

MiCA – The transformational regulation for the financial services industry

EU agrees on a uniform legal framework for crypto-assets

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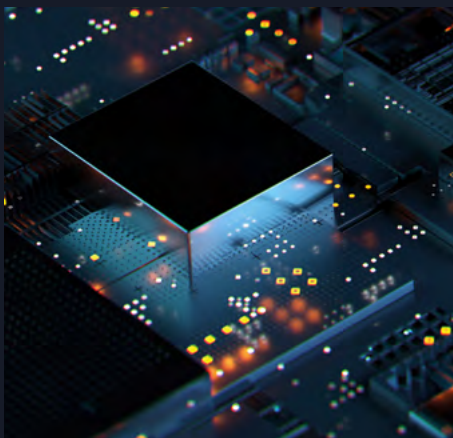
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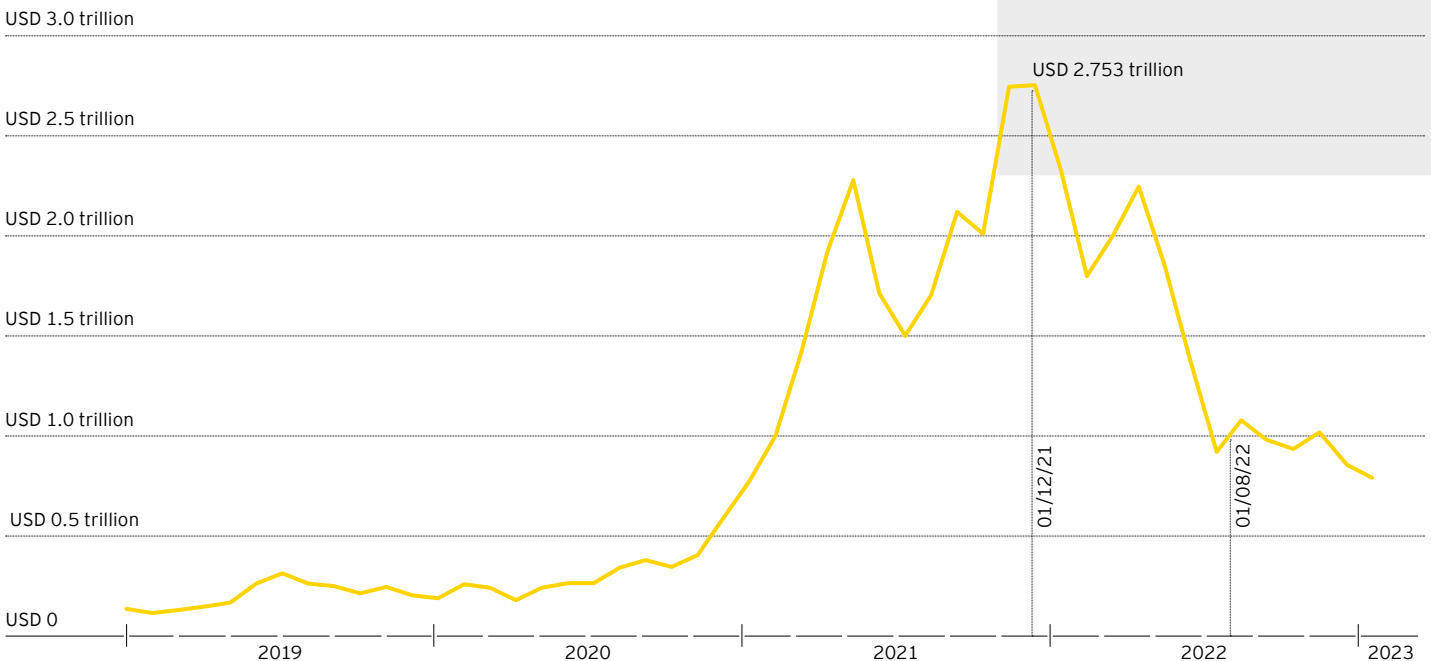
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The need for a crypto-assets regulation framework

The “Markets in Crypto-Assets” (MiCA) Regulation is expected to enter into force in Q2 2023. It creates a dedicated and harmonized regulatory framework for crypto-assets and related activities in the European Union.

