REGULATING THE LEGAL GREY AREA OF CRYPTO ASSETS

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Cryptocurrencies and assets are moving firmly towards legitimisation. However, as technology innovation outpaces the implementation of regulation of crypto assets, this presents challenges for regulators and businesses alike.

Much of what is attractive to investors and businesses about crypto assets and blockchain technology, such as anonymity and cross-border reach, pose challenges from a regulatory perspective. Regulators must reconcile legal certainty with crypto assets' libertarian roots.

On the one hand, regulators need to present clear, legal definitions regarding crypto assets that are flexible enough to allow innovation. On the other hand, regulations must provide firm legal safeguards for consumers and address perceived threats to monetary sovereignty and financial stability. This presents a delicate balance for regulators between innovation, legal risk and investor protection.

In recent years, we have seen regulatory responses from some global economies, such as China, that have placed an all-out ban on cryptocurrencies rather than regulating them. The European Union's ("EU") regulatory approach to crypto assets starkly differs to this.

The EU's harmonised approach to crypto regulation and supervision

In April 2023, the European Parliament held its final vote on the adoption of regulation on markets in crypto assets ("MiCA"), which was published in the Official Journal of the European Union on 9 June 2023.

From December 2024, MiCA will apply to all EU member states and will introduce a dedicated and harmonised regulatory framework for crypto assets service providers ("CASPs") in the EU.

MiCA will bring issuers of certain types of crypto assets into the EU regulatory framework and will establish new rules for stablecoins, including asset-referenced tokens, e-money tokens and utility tokens.

From a legal perspective, the introduction of MiCA will provide clarity on the regulatory status of crypto assets and protection for crypto asset holders in the EU because it will establish a set of common rules around the supervision of crypto assets and cryptocurrencies for the first time. It will also provide a blueprint for other regulators worldwide in terms of bridging gaps between regulation, investor protection and innovation.

Risk of "forum shopping"

On 17 October 2023, the European Securities and Market Authority ("ESMA") called on CASPs and national competent authorities ("NCAs") of EU member states, who are responsible for the implementation of MiCA in home member states, to ensure the smooth and coordinated transition of MiCA by December 2024.

ESMA has highlighted "forum shopping" as a potential risk if EU member states do not adopt a consistent approach when implementing MiCA. This could lead to divergences in the enforcement of MiCA in the EU thereby reducing the overall effectiveness of the regulatory framework. To avoid the risk of "forum shopping", ESMA has called on the NCAs of EU member states to ensure that they have adequate powers and resources to exercise their supervisory and enforcement responsibilities under MiCA.

A robust EU regulatory framework of harmonised rules for issuers of crypto assets and CASPs is necessary in the wake of crypto frauds and insolvencies such as FTX, Terraform Labs and Three Arrows Capital. These crypto frauds highlighted corporate governance failings and failure to retain or ringfence client assets in the absence of regulation.

MiCA will help close legal loopholes that have developed without clear regulation and will go some way towards ensuring regulatory compliance and limiting crypto fraud in a largely unregulated space.

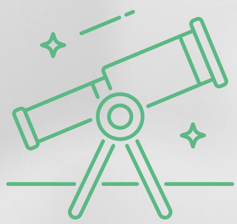
However, it will be necessary for ESMA and NCAs, such as the Central Bank of Ireland, to provide definitive clarification in due course on the extent of how existing regulatory regimes, such as Markets in Financial Instruments Directive ("MiFID"), apply to crypto assets.

Regulatory challenges for crypto businesses

2023 has been a defining year for regulatory investigations and disputes involving crypto assets, with record levels of investigations by US enforcement agencies against crypto exchanges and notable judgments handed down in crypto court cases. The courts have been pragmatic in adapting existing legal remedies to help protect rights in cases of crypto fraud in the absence of clear regulation or legislation. However, crypto businesses should now prioritise operational screening, such as anti-money laundering and know-your-client checks, to satisfy themselves that assets in their custody are not the proceeds of crypto fraud and to ensure operating resilience to financial crime. There is also a growing importance on enhanced due diligence investigations and cryptocurrency compliance at the outset for crypto businesses, who should satisfy themselves that they have adequately traced and identified the source of crypto funds so that any bad actors who have gained funds from illicit activities can be identified. Businesses should ensure that compliance is not simply a box-ticking exercise and key challenge for them will be to scale up their compliance functions with their growing business.

ESMA's recent statement helps clarify the supervisory expectations of both NCAs and CASPs operating in the EU. It expects NCAs to establish supervisory procedures relating to the authorisation processes set out under MiCA. It also expects CASPs to apply for MiCA authorisation as otherwise they cannot benefit from passporting rights under MiCA in the MiCA transition period, which runs up until December 2024.

To prepare, CASPs currently operating in the EU should ensure that business practices comply with incoming MiCA requirements to mitigate against disruption to business models. They should also now engage with NCAs to determine how the new regulatory framework will affect their current business activities. Lastly, for CASPs operating in more than one EU member state, ESMA reminds them that local law will apply until the end of the transitional period in December 2024.



The future of crypto regulation

Throughout 2023, US regulators have invested heavily in their regulatory resources to tackle crypto fraud, so regulatory enforcement and disputes concerning crypto assets will be a major theme in the coming years. We are entering an era of heightened regulatory supervision for crypto assets and the regulatory landscape will be dominated by enforcement at a global level with some regulators taking transnational steps to enforce crypto regulations.

Notable crypto judgments handed down in 2023 suggest the possibility of blockchain developers owing legal and fiduciary duties to cryptocurrency owners in cases of crypto fraud. Such judgments show that the old rules still apply and there is no substitute for effective due diligence.