What the EU's new MiCA regulation could mean for cryptocurrencies

The EU is currently in the process of negotiating a new regulation on crypto-assets. **Firat Cengiz** *explains the scope of the regulation and what it could mean for the crypto market in Europe.*

The cryptocurrency market has been experiencing arguably its most eventful bull run since the Bitcoin halving of May 2020. More institutional actors and ordinary citizens than before have invested in cryptocurrencies during this period.

The increasing popularity of cryptocurrencies has resulted in more intense regulatory scrutiny. Governmental and regulatory approaches to cryptocurrencies across the globe differ significantly. At one extreme, El Salvador has passed a law to declare Bitcoin legal tender, while at the other extreme, China – the country with the highest concentration of Bitcoin miners – has initiated a mining crackdown.

In the meantime, the European Commission's proposed Regulation on Markets in Crypto Assets (MiCA) is going through its first readings in the Council and the European Parliament. This regulation *will* form part of the EU's Digital Finance Strategy and is likely to significantly impact the operation of the crypto market in the EU. It is a complex (and 168-page-long) regulation, whose effects require extensive discussion.

The scope of the regulation

First and foremost, the regulation does not apply to the blockchain or distributed ledger technologies underlying cryptocurrencies. It does not apply to digital currencies issued by states and regulated by central banks either. All other cryptocurrencies that do not qualify as financial instruments, including utility tokens and payment tokens, fall within the scope of the regulation.

The decentralised distributed ledger technology underlying cryptocurrencies means that no single person or entity can control or compromise them. This is what makes cryptocurrencies attractive particularly to those who believe in the original Bitcoin principles of open, democratic, and decentralised monetary exchange and governance.

Nevertheless, decentralisation also means that crypto adopters cannot turn to the authorities in cases of fraud, cyber-attack or accidental loss of funds. The proposed EU regulation addresses this caveat to a certain degree by subjecting cryptocurrency exchanges (which the regulation calls 'crypto asset services') to consumer protection, transparency, and governance standards.

These changes will protect consumer funds against cyber-attacks, theft or malfunctions which are within the responsibility of the cryptocurrency exchanges. Nevertheless, the regulation leaves some crypto-specific risks unaddressed. For instance, although the regulation makes cryptocurrency exchanges responsible for the loss of consumer assets because of fraud, cyber-attack or negligence, it does not extend the requirement of compulsory insurance to these cases or accidental loss.

The regulation overregulates stablecoins

Stablecoins, alongside cryptocurrency exchanges, constitute the main focus of the regulation. Stablecoins are cryptocurrencies whose value is pegged to another asset, such as fiat money, gold, or another cryptocurrency. Stablecoins have been created to overcome the price volatility of cryptocurrencies, which stems from the fact that there is no robust mechanism to determine their real-world value.

However, this also means that, unlike other cryptocurrencies, stablecoins' value is not expected to increase exponentially over time. As a result, stablecoins are used in the crypto market for two main purposes. First, cryptocurrency owners turn profits into stablecoins in the short term with the intention of investing in other cryptocurrencies when opportunities arise, rather than turning profits into fiat money and transferring them to their bank account.

Second, stablecoins are invested in cryptocurrency exchanges or decentralised finance applications to return interest and yield respectively. The former in particular offers a safe and attractive alternative to traditional savings methods offered by legacy finance. Stablecoins can gain more than 10% annual interest compared with the 1% average offered by ISAs in the UK for which consumers will have to lock their funds away for five years.

The regulation uses peculiar terminology that is alien to the cryptocurrency market and separates stablecoins into categories such as 'e-money tokens' (stablecoins whose value is pegged to a single fiat currency) and 'significant asset referenced tokens' (determined based on the criteria listed in Article 39 of the regulation). Stablecoins (which the regulation calls 'asset-referenced' tokens) are subject to strict regulatory standards of transparency, operation, and governance. Unlike other cryptocurrencies, stablecoins need to be authorised by regulatory institutions to be traded within the EU and the authorisation requirement applies also to stablecoins already in circulation.

As a result, when the regulation comes into force, existing stablecoins will have to seek authorisation from the regulatory authorities to be traded in the EU. Most importantly, the regulation prohibits the issuance of interest to e-money tokens. There is no explanation in the regulation as to why this intrusion to financial autonomy is necessary. This prohibition will deprive European citizens of an attractive investment option, particularly considering that financial stimuli instruments adopted to limit the economic impact of lockdowns are expected to result in historically high inflation rates.

The regulation will make it more difficult for small players to enter the market

The crypto market is more egalitarian than other investment markets (such as the stock market) because it does not suffer from similarly high entry barriers. It is relatively easy for ordinary citizens to invest in cryptocurrencies without being subject to accredited investor standards which privilege investors with deeper pockets by giving them exclusive access to 'initial public offerings'.