The proposed regulation aims to increase protection of retail holders, market integrity and financial stability. This is an essential milestone as the crypto market has significantly grown in acceptance in recent years. While the all-time high **overall market capitalization** of cryptocurrencies in November 2021 reached USD three trillion (compared to USD 14 billion in November 2016), it currently fluctuates around USD one trillion (Mid-January 2023), as visualized in Figure 1.

FIGURE 1
Total crypto market capitalization

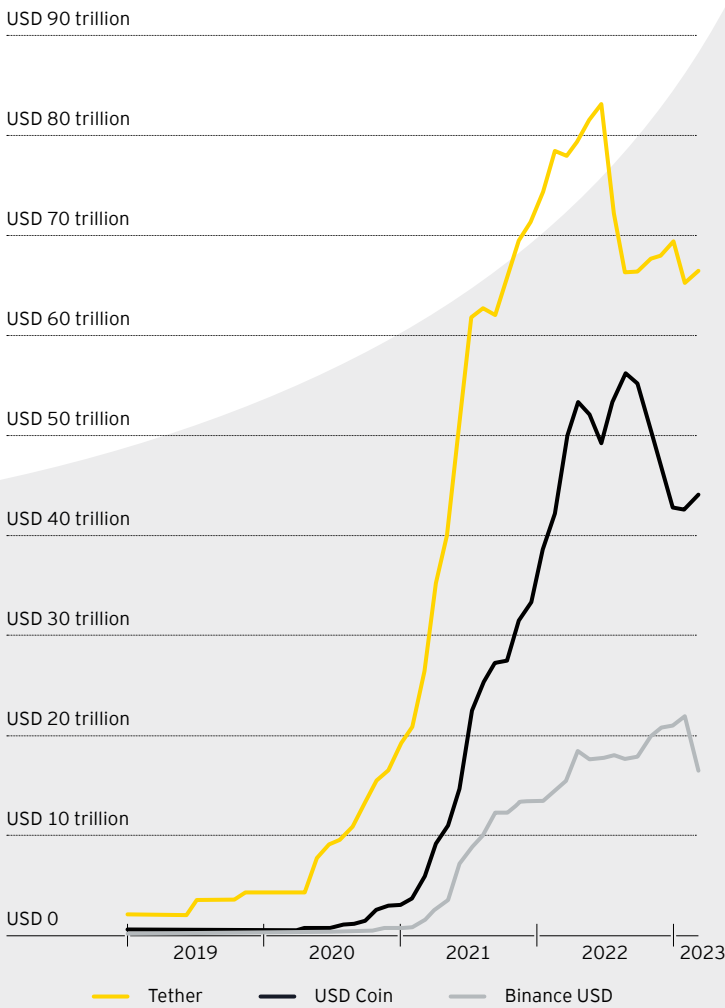


Source: <https://www.coingecko.com/en/global-charts>

Additionally, according to the data obtained from **Glassnode**, there are currently roughly one billion Bitcoin addresses (267 million in June 2017). Cryptocurrencies that are designed to minimize the volatility of the price and have a stable value, so-called “stablecoins”, have shown a

substantial increase. For instance, as illustrated in Figure 2, the all-time high market capitalization of all stablecoins (the most prominent are Tether, USD Coin and Binance USD) has reached **USD 188 billion in June 2022** (compared to **USD 108 million in June 2017**).

FIGURE 2
Top 3 stablecoins by market capitalization



Source: www.defillama.com/stablecoins

FIGURE 3
Total Value Locked DeFi



Source: www.defillama.com

In addition to the increase in the market capitalizations of the individual currencies, the **Total Value Locked (TVL)** of the individual “Decentralized Finance” (DeFi) ecosystems of the various blockchains has increased sharply in the recent past, as shown in Figure 3.

