

# Cryptoassets: are regulators on the curve?

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## 1. Current state of the cryptoasset market and ongoing trends

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Answering a question from the Chair about the recent downturn in the crypto market and the potential for improvement of cryptoasset valuations, an industry speaker acknowledged that crypto is currently in a 'bear market', which affects both investors and cryptoasset service providers (CASPs). The current market conditions are similar to a stress test. Several business failures have occurred, but these are isolated problems that have mostly affected certain decentralised finance (DeFi) platforms. Crypto remains an attractive investment opportunity. Bitcoin is a true scarce resource, and crypto offers diversification. The idea is not to substitute traditional assets for crypto, but to diversify by investing in crypto in addition to traditional assets.

A second industry representative noted that 'crypto winters' are inevitable in such an early-stage market and technology. This can be challenging for newcomers to crypto investment, but the latest downturn is an opportunity for more experienced market participants to consolidate their positions. There are three main lessons from the recent downturn. First, crypto markets are more correlated to the broader financial markets than previously thought. Two-thirds of the current downturn can be attributed to macro conditions and one third to crypto specific conditions. This reflects the maturation of the cryptoasset class and the breadth of adoption. Secondly, despite the sudden downturn since the peak of November 2021 and some sporadic dislocations of CASPs, the technology has proven resilient and most platforms have operated in a resilient manner. There has been an increasing adoption of stablecoins, particularly those that are well managed and well backed, which proves that the market is responding positively to improvements put in place by the main crypto players. At the same time, there has been a beneficial shake out of market participants and business models with poor risk management, such as some of the algorithmic stablecoins. Thirdly, the adoption of crypto continues. A partnership has been recently concluded between the speaker's firm, a major CASP, and a global asset manager to facilitate the provision of cryptoassets to institutional investors for example, showing a continued interest in the market for this asset class.

An official emphasised that monetary policy is one of the factors affecting the crypto market at present. The ongoing normalisation of monetary policy makes investors recalculate the risk reward ratio on certain assets and certain investors switch back to more traditional assets. There has been rapid development of the crypto market in several EU member states over recent years. In 2021 Europe emerged as one of the leading regions for DeFi. In Lithuania for example, the number of new CASPs coming

into the market has grown from 8 in 2020 to 188 in 2021, with significant growth also observed at the beginning of 2022. This growth in the EU market is happening despite the fragmented regulatory landscape within the Union. When the European level Markets in Crypto-Assets (MiCA) regulation comes into force, that will be a solid basis for a pan-EU market to develop and for the EU to become a leading region for crypto. While some firms are trying to avoid regulation and exploit loopholes, others are seeking the certainty it offers.

A regulator observed that crypto is primarily a technological development and it can have different uses. So far this technology has mainly been used for developing investment assets, but this is not its only use case. When assessing the potential of crypto it is necessary to examine the different use cases of crypto technology and identify those that can bring most value to the market. The first industry speaker considered that the phase of speculation and investment through which the crypto market has first gone through is normal. It was needed to enable the industry to generate sufficient investment capacity and provide a basis for future innovation and growth. This should enable the industry to move into a second stage of evolution and develop larger scale payment and money transmission services and other financial services customers can benefit from.

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## 2. Opportunities and risks from cryptoassets

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### 2.1 Opportunities and future prospects

An industry speaker emphasised that crypto's potential is what makes it attractive. The speaker's company, a major CASP, is using the relative calm of the bear market to enhance their platform, improve consumer protection features and prepare for new innovations in the market. There are significant changes happening around the infrastructure of the crypto market, such as the Ethereum platform moving from proof of work to proof of stake for approving new transactions in September 2022, the so-called 'Merge', which promises to dramatically cut the energy requirements of the blockchain and help tackle scalability issues.

The industry speaker expected that new projects and opportunities supported by crypto technology will continue to emerge. A key future evolution is Web3, which will facilitate the exchange of value through the internet with no intermediaries or third parties. Such a technology can potentially bring more transparency and efficiency to financial flows and processes. Additionally, the transportability of title ownerships can be done through non fungible tokens (NFTs). This can open the way to a multitude of new use cases of crypto technology beyond

investments and payments leading to potential improvements in the way financial markets operate.

The Chair noted that during the energy crisis in the early 1970s with double-digit inflation there were discussions about allowing private currencies to compete with national ones. Similarly, the present context should support the development of crypto as a private currency, but this has not yet happened. The industry speaker responded that crypto is a medium of exchanging value. If crypto is properly supervised and regulated and follows a common set of rules across markets, there is no reason why it could not be used as a currency.

Another industry representative agreed that the use cases of crypto are manifold and will eventually cover a number of different applications, including use as a form of payment. In a digitised society, it is critical for citizens to be able to manage their wealth and their assets in a digitised form. Crypto provides that opportunity through the use of stablecoins. It is essential that policymakers allow this evolution to occur. Many developments are happening in the market such as the Ethereum Merge and venture capital is continuing to flow into crypto projects, which is clearly a positive sign.

