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Innovation with protection: the next steps on the MiCA journey

Markets in Crypto-Assets Regulation, Financial Supervisors Academy (FSA) Forum – Malta

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Introduction

Many thanks Kenneth for your opening remarks and for your invitation to this edition of the FSA Forum, focusing on the Markets in Crypto-Asset Regulation, or as it is now known worldwide, MiCA.

I am honoured to deliver a keynote speech on this topic at such a crucial juncture for the application of MiCA, and for crypto-asset markets more broadly. I know that this is ranking high on the priorities list of financial services supervisors across Europe, as demonstrated by the many colleagues I saw on the programme and who I am happy to see in the room today.

It is also a pleasure to be here in Malta, who on this topic was one of the first EU jurisdictions to have put in place a regime for Virtual Asset Service Providers (VASPs), starting in 2018. I am sure Christopher will expand on this bespoke authorisation regime in a few minutes.

Today's programme is covering crucial aspects of one of our most audacious journeys as regulators and supervisors: the effective application of the MiCA Regulation by the end of next year, in 2024. As we embark on this journey together, our common objective is clear: enhancing the protection of investors, in particular retail consumers, and preserving the EU's financial stability.

ESMA has always been vocal in highlighting the vulnerabilities of crypto-asset markets. To date, the regulation of crypto-assets is, by and large, light and patchy across the EU. This leads to significantly lower levels of investor protection compared to traditional financial products, even though crypto-assets are proven to be relatively more volatile and creating a higher risk of investor detriment. MiCA will be an important step to reduce these risks, although it will certainly not be a silver bullet to remove all potential consumer harm.

Protecting investors as effectively as we can in light of these relatively new financial products and services being offered to them, this is our compass towards applying MiCA effectively.

Doing so will require robust technical standards: today I will present some of the key features of our most recent consultation paper on these so-called level 2 measures.

It will also require a stringent and pro-active approach to supervision and enforcement, and close cooperation and convergence among the supervisory authorities - even before MiCA applies: today I will also outline some of our recent actions in this regard, and recall our common stance on the preparation for MiCA implementation, as set out in a recently published supervisory statement and a letter to EU Finance Ministers adopted at the October Board of Supervisors.

Robust technical standards in the second MiCA consultation paper

Let me first turn to our on-going work to supplement MiCA with robust technical standards. As you know, the consultation on the first package of draft Technical Standards, mainly covering CASP authorisation, closed in September. We also launched in October our consultation on the second package, with comments expected by mid-December this year.

Allow me to focus on the content of this second consultation paper.

As a nod to Malta's maritime history, I could say that we want these technical standards to be useful tools for investors to navigate the troubled waters of crypto-asset markets.

Before embarking on their sea voyage, investors need to be informed on the hazards awaiting them. This is the role of the MiCA equivalents of nautical charts: white papers.

Currently, there are no requirements applicable to the information that crypto-assets issuers publish. What we can see circulating around in the form of so-called "white papers" is an unregulated mix of technical information and pure advertising material. This makes it difficult for investors to understand the characteristics and inherent risk of each crypto-asset offering, and in turn to make proper comparisons between different crypto-assets.

At the same time, these documents are not a useful source of information for regulators either. Their lack of consistency in terms of content and format limits the possibilities of classification and cross-sector analysis.

Our technical standards will ensure that issuers of crypto-assets provide the information required in MiCA in a common format. In particular, issuers will no longer be able to hide potential risks behind catchy slogans or prevent investors from comparing various options to make well-informed investment decisions.

As an international community of regulators, we will also reap the benefits of standardising white-papers . As white-papers will be required for all crypto-assets offered in the EU, whether they are issued inside or outside of the EU, a standardised format will allow for a better cross-jurisdictional analysis of crypto-assets markets that are global by nature.

This will be further enhanced by another important feature: machine readability. If coupled with the appropriate SupTech tools, machine readability has the potential to turn an otherwise unmanageable pile of information into an invaluable source of supervisory intelligence.

Standardisation will also be valuable when it comes to assessing the impact of the validation of crypto-assets transactions on the environment and the climate. One year and a half after heated political debates on this topic, I am glad to note that most stakeholders now agree that transparency on sustainability impacts is a must.