More and more protocols are being built on blockchains (top five with the most protocols are Ethereum, Binance Chain, Polygon, Fantom and Avalanche), which are clustered into the **top five categories** by TVL, among others:

1. **Decentralized Exchanges (Dexes – Protocols with possibility to swap and trade cryptocurrency)**
2. **Lending (Protocols that allow users to borrow and lend assets)**
3. **Liquid Staking (Protocols that allow to stake assets in exchange of a reward, plus the receipt for the staking position is tradeable and liquid)**
4. **Collateralized Debt Position (CDP – Protocols that mint its own stablecoin using some collateral)**
5. **Yield farming (Protocols that pay a reward for a staking or liquidity Provider on their platform)**

Despite the rapid increase in market capitalization and DeFi protocols, as well as trends regarding “Web 3”, “Non-Fungible Tokens” (NFTs) and “metaverse”, there are events that cast a negative shadow on the still young crypto market, as negative headlines occur in both, the “Centralized Finance” (CeFi – e.g., users can earn interest and get loans on their digital assets such as Bitcoin or Ethereum through a centralized platform) and DeFi markets.

Market participants are confronted by some adverse events happened during the last years:

- ▶ Interests were no longer paid out by the crypto-asset service providers (CASPs),
- ▶ CASPs have misused client funds
- ▶ CASPs went bankrupt and had to file for insolvency
- ▶ Blockchains and thus entire DeFi ecosystems have failed

In order to strengthen the trust of market participants of the still imperfect and volatile crypto market, the regulatory framework should support innovation and fair competition, while ensuring a high level of protection of retail holders and market integrity. The implementation of regulatory requirements enables CASPs to scale up their business on a cross-border basis and to facilitate their access to banking services to run their activities smoothly.

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Main scope and objectives of the new MiCA regulation

The Digital Finance Package provided by the European Commission on 24 September 2020 consists of digital finance and retail payment strategies as well as proposals with respect to digital resilience and a regulation on crypto-assets.

