tokens by subjecting them to new, ill-suited rules.

As with some utility tokens, hybrid tokens confer multiple rights on their holder, some of which may involve a right typically associated with a financial instrument. For hybrid tokens that do, ESMA should guide NCAs to use a principles-based approach for categorizing assets that focuses on how the asset is intended to be used and how it is predominantly used. Just because a hybrid token involves a right generally associated with a financial instrument does not mean that regulators should presumptively categorize it as a financial instrument. Instead, NCAs should carefully consider the crypto-asset’s intended and predominant purposes, and what risks it poses, to adequately categorize it. As previously mentioned with respect to utility tokens, the regulatory treatment of a crypto-asset should be based on its underlying characteristics and risk profile. Since decentralization is the primary characteristic that is relevant for determining the risk profile of a given crypto-asset, analyses of the risks posed by a crypto-asset should emphasize the extent to which decentralization mitigates risk. Policymakers and regulators should, therefore, develop rules tailored to the unique nature of blockchain networks that are capable of achieving critical regulatory outcomes, such as ensuring robust consumer protection, preserving market integrity, and fostering innovation. We thus urge ESMA to revise its guidelines on hybrid tokens to reflect that, with respect to hybrid tokens that involve a right generally associated with a financial instrument, NCAs should use a principles-based approach that focuses on how the asset is intended to be used, how it is predominantly used, and what risks it poses, to properly classify it.

¹² *Id.* at 37.

¹³ *Id.* at 22.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Nishanth Chari". The signature is fluid and cursive, with the first name "Nishanth" and last name "Chari" clearly distinguishable.

Nishanth Chari
Head of Legal
Alchemy Insights, Inc.