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| Reply form on the Consultation Paper on guidelines on conditions and criteria for the classification of crypto-assets as financial instruments for MiCA implementation |
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**Responding to this paper**

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions. Comments are most helpful if they:

* respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

ESMA will consider all comments received by **29 April 2024.**

**Instructions**

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.
2. Use this form and send your responses in Word format (**pdf documents will not be considered except for annexes**);
3. Please do not remove tags of the type <ESMA\_QUESTION \_MIC3\_1>. Your response to each question has to be framed by the two tags corresponding to the question.
4. If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
5. When you have drafted your response, name your response form according to the following convention: ESMA\_MIC3\_nameofrespondent\_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA\_MIC3\_ABCD\_RESPONSEFORM.
6. Upload the form containing your responses, **in Word format**, to ESMA’s website (www.esma.europa.eu under the heading “Your input – Open Consultations” -> Consultation Paper on guidelines on conditions and criteria for the classification of crypto-assets as financial instruments”).

**Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

**Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading [Legal Notice](http://www.esma.europa.eu/legal-notice).

**Who should read this paper**

# All interested stakeholders are invited to respond to this consultation paper. In particular, ESMA invites crypto-assets issuers, crypto-asset service providers and financial entities dealing with crypto-assets as well as all stakeholders that have an interest in crypto-assets.

**General information about respondent**

|  |  |
| --- | --- |
| Name of the company / organisation | Research and Education |
| Activity | Non-financial counterparty |
| Are you representing an association? |[ ]
| Country/Region | UK |

**Questions**

1. **Do you agree with the suggested approach on providing general conditions and criteria by avoiding establishing a one-size-fits-all guidance on the concepts of financial instruments and crypto-assets or would you support the establishment of more concrete condition and criteria?**

<ESMA\_QUESTION\_MIC3\_1>

It seems reasonable to have general conditions and criteria that steer clear of creating one-size-fits-all guidance on financial instruments and crypto-assets, especially when considering the principle of prioritising 'substance over form.' This becomes particularly important due to the potential complexities in classifying crypto tokens as either MiCA crypto assets or MiFID II securities. These complexities arise from the hybrid nature and multifaceted functionality of certain tokens, as well as certain securities-related characteristics being derived from a token’s byproduct and secondary mechanisms rather than being inherent to the token itself.

<ESMA\_QUESTION\_MIC3\_1>

1. **Do you agree with the conditions and criteria to help the identification of crypto-assets qualifying as transferable securities? Do you have any additional conditions and/or criteria to suggest? Please illustrate, if possible, your response with concrete examples.**

<ESMA\_QUESTION\_MIC3\_2>

Applying the existing MiFID II criteria for transferable securities to a specific subset of tokens in DeFi suggests that they may be classified as neither a MiCA crypto asset nor securities under MiFID II.

Many crypto assets, especially in the DeFi sector, do not confer any rights in their inherent or transferable form. An example of this is the VE tokenomics created by the Curve protocol, which is a token design model widely utilised in the DeFi sector. Taking the CRV token as an example, it confers no inherent security-like benefits in its liquid, tradable, and transferable form outside of the right to attain such benefits by taking on some additional risk. The characteristics that could be associated with securities, such as governance or profit redistribution, are only obtained by locking CRV to receive veCRV (vote-escrowed CRV), an action that renders the CRV tokens illiquid for a duration of time. The process applies time-based weighting to derive the veCRV balance, which then determines the staker's voting power and their share of protocol profits. The longer CRV is staked, the greater the voting power and potential profit share.

Notably, veCRV is not a token per se, but rather a specific user state within a smart contract that cannot be traded on capital markets or transferred between users. The non-liquid nature of veCRV and its desirability for influencing governance on the Curve platform have led third-party protocols, such as Convex, to create layers of composability with Curve. This allows users to stake their CRV and receive a liquid representation of veCRV known as cvxCRV (convex CRV). Through this system, staked CRV on Convex is used to acquire veCRV, positioning Convex as a major influencer over Curve's governance. Stakers on the Convex platform receive some additional benefits for facilitating this undertaking. The cvxCRV token aims to be pegged 1:1 with veCRV but may trade at a discount in the on-chain market by virtue of it being a liquid representation of veCRV.