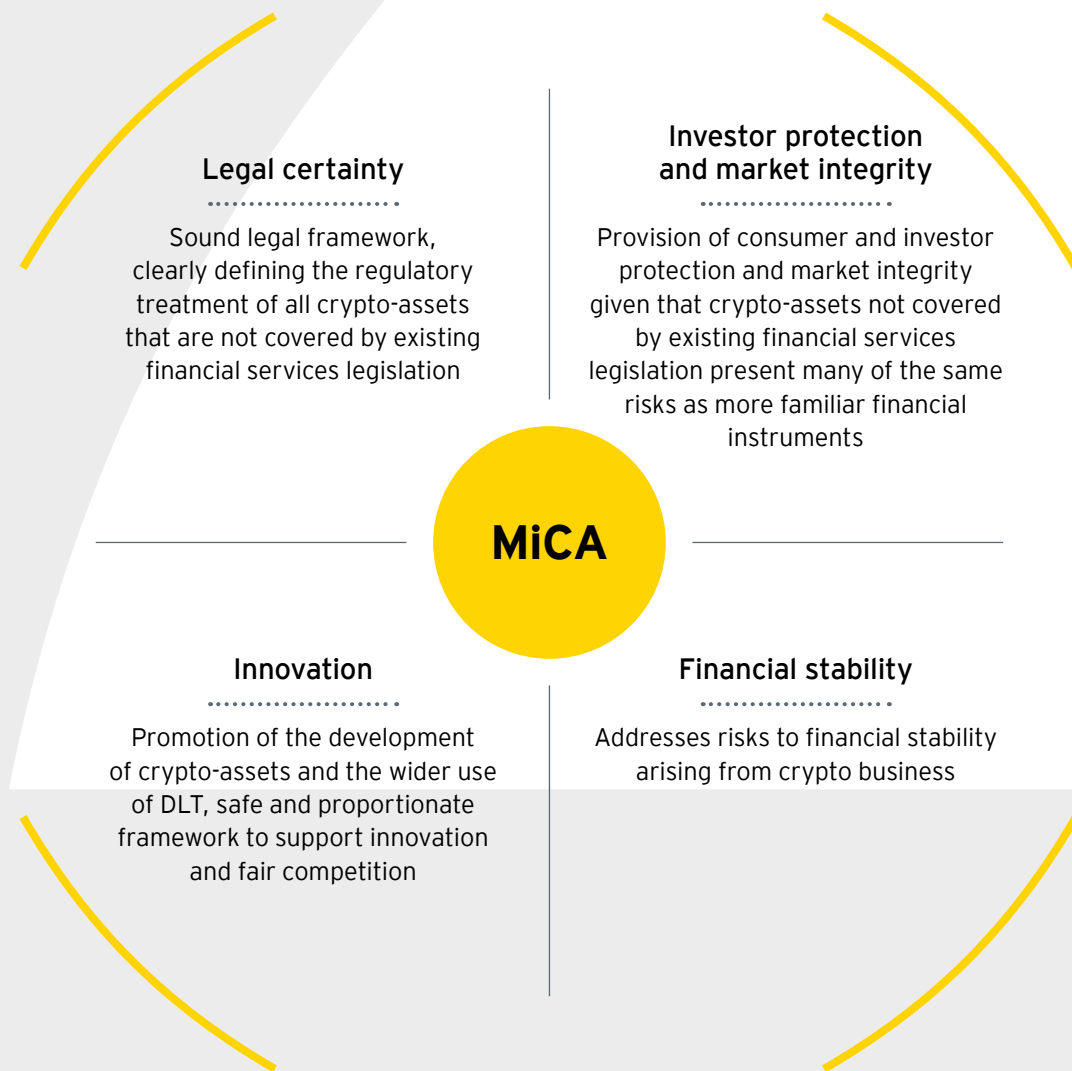
As a major pillar of this package, the proposal for a regulation on MiCA in addition to a pilot regime for market infrastructures on distributed ledger technology (DLT) responds to the increasing use of digital financial services, both by businesses and consumers in Europe.

The regulation was set up with the intention of boosting both competitiveness and digital innovation within Europe's financial sector while mitigating risks and protecting consumers. The overall goals of the proposal can therefore be summarized as fostering innovation to the highest degree possible while keeping the focus on legal certainty, investor protection, market integrity and financial stability.

MiCA stipulates comprehensive regulatory requirements in the context of crypto-asset related businesses depending on whether a market participant acts as an "issuer" of respective types of crypto-assets or as a crypto-asset service provider (CASPs) in dealing with third parties.



FIGURE 4
Major objectives of MiCA



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What are we talking about? Tokens as the key element of MiCA

The European Commission defines the different types of tokens as follows:

► **Utility tokens**

Type of crypto-asset that is only intended to provide access to a good or a service supplied by its issuer (Art. 3 (1) Nr. 9 MiCA).

► **Asset-referenced tokens (ART)**

Type of crypto-asset that is not an electronic money token and that purports to maintain a stable value by referencing another value or right or a combination thereof, including one or more official currencies (Art. 3 (1) Nr. 6 MiCA).

► **Electronic Money tokens (EMT)**

Type of crypto-asset that purports to maintain a stable value by referencing the value of one official currency (Art. 3 (1) Nr. 7 MiCA).

The regulation is structured into three major parts:

The first part deals with the authorization process for crypto-asset issuers and the respective obligations for the three token types which fall under scope of the regulation: asset-referenced tokens, e-money tokens and crypto-assets (other than asset-referenced tokens or e-money tokens). On the other hand, MiCA excludes crypto-assets that qualify as financial instruments (e.g., security tokens) as defined under MiFID II (Directive 2014/65/EU).