Our consultation paper provides for harmonised disclosures Which we are confident can help investors compare the impact of different crypto-assets on the climate and the environment, in particular on CASPs' website. Already today, estimates are available for the key indicators we propose, such as the use of energy to validate transactions, and the related emissions of greenhouse gas, and we can be hopeful that data availability and reliability will improve throughout the year to come.

To follow on the maritime metaphor, we also need to ensure the CASPs are sturdy, able to brace the seas on long-distance journeys. This is the ultimate objective of the technical standards on business continuity.

ESMA considers the resilience and continuity of crypto-asset services an important investor protection objective in MiCA. Many of today's financial services rely on complex ICT infrastructure and nowhere is this more evident than in crypto-asset markets. In recent years, we have seen several high-profile outages or degradations of service affecting crypto-asset services, which have resulted in both direct losses of on-chain client assets and indirect losses due to falling crypto-asset valuations.[1]

The standards we propose for business continuity of CASP services aim to address novel operational risks posed by distributed ledgers, while maintaining a level playing field for all types of underlying ICT infrastructures of relevance for crypto-assets.

In particular, we are concerned that permissionless distributed ledgers (those blockchains with no central points of authority) may be outside of the scope of outsourcing and business continuity rules found either in MiCA or in the Digital Operational Resilience Act (DORA). We have sought to clarify the perimeter of each Regulation in our consultation paper.

The challenge of ensuring continuity of services that rely on a permissionless distributed ledger rests on the limits of standardisation and interoperability between blockchain networks. The absence of a viable "back-up" or redundancy option in the event of a disruption to these types

[1] See: repeat Solana outages in 2021-2022, See: degradation of services via out-of-sync nodes on Polygon, 22 February 2023

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of ledgers poses significant “lock-in” risk for CASPs. In other words, clients may not be able to access their on-chain assets for hours, or even days, in case of a disruption.

ESMA therefore proposes requirements for CASPs to take extra precautions for permissionless distributed ledgers in their business continuity measures, including regular communication with clients in the event of service downtime.

Finally, the second consultation paper further specifies how the well-established tools of inside information disclosure, trade transparency and record-keeping can be used to the benefit of investors and regulators alike.

Much like sonar for mapping the topography of the ocean floor, we are determined to promote an active use of these surveillance tools to measure the ups and downs in crypto-asset markets.

An important deterrent against market abuse in financial markets is the obligation to publish inside information and this also holds for crypto markets.

As with any disclosure of information, the objective should be to reach the holders of crypto-assets where they are most likely to look for such information. In other words, we expect disclosures to be actively disseminated in the media most relied upon by the public to prevent certain participants from benefiting from unfair information advantages.

Given the high incidence of retail investors and a heavy reliance on social media[2] in the crypto markets, we offer the possibility for issuers of crypto-assets to choose social media channels or other web-based platforms for effective dissemination of inside information. However, such disclosures should always be open and freely accessible to the public, including via a link on the website of the issuer.

In a similar fashion, we are determined to use the records that CASPs must keep to the fullest possible extent in support of the supervision of many MiCA requirements, ranging from investor protection to market abuse.

This is the rationale behind our proposed technical standards on recordkeeping. They set forth a list of data points that should allow proper monitoring of orders and transactions undertaken by each CASP (thus enabling supervision of market conduct) as well as information covering all other services and activities performed, in turn allowing regulatory oversight of business conduct rules.

Another crucial aspect is that our supervisory capabilities, especially when it comes to market abuse, do not stop at the EU borders. We have therefore specifically requested CASPs and

[2] See: June 2023 report from BEUC (link)

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trading platforms to keep some additional information for the case where third country entities are involved in the transaction.

Trade transparency obligations applicable to trading platforms for crypto-assets are a third tool at our disposal. Here as well, we have used the rules of traditional financial markets as a basis, with some adjustments to reflect the specific nature of crypto-assets.

In particular, we have gone a step further from MiFIR, as our proposal includes a list of pre-trade fields to be published for each order, aiming to harmonise the content and formats for all crypto trading platforms. Codifying how crypto-asset service providers publish this information will make it easier for investors and supervisors to understand and compare the data.