## 2.2 Challenges and risks from cryptoassets and related regulatory objectives

A regulator explained that supervisors have long been concerned about the risks posed by crypto as financial assets. The EBA has issued many warnings to banks about the risks of holding these assets and recommending them to their customers as investments and also about their potential illegal use for money laundering. While crypto technology offers traceability and transparency features, the speed of transactions and the lack of AML/CFT checks until now, reinforced by the decentralisation of certain platforms and pseudo-anonymity used on some of them have also encouraged misuse. Warnings have also been issued by regulators to the retail customer base regarding the risks of fraud and the high volatility of these assets. These risks illustrate some of the important loopholes in the current regulatory approach that need to be tackled. In the future it is likely that there will be a shake up in the crypto market, as with any innovation, allowing a sorting out of the good and bad business models and products. The regulatory framework must ensure that the market converges towards the most beneficial use cases and that the more risky or less useful ones are limited or banned.

An official agreed that, as with many innovations, cryptoassets bring both opportunities and risks. It is up to policymakers and regulators to build a regulatory and supervisory framework that minimises the risks and fosters a sustainable development of the sector, leveraging the potential of the underlying technology.

Another official observed that the recent crypto crash has highlighted the basic failure of the market around some very fundamental requirements of prudential regulation and risk management. There were firms which, if not outright fraudulent, had little to no risk management in place. It is natural that some of these firms eventually failed, and there is no need to overreact to this. This may not have happened had they been following some basic risk management requirements.

## 3. Ongoing regulatory initiatives at the EU and international levels

### 3.1 The EU regulatory approach to crypto: Markets in Crypto assets (MiCA) and Anti-Money Laundering (AML) rules

A regulator explained that MiCA is in the final stages of adoption and will come into effect in the second quarter of 2023. It imposes requirements on CASPs and regulates the issuance of cryptoassets, identifying two main categories: asset referenced tokens, i.e. stablecoins that claim to be stable vis-à-vis other assets and are fully backed by a reserve of assets, and e money tokens, i.e. cryptoassets perceived as investments and unbacked stablecoins. Concerning asset-referenced tokens, criteria for evaluating their criticality to the financial system are due to be established and the most significant ones are due to be supervised at the European level, as well as their issuers. These criteria will cover different aspects, such as the total market capitalisation, the significance of cross-border activity, the importance for the payment system and the level of interconnectedness with the financial system, and will be further specified by technical standards. In addition to MiCA, the EU AML package has been updated to cover cryptoassets and it is expected that crypto will be within the regulatory perimeter of the new AML authority. The Transfer of Funds Regulation (TFR) information requirements are moreover being extended to transfers in cryptoassets. The combination of MiCA and the reviewed AML and TFR packages should contribute to creating confidence in the crypto market and fostering financial stability, while allowing the industry to continue innovating and growing.

Concerning stablecoins the regulator noted that some issues remain to be addressed as part of the implementation of MiCA. This includes ensuring that a stablecoin can be used without interfering with the transmission of monetary policy, which is a fundamental part of the payment system. If this is not the case, central banks will seek to ensure they can maintain a certain amount of control.

An official welcomed the political agreement on the MiCA framework and the updates to the AML package and TFR regulation. With such a bespoke regulatory regime, the EU has the potential to become one of the leading global jurisdictions in crypto. This will bring crypto into the regulatory perimeter, which has not yet been done in a major jurisdiction. The regime should provide a sound framework within which CASPs can develop new business models likely to bring added value to the market and this will enhance user protection and certainty in the market, as well as foster a level playing field with traditional finance.

The official emphasized that despite the progress being made on the EU crypto regulatory framework, an important caveat is that it will most likely only come fully into effect in 2025. This means that most of the industry will continue to operate for two more years under the currently fragmented and imperfect framework, period during which considerable growth is expected in the crypto segment. Lithuania has decided to anticipate this evolution with an enhancement of its domestic regulatory framework in line with the future MiCA and AML requirements, in order to provide the competent authorities with the ability to mitigate the risks from crypto

activities mounting in the market and enhance Lithuania's position as a regional fintech hub. The measures taken aim at increasing transparency, trust and investor protection. Capital requirements for CASPs have been raised; reputational requirements have been introduced, as well as more thorough customer identification procedures, including a prohibition of anonymous accounts. A public list of all CASPs operating in Lithuania has been established. However, the domestic regulatory changes do not go as far as MiCA in some important respects, for instance with regards to the establishment of a licencing regime for CASPs.