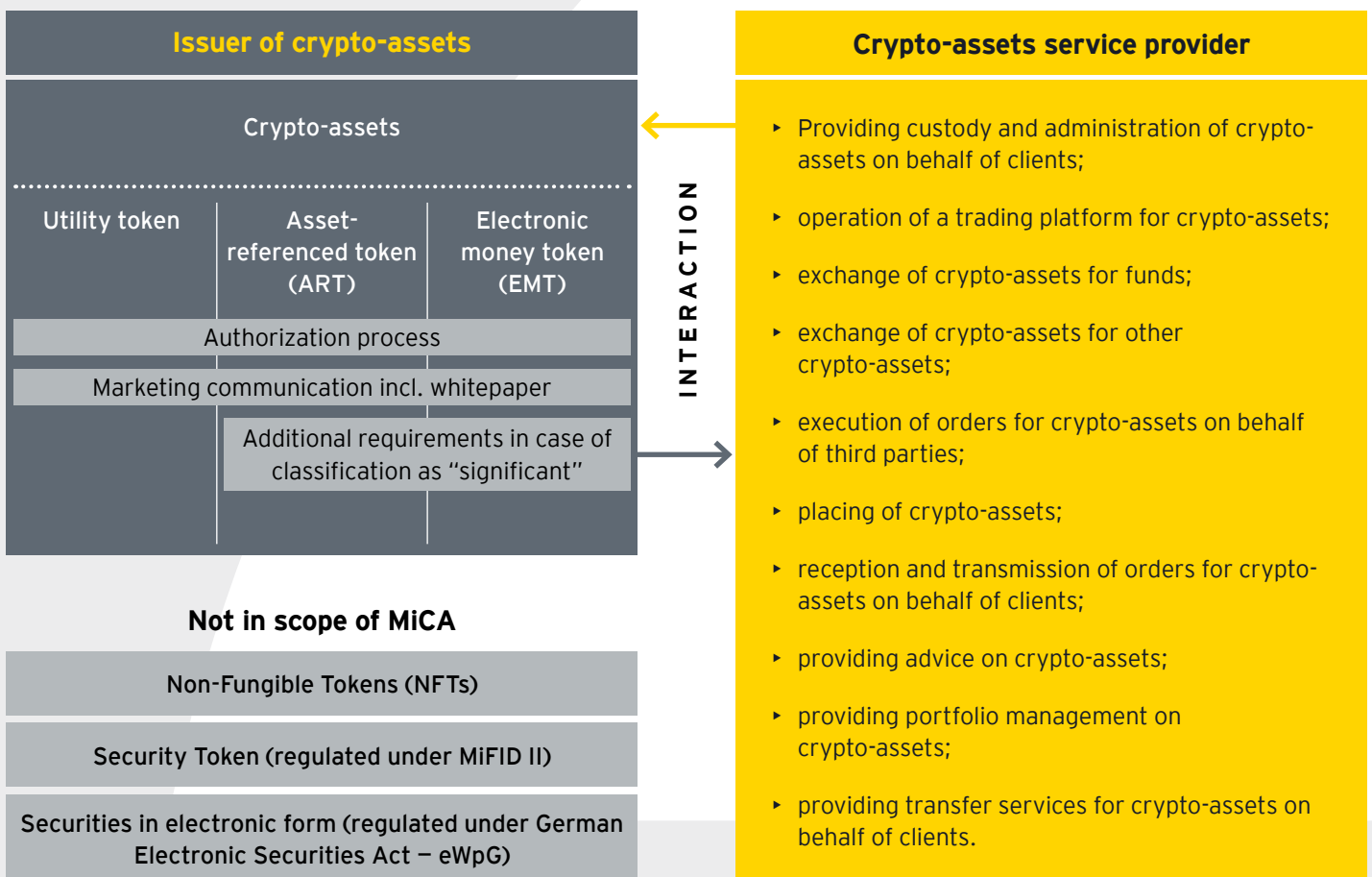
Furthermore, this regulation does not apply to “Non-Fungible Tokens” (NFTs), crypto-assets that are unique and not fungible with other crypto-assets, including digital art and collectibles. However, fractional parts of NFTs and the issuance of NFTs in a large series or collection do not fall under the exclusion.