So, while CRV inherently possesses no characteristics that would be akin to that of a security as per the definition, its non-negotiable, non-transferable representation (veCRV) does. The full set of requirements from the guidelines becomes relevant to CRV only when it is staked for cvxCRV, which is issued by an entirely separate entity. In practicality, classifying  CRV or similar tokens poses challenges. Classifying them based on their inherent form may suggest that they are utility tokens under MiCA. If we were to take into account their substance instead and classify them as MiFID II securities, we would need to apply the classification on the tokens’ byproduct (i.e veCRV) which does not meet the criteria of a transferable security.

It is also important to note that, while some tokens may exhibit characteristics akin to those of a security, they may also possess other characteristics that negate this definition as per the guidelines. Namely, their fundamental purpose as a means of payment. For example, many Layer 1 blockchain tokens such as ETH are used as a means of payment to facilitate transactions on the Ethereum blockchain while also providing ETH holders with the option to participate in Proof of Stake and receive a yield in ETH.

<ESMA\_QUESTION\_MIC3\_2>

1. **Based on your experience, how is the settlement process for derivatives conducted using crypto-assets or stablecoins? Please illustrate, if possible, your response with concrete examples**

<ESMA\_QUESTION\_MIC3\_3>

It is crucial to recognize that, while smart contracts embed predefined logic for transactions, they are not inherently self-executing and typically require an external trigger. Furthermore, the inherent fragility in the DeFi ecosystem has significant bearing on the settlement of derivatives in DeFi which necessitates continuous calibration of protocol parameters and the establishment of contingency measures to maintain settlement integrity. The reliance on accurate oracles, the available on-chain liquidity for specific tokens, the potential impact of settlement-related trades on market prices, and the general preference for incentive-based settlements (e.g., a liquidation process that rewards liquidators with fees), and over-dependence on a single entity introduces significant risks to participants and presents complex design and governance challenges for developers.

In the context of derivatives, like European options, there can be a dependence on third parties, referred to as ‘keepers’, to facilitate settlement. DeFi protocols with options-based instruments may employ keepers — on-chain entities compensated for triggering a function at a specified time or event. For instance, the seller of a call option might deposit 1 ETH into an options vault at a strike price of $4,000, while the buyer pays a premium for the right to purchase this ETH. At expiration, the keeper is tasked with executing the settlement function; if the option is 'in the money' (say ETH is valued at $4,500), the buyer receives 500$ worth of ETH and the seller is left with 4,000$ worth of ETH (cash settlement). This system still depends on oracles for accurate pricing, and protocols may vary in their settlement mechanisms. The cost for a keeper's service depends on the gas price at the time of settlement plus a profit margin, which can be unpredictable, leading protocols to implement a range of heuristics and design considerations. There are also risks with a keeper ecosystem failing to execute.

For perpetual contracts and other collateral-dependent instruments, liquidation processes are in place to ensure the integrity of settlement. A primary concern is the calibration of parameters — from funding rates to liquidation thresholds — as miscalculations can lead to losses for liquidators, ultimately resulting in liquidation failures, default and systemic risk in the DeFi ecosystem. Most derivatives in DeFi are cash settled but complex innovations in the DeFi space (i.e, Pendle and Panoptic protocol) introduce intricate designs especially concerning settlement.

<ESMA\_QUESTION\_MIC3\_3>

1. **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 conditions, criteria and/or concrete examples to suggest?**

<ESMA\_QUESTION\_MIC3\_4>

The described instruments in the MiFID II appear to encompass the broad set of possible securities instruments in the digital asset landscape, and the criteria for each seem reflective of the complex nature of crypto-assets. However, difficulties in classifying tokens may arise in instances where certain instruments exhibit multifaceted characteristics.