An industry representative commended the European authorities for the adoption of MiCA. Providing a single rulebook in Europe for the whole cryptoasset market covering 27 member states and 550 million consumers and providing a specific framework that aims to recognise the specificities of the crypto technology, rather than simply adopting technology neutral approach is a major achievement. In particular, the rules around CASPs are thoughtfully defined and should encourage crypto market players to request licences and build their operations in Europe around this new framework. There are however concerns around the rules for stablecoins, the emergence of which will be significantly restrained by MiCA. Europe has made a decision about store of value cryptoassets in MiCA which may be questionable at an early stage of adoption of these assets in the European market, given the importance of providing citizens with solutions for managing their assets in an increasingly digitised world. It is expected that the discussion around Level 2 standards will shed some light on the ultimate impact of the ruleset, particularly concerning stablecoins. This will require thorough assessment and dialogue between the relevant public and private stakeholders in the months ahead. Additionally, the FTR regulation has landed in a good place, though there will need to be further discussion on self hosted wallets and their implications for individual users.

Responding to a question about whether regulators are on the curve in the area of crypto, the industry representative stated that this is a difficult issue. One approach is to consider the vast amount of innovation occurring and expecting the authorities to regulate each increment of innovation as it happens. An alternative approach is for regulators to take proportionate action only when risks materialise and if there is an imperative for them to intervene.

Another industry speaker suggested that MiCA and the updated AML / FTR rules should be implemented at the same time. Otherwise, there could be different Know Your Customer (KYC) standards across markets, creating frictions for consumers and firms due to differences e.g. in onboarding processes. The rules for crypto should be consistent with those for the traditional financial system in order to achieve an interoperability between the two, since cryptoassets should gradually become part of the financial system and not remain as a parallel system. Additionally, it is important to remember that the FTR will apply to business to business (B2B) transfers as well as consumer to consumer ones. The rules for B2B transfers need to be clarified, notably concerning interoperability within the EU

and at the international level, in order to be able to manage such transactions in an effective way under AML requirements.

An official considered that MiCA brings much certainty and clarity. The regulation makes an important distinction in particular between the tokenisation of real assets or existing financial instruments and truly novel or native cryptoassets, which is quite a new approach.

### 3.2 The regulatory approach to crypto in other key jurisdictions: Japan and the United States

An official explained that the Japanese regulatory framework for crypto was created in response to cases of hacking and the spread of speculative transactions. For several years, cryptoassets have also faced questions about anti money laundering and countering the financing of terrorism (AML/CFT). The basic ideas of the Japanese framework are similar to MiCA, but there are differences. This framework has increased the level of certainty and as a result, there has been less speculative trading, no significant 'crypto winter' and fewer service provider failures in Japan. There is nevertheless a constant evolution in the types of services provided by CASPs and the new technologies and services being developed by them, with which regulators and supervisors need to keep up.

In 2019, Japan introduced a regulatory framework concerning cryptoassets other than stablecoins in order to enhance user protection, including the protection of user assets and the provision of sufficient information to users. Cryptoasset exchange serviced providers, including custody service providers, are subject to regulatory and supervisory rules and are required to maintain proper internal control systems. Japanese CASPs are also required to put in place a proper segregation of assets and audited financial statements and to maintain system security in order to preserve client assets. Following several major hacking incidents, CASPs are required to manage cryptoassets deposited by customers in an offline environment, a so called cold wallet. In terms of information provision, CASPs are also subject to advertising and solicitation regulations and prohibited from deceptive advertisement as well as solicitation enticing speculation. Furthermore, in order to avoid highly leveraged speculative transactions, a minimum margin of 50% is required for CFD transactions by retail users.

Japan has also amended the law to provide a regulatory framework for money type stablecoins which are or claim to be linked to a fiat currency<sup>1</sup>. The main objective of these amendments, which will come into force in June 2023 are to mitigate financial stability risks, since stablecoins are susceptible to runs. To address these risks, only banks, fund transfer service providers and trust companies will be entitled to issue stablecoins. These institutions will be subject to specific requirements to ensure redemptions. Banks issuing stablecoins as deposits will be subject to prudential regulations and stablecoin holders will be protected by deposit insurance in the same manner as conventional bank deposits. Fund transfer service providers will issue stablecoins as claims on outstanding obligations and will be required to secure the obligation through either

1. Stablecoin intermediaries are subject to similar requirements to protect user assets as cryptoasset intermediaries. In addition, they are required to enter into contractual agreements with issuers that stipulate the sharing of liability for losses in order to ensure proper coordination between the issuers and intermediaries in case of accidents.

money deposited with official depositaries, bank guarantees or segregated safe assets such as bank deposits and government bonds. Trust companies will issue stablecoins as trust beneficiary rights and will be required to hold their trusted assets in the form of bank deposits only. Moreover, under the Japanese regulatory framework, tokens that do not meet the above requirements are categorised as cryptoassets and not money-type stablecoins. In this case, CASPs are subject to advertising solicitation regulations and are required to explain the risk of price fluctuations to customers, even though some of them may be labelled as stablecoins. They may handle these so-called stablecoins, but they must explain that their prices will not necessarily be stable. As of now, DAI is the only token, or so-called stablecoin, circulated in Japan.