We are also consulting on targeted exemptions from pre-trade transparency for specific order types that can be conducive to investor protection. The first is “stop” orders, which can protect investors from adverse trading strategies that target stop losses. The second is “reserve” orders, which can allow traders to break up large orders into smaller ones, reducing their market impact and the possibility of opportunistic arbitrage.

In short, our second consultation paper aims to empower investors and regulators with robust tools to sail as smoothly as possible on the new oceans of crypto-asset markets.

Recent actions for stringent and pro-active supervisory convergence

I have just explained ESMA’s approach to supplement the MiCA regulatory framework. However, the MiCA rulebook will only protect investors if it is effectively applied. Skilled sailors with robust navigation tools still face perils if the law of the sea is not respected.

For this reason, I would now like to shift focus to how ESMA is preparing for the transition to the new MiCA regime, in close cooperation with our colleagues in the national competent authorities who will ultimately be responsible for supervision and enforcement of MiCA.

As I mentioned in the introduction, ESMA published last month a letter to EU finance ministers and a statement outlining our expectations for competent authorities and the industry during the transitional phase of MiCA beginning in 2025. Allow me to briefly explain our motivations for these two publications, beginning with the statement.

Our immediate objective at ESMA is to foster robust supervisory convergence among the competent authorities even before MiCA enters into application. I think we all agree with the wisdom of this approach. To make MiCA’s single rulebook for crypto-assets as effective as possible, crypto-asset service providers (and investors) should be confident in knowing that the rules are implemented uniformly across the EU.

This will discourage the industry from engaging in “forum shopping” as there should be no competitive advantage for service providers based on where they choose to establish

themselves. The same principle of uniformity applies to achieving a common supervisory approach. Therefore, at ESMA we are working hard with the national authorities to harmonise practices when it comes to authorisation, supervision and enforcement, starting with the authorisation procedures as the most urgent necessity.

Aligning supervisory practices in relation to authorisation procedures is one of several ways ESMA is aiming to prevent regulatory arbitrage even before the MiCA Regulation and the relevant level 2 measures apply. On this point, the example of the MFSA's risk-based licensing framework for virtual financial asset service providers[3] may serve as one model to look at as competent authorities design their own authorisation procedures for crypto-asset service providers. In fact, capitalising on the experience of those competent authorities with existing national legislation for crypto-assets, and who can share valuable lessons learned, is part of the mandate of ESMA's Digital Finance Standing Committee.

We are also determined that this Committee serve as a forum for supervisors to share information about authorisation requests in their jurisdictions, specifically those requests from crypto firms active in multiple EU Member States. In fact, ESMA is encouraging enhanced communication and monitoring by our members as it relates to large crypto firms with a strong presence across several global jurisdictions. These large crypto firms, whose agile operational structures enables them to engage in forum-shopping, are a source of elevated regulatory risk.

Our commitment to a forward-looking approach also entails several mapping exercises, in close cooperation with the EBA, to understand the scale of the future EU market for regulated crypto services and each Member State's approach to the transition to MiCA. This will allow us to collectively anticipate the volume and the types of authorisation requests supervisors can expect, both from entities already providing crypto services in the EU under national applicable laws and from entities unregulated to date.

We are confident that this experience will provide a blueprint for close cooperation among the competent authorities not only to improve the supervision of crypto service providers, but also on other aspects of the MiCA regime, including enforcement.

Together with Carlo Comporti, both as my colleague on the ESMA Board and as the Chair of the Digital Finance Standing Committee, we will share more details on what this process looks like during the panel later today, but I wanted to outline upfront some of the key elements of our crucial workstreams on supervisory convergence.

Preparing for MiCA implementation

[3] See: MFSA, The Nature and Art of Financial Supervision - Volume VIII, 16 October 2023, link

Turning now to the supervisory statement and the letter to the EU Finance ministers, which can be summarised in one phrase: time to batten down the hatches.