The second part is dedicated to authorization and operating conditions for crypto-asset service providers and explains the relevant steps and requirements in detail, including the provisions on market abuse.

The third part outlines in detail the field of activity of the national competent authorities, EBA and ESMA, the administrative measures and supervisory authorities.



FIGURE 5
Crypto-assets ecosystem under the scope of MiCA



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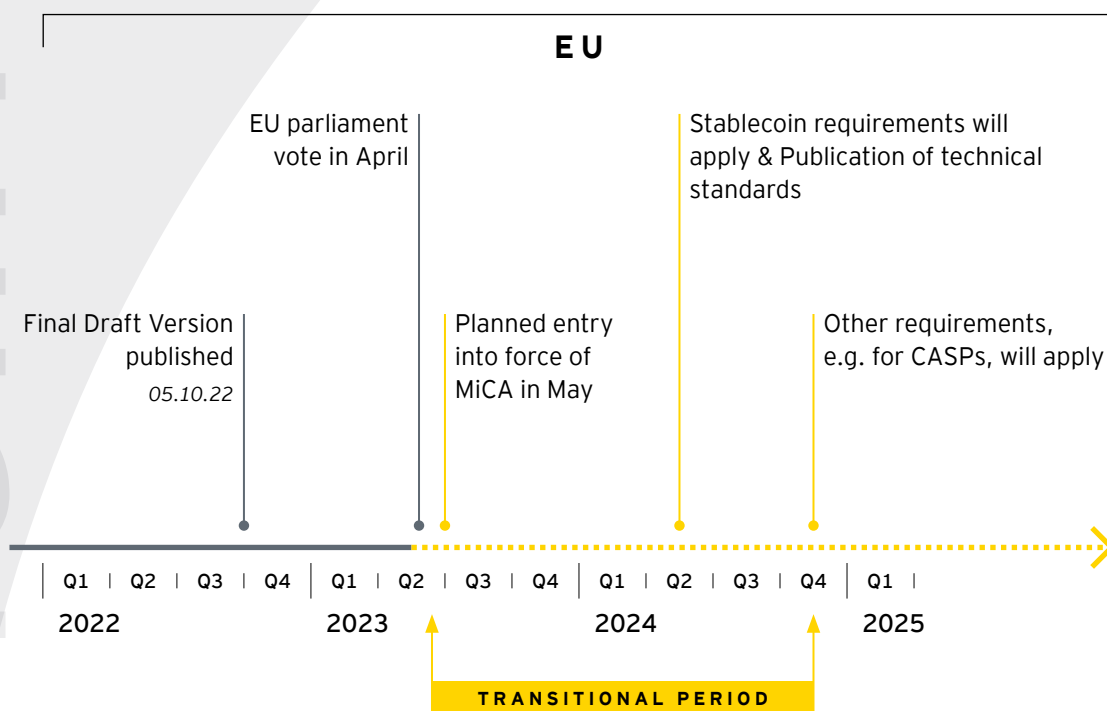
Main scope and objectives of the new MiCA regulation



Timeline

The EU Parliament voted in favor of the approval of crypto-licensing (MiCA) on 20 April 2023. The regulation will be published in the EU's Official Journal and enters into force 20 days thereafter. After the regulation's entry into force, the time frame until "full go-live" of MiCA is supposed to be 18 months to perform necessary operative implementation, meaning that MiCA will likely come into effect in Q4 2024. The requirements for stablecoins will start applying after a transitional period of 12 months and hence could take effect from Q2 2024. Regulatory and implementing technical standard shall be published 12 months after entry into force.