Another official observed that the United States does not have specific legislation for the crypto space at this stage, and in an election year, it is unlikely that a comprehensive legislative package will emerge. However, the right pillars have been established to create the regulatory certainty that is needed in the crypto market. In 2015, the CFTC established that Bitcoin is a commodity under the CFTC's jurisdiction for commodity derivatives. In 2017, the first Bitcoin futures were listed, which were followed by Ethereum futures and other products. These are all regulated, listed on exchanges and managed by regulated entities. There have been debates about whether cryptoassets are securities or commodities, but given the very broad definition of commodities under US laws, if an instrument is not clearly a security, then it can most probably be considered as a commodity and fall within the scope of the CFTC. The CFTC has a broad anti fraud and anti manipulation authority over spot commodities, and Congress has given the CFTC the authority to provide direct regulation and oversight over certain spot products, including retail foreign exchange and retail leveraged commodity transactions such as precious metal transactions on margin using leverage. These are two areas where the CFTC can use its existing authorities to consider what else might be done to provide retail protections.

There are also several legislative proposals currently underway in the United States. One of these which has captured considerable attention is Senators Lummis and Gillibrand's Responsible Financial Innovation Act<sup>2</sup>. Regulation on digital assets has also been implemented by several states, such as the BitLicense, a business license for virtual currency activities created by the New York State Department of Financial Services. Finally, the regulatory authorities in the US, particularly the bank regulators, have a broad range of tools to use in order to provide certainty, clarity and user protection in the crypto sector with respect to banking activities.

Concerning stablecoins there is an ongoing debate in the US about whether a stablecoin is a specific cryptoasset or a technology wrapper around an existing type of currency or a financial product or service i.e. a central bank digital currency (CBDC), if it becomes available, or tokenised commercial bank money. There may be a wrapper around it but in effect this would still be in effect fiat currency or commercial bank money.

The US also believes, as the EU, that taking a technology neutral approach to regulation is essential. The US CFTC's principles based regulatory framework is in essence technology neutral. It is also important to have future proof or evergreen regulations because it is very difficult to anticipate every future technological development.

A participant invited the panellists to comment on the different ways to interpret cryptoassets – i.e. whether they are a commodity, a security, a deposit – and how this influences the way they should be regulated in relation to deposit insurance, consumer protection, securities regulation and payment systems. An official suggested that the nature of financial instruments depends on how they are structured and this will determine the product's legal and regulatory treatment. This is the case for synthetics for example. While it makes sense to consider different alternatives, there is plenty of space within the securities and commodities regimes to cover all the various crypto financial products. In addition, if certain cryptoassets were to be treated as banking products, for example, that would require the regulators to consider monetary policy, bank runs, credit creation and the prospect of extending the US federal safety net over them.

### 3.3 Global consistency issues

An industry speaker stressed that a key challenge for the industry is the growing diversity of the regulatory approaches to the crypto space at the international level. Two different trends can be observed in the crypto industry as a result of this. First, certain companies are following a trend of avoidance, i.e. they wait until the last moment to adjust their processes or they operate from less regulated jurisdictions. Secondly, the more established companies are looking for certainty, i.e. obtaining licenses and following regulatory requirements in order to grow and reinforce user trust. The cross border nature of many crypto companies makes it crucial to move towards more regulatory consistency, predictability and interoperability.

An official emphasised that cross border aspects are very important for cryptoassets. A cross border stablecoin requires a solid regulatory framework in the home jurisdiction of the stablecoin and also in other jurisdictions. In addition, there must be a mechanism for cross border resolution and user protection. Until now the practical application of such principles has not been further considered because Japan was the only major jurisdiction to have a legal framework in place regarding stablecoins and other cryptoassets. As MiCA is progressing, now is the time for regulators and supervisors around the world to think more about the cross border aspects of regulation.

A regulator noted that the cross-border nature of these products requires addressing the cross border aspects of regulation. The number of jurisdictions with a stabilised regulatory framework for cryptoassets is still limited, but there is a need to start building a cross-border regulatory dialogue. It will require a forum involving national competent authorities from different jurisdictions and defining new ways of collaboration with other authorities, such as those handling AML and ICT risks.

2. Senators Lummis and Gillibrand introduced in June 2022 the Responsible Financial Innovation Act, a bipartisan legislation that would create a complete regulatory framework for digital assets that encourages responsible financial innovation, flexibility, transparency and robust consumer protections while integrating digital assets into existing law.