Similarly, the crypto market provides a platform for low-budget and small-scale projects with a high potential to access liquidity relatively easily without being subject to legal and financial requirements. It is the responsibility of individual investors to 'do their own research' (DYOR as commonly phrased in the crypto space) to decide whether a project has got sufficient potential before investing in it. As a custom, crypto projects publish white papers (among other information resources) to declare the details of the project to help investors with that decision.

The regulation makes it a legal obligation for crypto projects to issue a white paper and submit it to the regulatory authorities, although the submission will be merely declaratory and the regulatory authorities do not enjoy the power to authorise or reject crypto projects, other than stablecoins. Nevertheless, the regulation still creates a regulatory and legal hurdle for the launch of crypto projects by, for instance, requiring them to be established as a legal entity in one of the member states.

The list of information that crypto projects are required to share with the public is relatively slim and does not include many aspects that are already customarily included in white papers. Most importantly, the regulation does not require white papers to explain the project's 'tokenomics' (the distribution and vesting schedule of tokens). From a consumer protection perspective, tokenomics is extremely important, as it informs consumers about the number of tokens held by the project team and privileged investors and how quickly these tokens can be sold in the market for profit, which can have a significant effect on the price of the token.

Finally, the regulation subjects the release of cryptocurrencies, including stablecoins, to a 'qualified investor' standard which means that individuals with a significant amount of wealth will be able to acquire cryptocurrencies earlier than ordinary citizens and without being subject to the same regulatory hurdles.

The regulation brings forward an 'Elon Musk' clause

Arguably, the crypto market has been more volatile during the latest bull run due to the increasing entrance of institutional actors with deep pockets to the market, which creates further inequality in the distribution of wealth and makes manipulation more likely. For instance, Elon Musk's continuous tweets about Tesla's stance regarding Bitcoin instigated extreme price changes. Needless to say, whether Musk personally benefitted from these price changes either due to increased demand for the Doge Coin he has been promoting or by acquiring Bitcoin at a lower price is far from certain.

Nevertheless, the so-called 'market influencers' might refrain from utilising social or conventional media to cause a decrease or increase in the price of cryptocurrencies once the regulation comes into force. The regulation prohibits such market manipulations which could be punishable with criminal remedies depending on the applicable national law. On the issue of market power, the regulation also prohibits the acquisition of a dominant position in crypto markets, which is interesting considering EU competition rules prohibit the abuse of dominant position, rather than its existence or acquisition.

The regulation adopts an enforcement model with decentralised and centralised elements

The regulation follows a similar model to that of EU competition law enforcement under Regulation 1/2003. It will primarily be enforced by national regulatory authorities designated by the member states. National authorities will employ national procedural rules and impose remedies foreseen in national law, including criminal remedies where applicable, when they enforce the regulation.

Although it follows a decentralised enforcement model, the regulation also gives the European Banking Authority and the European Securities and Markets Authority significant supervisory and investigative powers. Similarly, the European Central Bank will be involved in the approval procedure of stablecoins with a non-binding opinion, which will undoubtedly be highly influential. Finally, the European Commission has significant authority to determine further details of the regulation by adopting delegated acts.

The decentralised enforcement model foreseen in the regulation is likely to result in forum shopping, as crypto projects will be likely to adopt the member states with the most efficient and crypto-friendly authorities as their home state. It is expected that the European Commission will establish a network between the regulatory authorities (similar to the European Competition Network) to prevent forum shopping and facilitate cooperation in cross-border enforcement.

How will the regulation affect the crypto space?

Cryptocurrencies are at present largely unregulated in the EU. This potentially causes certain harms to consumers, including accidental or fraud-related loss of funds or investment in so-called 'pump and dump' projects whose only purpose is to increase the wealth of a handful of privileged individuals. As a result, consumer protection standards adopted in the regulation are welcome, although these will not provide protection against all of the risks associated with cryptocurrencies. Individuals' own knowledge and analyses will therefore continue to be the key methods of consumer protection.

Arguably, some aspects of the regulation regarding stablecoins, most notably the prohibition of interest, constitute an undue intrusion into financial autonomy. If adopted on a mass scale, stablecoins could jeopardise monetary institutions' ability to regulate liquidity at the expense of monetary stability. Nevertheless, mass adoption of stablecoins is very unlikely to happen soon considering their market caps are still relatively low.

With the interest ban, the EU legislator is arguably aiming to disincentivise the investment of crypto profits in stablecoins, and consequently to protect the interests of the European banking sector. This also protects the interests of national tax authorities who will find it substantially easier to monitor crypto profits if they are turned into fiat money rather than kept in stablecoins.

Finally, from a governance perspective, similar to the EU competition law model, the regulation follows an interesting mixture of decentralisation and centralisation. It will be interesting to follow how the relationships between national and EU-level authorities develop in the future and how these will affect the European crypto space.

Note: This article gives the views of the author, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: Cedrik Wesche on Unsplash

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