FIGURE 6
Timeline of recent and future actions and initiatives



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Main scope and objectives of the new MiCA regulation

Obligations for crypto-asset issuers and service providers

Issuers of crypto-assets and CASPs need to adhere to various requirements to be compliant with the regulation. Essential areas that require regulatory compliance are, among others, authorization procedures, robust governance structures and clear as well as comprehensive marketing communications.

Obligations for issuers of crypto-assets

Issuers need to adhere certain administrative and regulatory standards. Issuers of all three types of crypto-assets must issue white papers in order to ensure protection of crypto-assets. Potential holders of crypto-assets should be informed about the characteristics, functions and risks of crypto-assets they intend to purchase. The information contained in the white-paper and marketing communication, including advertising messages and marketing communications, also through new channels such as social media platforms, need to be fair clear and not misleading.

White paper disclosure requirements

White papers as a central client information document

Issuers of crypto-assets need to publish a white paper on the issuer's website prior to the launch of the respective tokens. Before its publication, the white paper must be published to the national competent authority (NCA).

The specific content of the white paper depends on the type of token to be offered and must meet certain formal and regulatory requirements. In general, a white paper must describe the essential features of the crypto token and present the associated risks. Key content details are amongst others the issuer's general information, the offering or trading of crypto-assets, the related rights and obligations, and the underlying technology used.

Once approved and published, a white paper entitles the issuer to offer a token within the EU.

Issuers of utility tokens need to meet certain requirements when offering the tokens to the general public. Regarding offerings to the public with a defined time limit, the issuer has to publish the result of the offering within 20 working days after the subscription period. In addition, the issuer must meet certain conduct requirements. The draft document contains different prohibitions to prevent market abuse, including prohibitions on insider dealing, unlawful disclosure of inside information and market manipulation. Issuers of utility tokens must also adhere to organizational or behavioral prerequisites, for example the maintenance of a robust IT infrastructure and meeting security requirements.

Stricter requirements are set for the issue of ARTs and EMTs. Issuer of ARTs and EMTs within the EU generally requires authorization.

Issuers of ARTs have to meet certain capital requirements and all providers need to obtain permission from the competent authority. The white paper not only has to be published; it must also be approved by the competent authority. To notify the holders adequately, the issuer has to publish and update the exact number of asset-referenced tokens in circulation and the value and composition of the reserve assets on its website at least every month. Issuers also need to comply with requirements relating to the maintenance and custody of reserve assets. They are obliged to separate reserve assets from the issuers' assets and need to secure prompt access to such reserve assets.

A permission to issue ART is valid for the entire EU; however, supervision remains with the competent authority of the EU member state in which the issuer is domiciled. If significant ART are issued, more stringent requirements apply. Supervision will then be carried out by the EBA.

Enhanced requirements are also in place for the issuance of EMT that may only be issued by credit institutions and e-money institutions. As with other tokens, a white paper must be published and presented to the competent authority. Issuers of EMT must ensure i.e., a holders' claim on the issuer of tokens at par value on the receipt of funds, an immediate repayment of the funds at the demand of holders at par value, and the clear statement on conditions of redemption. Issuers of e-money tokens are also prohibited from paying interest on the tokens.

Issuers of ART and EMT as well as CASPs, when providing crypto-asset services should not grant interest to users of ART/EMT for the time such holders are holding those tokens.

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Main scope and objectives of the new MiCA regulation

Obligations for crypto-asset service providers

The provision of crypto-assets services in the EU will generally require an authorisation of the competent authority of the home Member State. CASPs have a registered office in a Member State of the Union, have the place of effective management in the Union and at least one of the directors should be resident in the EU. MiCA provides general regulatory requirements that CASPs will need to adhere to. These include among others transparency, governance and other prudential requirements.

In terms of transparency, CASPs need to provide their clients with clear, fair and not misleading information and warn about the risks associated with crypto-assets. They also need to provide their clients information related to principal adverse environmental and climate-related impact of the consensus mechanism used to issue the crypto-asset (Art. 59 MiCA).

