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The EU Regulation of Crypto-assets—Fit for Purpose?

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Introduction

The European Union has said that current laws on the regulation of crypto-assets may not be “*fit for purpose*” and may need to be overhauled.

In a recent speech, the EU Commissioner responsible for financial services policy, Valdis Dombrovskis, stated that there will be a review of existing legislation and a feasibility study in search of a common EU approach to developing an EU-wide regulatory crypto-asset policy. Dombrovskis’ remarks highlight the fact that the existing EU regulatory framework gives rise to the risk of inconsistent interpretation across EU Member States and the potential for regulatory arbitrage.¹

The need for a common EU approach in this area is strengthened by the fact that individual Member States are passing their own domestic legislation to fill the gap that exists at the European Union level. Notably, Malta has already instituted a regulatory framework for crypto-assets and blockchain. Luxembourg passed laws in February 2019 to recognize and confer legal status on digital assets held on a blockchain, and Member States like the UK, France, and Germany are presently consulting on reforms. The absence of an EU-wide framework creates uncertainty as to the regulatory status of crypto-related activities across Europe. It can also mean that a single market passport is not available to cover activities across the EU.

Against this, in Europe, ownership and use of digital assets is not widespread. The EU regulators have said that the relatively low level of crypto-asset activity does not give rise to implications for financial stability, so that present concerns are more focused on conduct and financial crime issues.

In January 2019, both the European Banking Authority (the “**EBA**”) and the European Securities and Markets Authority (“**ESMA**”) issued Reports on crypto-assets. The EBA’s report focused on crypto-assets in banking and payment transactions, whereas the ESMA Report focused on how digital assets fit into the framework for the regulation of securities.²

Securities Regulation at an EU Level

Securities and investments are regulated at a European Union level by the Second Markets in Financial Instruments Directive (“**MiFID II**”).³

This lists a number of “*financial instruments*” that are regulated. Financial instruments include “*transferable securities*” which in turn are defined as covering securities “*negotiable on the capital*”



markets” such as “shares in a company”, “securities equivalent to shares”, or “bonds” and “other forms of securitised debt.”

Digital assets may not fit neatly into these categories.

The current Chair of ESMA, Steven Maijor, spoke in Brussels of ESMA’s characterisation of crypto-assets under MiFID II in February and noted that *“a significant share of existing crypto-assets are likely to fall outside the rules, as things stand...[but] Importantly, we believe that a more elaborate bespoke regime for those crypto-assets that do not qualify as financial instruments is premature. The phenomenon is still novel and business models continue to evolve.”*⁴

The EU does not have a test equivalent to the *Howey*⁵ Test in the United States, which is more flexible and is focused more on the purpose of any asset offering.

Accordingly, under the MiFID II regime there is a potential that certain offerings of digital assets will fall outside the scope of regulation. Based on the comments made by the head of ESMA and the recent ESMA report, it seems that ESMA will take a cautious approach to introducing new regulations. This approach seems correct. As well as introducing regulation of crypto-products themselves, ESMA will need to consider the appropriate way to extend regulation to custodians of the assets and intermediaries in the sale and transfer of the assets.

Payments and Banking

The banking and payments industries in Europe are regulated by the Capital Requirements Directive, the Second Payment Services Directive (“**PSD 2**”) and the Second Electronic Money Directive (“EMD”). Crypto-currencies are not regulated as currencies in Europe on the basis that they are not presently widely enough accepted to constitute a medium of exchange. As such, they largely fall outside the scope of the above European Union laws.

The one exception to this is that stored value products are likely to fall within the concept of e-money, a product regulated under the EMD. Stablecoins, whose value is pegged to fiat currency will usually be regarded as e-money on the basis that the stablecoins have an intrinsic monetary value.

As with securities, the use of crypto-currencies in Europe is still not sufficiently widespread to establish an unequivocal case for Pan-European regulation.

Anti-Money Laundering Regulation

Although a composite framework for the regulation of crypto-assets is still being debated, the EU has been quicker to address financial crime risks posed by this asset class.

The EU’s Fifth Money Laundering Directive (“**5MLD**”) will subject certain participants in the crypto-asset sector to regulation for anti-money laundering compliance purposes. With effect from 10 January 2020 digital wallet providers and exchanges will be subject to registration and supervision for AML compliance.

Exchanges will be regulated where they provide exchange services between virtual currencies and fiat currencies. A pure crypto to crypto exchange would not, therefore, fall within the scope of regulation. For the purposes of 5MLD custodian wallet providers are defined as including *“an entity that provides services to safeguard private cryptographic keys on behalf of its customers, to hold, store and transfer virtual currencies.”*⁶



Businesses that fall within the above categories will need to implement AML policies, controls, and procedures and become subject to supervision for AML compliance purposes, even though they are not subject to any other banking or financial services regulations.

Conclusion

The position in Europe is likely to evolve rapidly over the coming months and years. Although crypto-assets do not presently form a significant part of the European economy, the development of local regulations on a Member State by Member State basis and an appreciation of conduct, financial crime, and growing financial stability risks mean that it is only a matter of time before we see tangible proposals for an EU-wide framework.



Paul Hastings is actively monitoring the approach taken by agencies and regulators of cryptoassets globally, and our lawyers regularly address the development of regulation and the development of innovative products and services.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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¹ Speech by Vice-President Dombrovskis at the Eurofi High-level Seminar 2019 - Bucharest, Romania, available at http://europa.eu/rapid/press-release_SPEECH-19-1999_en.htm?locale=en

² ESMA advice available at <https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection>; EBA Report available at <https://eba.europa.eu/documents/10180/2545547/EBA+Report+on+crypto+assets.pdf>

³ DIRECTIVE 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID II) available at <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN>

⁴ Speech by Steven Maijor, Crypto-Assets: time to deliver 3rd Annual FinTech Conference – FinTech and Regulation, available at https://www.esma.europa.eu/sites/default/files/library/esma71-99-1120_maijor_keynote_on_crypto-assets_-_time_to_deliver.pdf

⁵ See *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946).

⁶ DIRECTIVE (EU) 2018/843 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU (5MLD) available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018L0843>

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