In DeFi, many of the money market tokens issued as certificates of deposit into lending pools share characteristics of 'money markets,' 'units of collective investment,' and 'derivatives,' as per the criteria. However, they often don't meet all the criteria for each category. Type A money market tokens represent a share of pooled liquidity used to facilitate loans at a floating interest rate, algorithmically adjusted to manage liquidity risk. According to the 'money market' criteria, such tokens do not have a maturity/residual maturity (Article 3 of Commission Directive 2007/16/EC); rather, the yield is perpetual and accrues to the token as long as it is held. The token's value accrual comes from the floating interest rate charged on new and existing debts. When pooled liquidity is abundant, the interest rate is low to encourage new debts, and when liquidity is scarce, the interest rate is high to encourage repayment of existing debts and new liquidity deposits. So, while these instruments undergo regular yield adjustments in line with money market conditions (Article 3 of Commission Directive 2007/16/EC), they are not bound by maturities and may also allow holders to participate in governance processes geared towards calibrating interest rate parameters and other factors affecting the risk profile of the pool. This criterion also points to another consideration: Protocols that have achieved sufficient decentralisation, exhibiting community ownership, where investors/participants have significant (or absolute) control over the operations related to certain instruments and offerings, raise the question of who the manager of the undertaking.

Similarly, Type B tokens satisfy both 'money market' and 'derivative' criteria. They originate from Type A tokens, which are used as collateral to engage in interest rate swaps through protocols such as Pendle, resulting in a token similar to a zero-coupon bond. The settlement of these instruments is consistent with the criteria for derivatives.

Generally, the criteria for derivatives seem sufficient to address the DeFi landscape, although the multifaceted characteristics of certain crypto tokens across the 'instrument' categories, coupled with the need to reach a classification based on 'substance over form,' may prove cumbersome and complex.

<ESMA\_QUESTION\_MIC3\_4>

1. **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.**

<ESMA\_QUESTION\_MIC3\_5>

We generally agree with the suggested conditions and criteria to differentiate between MiFID II financial instruments and MiCA crypto-assets, as they allow MiCA to maintain an effective scope that is complementary and compatible to the existing regulations imposed by MiFID II.

The practical complications tend to arise from the governance and income rights associated with crypto-assets and the structure of the corresponding platforms or services. The line between MiFID II financial instruments and MiCA crypto-assets may become blurred when crypto-assets are entitled to governance rights and incomes related to decentralised platforms, in particular those named as decentralised autonomous organisations (DAOs). In practice, a self-declared decentralised platform is often first founded by a company, which tends to hold more concentrated governance over the platform through their core management team at the beginning. In the setting of a platform, issued tokens usually carry certain governance powers over the platform, including the distribution of incomes from the platform and set-ups of advisory committees. It can thus be controversial on whether the token holders are essentially entitled to the company’s profits and corporate policymaking. The relationships between the company, the token holders and the platform (or any other services) should be examined from perspectives including legal structures and corporate governance. Accordingly, governance and legal independence of the founding company from the other crypto-asset holders should be key criteria for examining whether a MiCA crypto-asset should be classified as a MiFID II financial instrument.  In that direction, as MiCA does not aim to regulate fully decentralised crypto services, concerns emerge regarding how to determine the extent of decentralisation and whether some exotic products like DeFi lending can be sufficiently covered in the two frameworks.

The practical complexities also imply that the authorities need to develop a holistic approach on evaluating whether any MiCA crypto-asset is an MiFID II financial instrument, considering criteria such as the comparability of a self-claimed decentralised platform to a company and the practical utilities of the platforms’ native tokens as compared to traditional company shares or other financial instruments.

<ESMA\_QUESTION\_MIC3\_5>

1. **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 conditions and/or criteria to suggest? Please illustrate, if possible, your response with concrete examples.**

<ESMA\_QUESTION\_MIC3\_6>

We generally agree with the broad principle of “substance over form” suggested for determining the uniqueness and non-fungibility of attributes for an asset. That being said, the suggested conditions and criteria involve potential complications.