The governance requirements stipulate that members of the management body of CASPs and their shareholder need to have good repute and be fit and proper, including for the purpose of anti-money laundering and combatting the financing of terrorism. CASPs also need to employ management and staff with adequate skills, knowledge and expertise and need to take all reasonable steps to perform their functions, including through the preparation of a business continuity plan. CASPs need to have internal control and risk assessment mechanisms as well as adequate systems and procedures to ensure integrity and confidentiality of information received. They also need to

have appropriate arrangements to keep records of all transactions, orders and services related to crypto-assets that they provide and systems to detect potential market abuse committed by clients in place (Art. 61 MiCA). In order to protect funds of their clients, CASPs need to have adequate arrangements to safeguard the ownership right of client's holding of crypto-assets (Art. 63 MiCA). Further, CASPs are required to establish a complaint handling procedures (Art. 64 MiCA), to identify, prevent, manage and disclose conflict of interests (Art. 65 MiCA) and in order to avoid further operational risk to remain fully responsible for operational functions that rely on third parties (Art. 66 MiCA).

MiCA also stipulates specific regulatory requirements for the provision of specific crypto-asset services as outlined in Figure 5 (Chapter 3 MiCA).

The ESMA, in cooperation with EBA, will develop further regulatory technical standards in order to specify the requirements mentioned above and requirements which are not highlighted in more detail. ESMA should submit those standards to the Commission by 12 months after the entry into force.



Sanctions mechanism

In case of regulatory incompliance, competent authorities will have the power to impose far-reaching sanctions on issuers and service providers of crypto-assets.

The sanctions can be categorized into monetary, reputational, or operational sanctions and are targeted at legal or natural persons.

The consequences of the respective sanctions are as follows:

FIGURE 7
Overview of sanctions

Monetary sanctions

- ▶ **Legal persons:**
At least EUR 5,000,000 or 3%, 5%, 12.5% of the total annual turnover
- ▶ **Natural persons:**
At least EUR 700,000 for natural persons

Reputational sanctions

Provisions of a **public statement** indicating

- ▶ The natural person or legal entity responsible
- ▶ The nature of the infringement

Operational sanctions

- ▶ **Withdrawal or suspension** of the authorization of a crypto-asset service provider
- ▶ Temporary **ban** of any member of the **management body**

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How EY can help you

From an unregulated environment to a fully applicable MiCA regulation within less than two years – relevant market participants need to find their place at an early stage within the fast-moving crypto-asset ecosystem. The regulation will be directly applicable in all member states, requiring no national laws and therefore no additional timeframe for implementation. Established banks and custodians need to validate their current business model including the assessment of future partnerships. Start-ups and FinTechs should start setting up digital asset compliance frameworks if they cannot leverage existing securities frameworks, including all necessary policies and procedures to be reviewed by the national competent authority.

EY offers an end-to-end implementation support. For a substantial and sustainable positioning, EY supports the identification for applicable regulatory requirements, coordinates the necessary implementation work packages and streams, provides training for affected staff and supports the implementation of an uniform written framework as well as the corresponding processes.



Start now with setting up project organization, impact assessment and digital roadmap

Digital asset strategy

How will you play the crypto-asset game?

- ▶ Peer group benchmarking and identification of a viable market positioning
- ▶ End-to-end support of crypto service offering to foster customer conversion
- ▶ Support regarding make-or-buy decisions, sourcing framework and identification of adequate partners in a dynamic market environment

Regulatory readiness

Does your current compliance setup cover the required outcome?

- ▶ Regulatory gap and impact assessment for regulated and unregulated market participants with respect to MiCA requirements
- ▶ Supporting consultation phases during legislative implementation process
- ▶ Supporting required application and authorization process with national competent authorities

Operational implementation

Are your business operations sufficiently resilient to respond to the complex digital assets' requirements?

- ▶ Setting up of crypto compliance departments and related processes, regulatory policies, working instructions as well as control and monitoring plans
- ▶ End-to-end regulatory implementation support
- ▶ Post-implementation review and operational stabilization

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