Firstly, our work on technical standards and supervisory convergence cannot fully be put into practice until Member States designate competent authorities and empower them with the resources and expertise to carry out their new supervisory and enforcement functions under MiCA. Therefore, ESMA encourages the Member States to make this designation (before the June 2024 deadline mandated in legislation) ideally by the end of this year. This is one of the main messages in the letter we sent to finance ministers last month.

The other message of the letter focusses on the risks of a disorderly transition to MiCA. As with any new regulatory framework, the rules will take time to socialise with the market and will require competent authorities to prepare for their new responsibilities even before the Level 2 measures are finalised.

The need for time to adjust is acknowledged in a grand-fathering clause, lasting for up to 18 months. This phase may be shortened according to each Member State's preference. During this time, entities already providing crypto services before 2025 may be entitled to continue doing so according to their legal *status quo ante* before MiCA's entry into force, extending the period of fragmentation of regulatory regimes across the EU for a duration that ESMA considers too long.

To avoid the risks associated with this prolonged fragmentation, ESMA is calling on Member States to consider limiting this transitional phase to 12 months. It is our view that minimising the time during which a patchwork of different laws will apply across the Member States will assist in creating a level playing field and limit potential harm to investors who may have difficulty discerning the regulatory status of an asset or service they are using during the transitional phase.

This would also set a clear deadline for the industry by which they must align their business practices to comply with incoming requirements under MiCA. During this time, crypto service providers are encouraged to inform their competent authorities and clients of their transition plans as early as possible in this process.

A key objective of MiCA is to provide the crypto market with regulatory certainty that will enable sound innovative technologies, such as distributed ledgers, to develop in the EU. We have already seen a positive reception from many in the crypto industry, who often cite the passporting rights under MiCA as a welcome feature of the regulation.

These passporting rights are based on a simple premise: to do business in the EU, you have to properly comply with EU rules. This entails an expectation that EU-based crypto-asset service providers would not rely extensively on non-EU entities for the performance of services for clients based in the EU.

I emphasise this point on establishment because we often hear the idea that the crypto market is "borderless". This may be true in a technological sense, but not from a legal perspective. Indeed, certain large crypto firms are sailing close to the wind and have made this 'borderless' philosophy part of their *modus operandi*, providing their services globally without a formal operational presence in any single jurisdiction.

Such a setup should be discouraged.

We as EU supervisors will favour a firm presence and commitment to the EU regulatory framework. With this comes a broad interpretation of what constitutes solicitation of EU clients from third-country firms, through which we will want to limit the scope of the 'reverse solicitation' clause to genuinely exceptional cases.

So, let me send a clear warning from the ESMA lighthouse, breaches of the reverse solicitation clause will be met with stringent enforcement by ESMA and the competent authorities. This is both to protect MiCA-compliant firms from unfair competition and to shield EU investors from unknowingly using unregulated crypto-asset services.

Conclusions and next steps

Today I only had a chance to give you a brief overview of all the work ahead of us: to ensure a robust implementation matching our ambition for the MiCA framework and to ensure a smooth transition to start effective supervision from day one.

I am happy to see the collective effort that all the competent authorities in the ESMA Board, some of which are assembled here today, put into making crypto-asset markets safer for all investors.

If, as the saying goes, a smooth sea never made a skilful sailor, I think we can say that the seas are challenging and therefore we will certainly have extended our supervisory sailing skills when MiCA will come into application.

But I should also remind all investors of the limits of MiCA: The framework is designed to make the market safer for investors by regulating the intermediaries. It cannot prevent sailors from crashing against the rocks in pursuit of the siren's song of quick and easy profits. Investors should continue to protect themselves from scams, especially when they venture into the decentralised corners of the market that MiCA cannot reach[4].

Thanks again to the MFSA for organising this forum. I look forward to engage with my colleagues further in the Panel to follow and discuss our shared strategic priorities, not just to build a robust MiCA rulebook, but also to converge on its practical application. I will now turn

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[4] Losses from DeFi rug pulls in 2022 were greater than the combined losses from the collapse of centralised entities FTX, Celsius, and Voyager Digital. See: Solidus Labs, What is a Rug Pull? DeFi Scams Explained, 27 October 2022 (link).

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to Christopher, whose insights on the Maltese experience will no doubt be as informative to us today, as they have been to our work at ESMA level to date.