**Value interdependency among NFTs:** It will be empirically challenging to evaluate the degrees of value interdependency that is targeted at measuring the fungibility of an asset. Even if the NFTs are not from the same collection or same creators, they can have highly correlated values in reality. For example, the nature of being an NFT itself can lead to similar or even nearly synchronous market behaviour in trading and speculation. Then this leads to empirical challenges on how to disentangle the more systematic and “interconnected value dynamics” from those idiosyncratic characteristics related to an NFT. More nuanced differences should be addressed when identifying the value interdependency. An example is that two assets can have similar price or value changes but they trade at significantly different levels. They definitely have value interdependency to a certain extent but they are hardly interchangeable in practice.

**Utilities versus other specific attributes:** The perspective raised in the consulting paper can be argued alternatively: While an NFT with an utility is more homogeneous with other NFTs carrying the same utility, it is simultaneously more heterogeneous from those without this particular utility. Thus, the uniqueness or rarity of a specific utility also decides whether an NFT is functionally interchangeable with other NFTs. As per the guidelines, “the specific attributes of the NFT become less relevant compared to the utility it provides, making different NFTs functionally interchangeable for practical purposes”, seeming to imply that functional homogeneity may outweigh other attributes. Note that it is common that NFTs can have no utilities except for being artistic collectibles. Following the same logic as raised in the guidelines, we may argue that these NFTs are more interchangeable in a sense, but this argument may be unsound to market participants. Functional homogeneity does not necessarily trump other attributes such as artistic attributes and rarity from the market’s perspective. For instance, all the collectibles in the CryptoPunk series have barely any utilities in themselves but they trade at substantially different prices simply due to rarity. The rarest nine collectibles known as the “alien punks” can hardly be viewed as interchangeable with other collectibles in the same collection.

Based on the above discussions, we may improve the assessments by explicitly covering the following conditions and criteria:

**Uniqueness or rarity in the overall combination of attributes and/or functions:** In practice, an asset unavoidably shares some common features with other assets to a certain extent. Thus, the source of uniqueness or rarity of an asset tends to be more related to the overall combination of attributes and/or functions. It can be treated as one the most critical criteria in determining the uniqueness of an asset. This criterion can also be covered explicitly in the “interdependent value test” as suggested in the Guidelines.

**Market information:** Assets’ values can essentially lie in the markets’ collective judgements, which may even look inconsistent or incompatible with existing frameworks that are designed based on past experiences and theoretical principles. Historical price and trading behaviour are thus also key references for evaluating assets’ homogeneity from the market’s perspective. The example of CryptoPunk mentioned above is a case in point. The market activities of some collectibles in this collection tend to deviate from the remaining ones, and we may conclude only after they have been trading for some time on the market. This may also lead to complications concerning whether the authorities can fully justify the nature of an asset a priori. At the very least, the assets that have been trading on the market can provide more relevant information on their nature of uniqueness.<ESMA\_QUESTION\_MIC3\_6>

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

<ESMA\_QUESTION\_MIC3\_7>

For compatibility with the existing regulations imposed by MiFID II, we agree with the hierarchical approach to have the classification of financial instruments as the precedent factor.

The broad types and uses of crypto-assets tend to be intuitive to understand in the majority of cases. Still, it can be uncertain whether they deliver the functions as claimed by the entities designing and launching them. The relevant entities may be required to submit evidence and proofs regarding their real uses, including but not limited to the on-chain transaction records, codes, whitepaper designs and community viewpoints. Judgements on whether a crypto-asset is hybrid in nature should be mostly based on its currently available uses instead of theoretical claims and historical uses. Guidelines may require the entities to regularly disclose the usage data with respect to every token functionality for public verifications and further classifications, for example, the frequency of payments, the staking amounts and the voting activities.

It makes sense that broad classifications, such as utility, governance, payments and securities, are sufficient for defining the essential nature of a crypto-asset from a regulatory perspective. Common functions identified in each broad category can be further used for matching with individual crypto-assets, such as treasury management under the governance type and payment for gas fees under the payment type. A basic taxonomy can be developed and updated for accommodating common current uses and future evolvements.

<ESMA\_QUESTION\_MIC3\_7>