Crypto and other digital assets: Europe, the United States and the United Arab Emirates

We have reviewed the relevant regulatory and commercial environment in Europe, the United States and the UAE.

Crypto and other digital assets: Europe

In September 2020, the European Commission published a draft regulation on crypto-assets, the so-called Markets in Crypto-assets (MiCAs) regulation. The European Parliament adopted its negotiating position on March 14, 2022, which cleared the way for the formal "trilogue" between the European Commission (the Commission), Council, and Parliament. On June 30, 2022, the trilogue negotiations resulted in an agreement whereby, after formal adoption by the Council and the Parliament, the regulation could enter into force over the course of this year. Then, according to the current draft, it would take effect 18 months after its promulgation.

As a regulation, MiCA will have direct effect in all EU member states, while creating an EU-wide and uniform set of regulations with regard to crypto and other digital assets. It contains measures to achieve objectives such as transparency, disclosure, authorization, and supervision of transactions in relation to the distribution, issuance, and trading of crypto and digital assets. This is intended to create comprehensive consumer protection and at the same time establish measures against criminal activities such as market manipulation, money laundering, and terrorist financing in all EU member states.

MiCA imposes strict rules regarding the authorization and licensing of financial intermediaries and therefore will have the greatest impact on issuers, service providers, and trading venues – which, however, serves the interest of achieving a secure EU-wide crypto financial market.

Measures such as increased information requirements with the aim of informing potential buyers about the characteristics, function, and risks of crypto token and digital assets are enshrined in detail. The requirements for the information document to be prepared for this purpose – the so-called "white paper" that must be submitted to the relevant financial supervisory authority – are regulated in article 5 of the MiCA regulation. It must include detailed descriptions of the issuer, the issuer's project, and the type of crypto-asset to be offered or for which admission to trading is sought. Also required is a description of the rights and obligations associated with the crypto-assets and the disclosure of information about the underlying technologies and standards that the crypto-assets issuer uses to enable holding, storing, and transferring the crypto-assets. Likewise, a detailed description of the risks associated with the respective assets is mandatory.

MiCA also includes rules on capital requirements for custody of assets and a mandatory complaint procedure available to investors. Issuers of significant asset-backed cryptocurrencies (global stablecoins) would be subject to more stringent requirements, for example, with respect to required capital, investor rights, and oversight.

Further, MiCA determines that crypto service providers, such as crypto-asset custodians and operators of trading venues, must have a registered office in a member state if they want to offer their products and services in the European Union.

For smaller companies and fintechs, these provisions could cause certain disadvantages. In member states where the market has been virtually unregulated to date, companies face high costs due to, for example, the acquisition of licenses or the costs incurred in connection with reporting requirements or a secure IT infrastructure. It is therefore foreseeable that the regulation will make it more difficult for cryptocurrency issuers to enter the market.

However, once licensed, the strict rules allow for fewer legal and administrative hurdles when intermediaries enter another EU market in another member state with the goal of expanding their financial services. The reason for this is that once a crypto intermediate is licensed in one EU member state, that license can become "passportable" under MiCA, meaning that the intermediate could choose to operate in another EU country without having to obtain further approval or additional licenses from the local government. The current patchy legal framework in different European countries makes it difficult for companies to start a business in this still new area of the capital market. In addition, the different national regulations create unequal opportunities for market participants. Against this backdrop, the possibility of "passporting" could provide for simplification in the future.

A central innovation is the regulation of the future supervision of issuers and crypto-asset service providers by the European Supervisory Authorities and the national authorities. According to MiCA, the European Securities and Markets Authority is to supervise the issuance of asset-referenced tokens, whereas the European Banking Authority will be in charge of supervising electronic money tokens. To distinguish between the individual crypto-assets, the regulation provides a set of definitions of the different crypto-assets, including utility tokens and certain types of stablecoins and thereby undertakes a categorization of different crypto-asset types, each with different legal consequences.

In terms of sustainability, it must be noted that the EU Parliament's and Council's proposal on MiCA envisaged a total ban on individual cryptocurrencies. This is not against the backdrop of regulatory difficulties, but is due to the negative impact on the environment caused by high-energy consumption in the process of mining the currency – so-called proof of work. Such a ban, however, has not prevailed.

For the crypto industry, it is relieving that a ban on proof of work was not adopted, as corresponding provisions would otherwise have limited the development of the crypto market in the EU.

Nevertheless, even if there is no ban, the EU continues to make efforts to stimulate environmentally friendly investments in order to reduce the high carbon footprint that is inevitably connected with some cryptocurrencies. Members of the EU Parliament have urged the Commission to prepare a legislative proposal by January 1, 2025, to include in the EU taxonomy a classification system for all crypto-assets that contribute significantly to climate change. Currencies that operate outside the proof of work mechanism and that subsequently have a lower carbon footprint could then be considered "green" according to the EU Taxonomy Regulation.

MiCAs' impact on German legal regulation regarding crypto and digital assets

When it comes to MiCAs' effect on the national German regulatory landscape, we anticipate that the new regulation will not have an extensive impact on existing national provisions since reporting obligations and the handling of crypto-assets specified in MiCA are already covered by existing financial regulations in Germany. For this reason, Germany is considered a good entry point for companies looking to enter the European crypto market.

This is because the existing national regulatory network is structured in such a way that it applies generally to financial instruments in Germany with which also relatively new crypto tokens that meet the relevant factual requirements are subject to the existing regulatory structure.

Applicable laws include the German Securities Trading Act, (Wertpapierhandelsgesetz), the German Securities Prospectus Act (Wertpapierprospektgesetz), the German Capital Investment Act (Vermögensanlagengesetz or VermAnlG), the German Investment Code (Kapitalanlagegesetzbuch), the German Banking Act (Kreditwesengesetz of KWG), the German Insurance Supervision Act (Versicherungsaufsichtsgesetz or VAG), and the German Payment Services Oversight Act (Zahlungsdiensteaufsichtsgesetz).

In the context of the question of whether a token is subject to the existing national regulatory framework, it should be noted that crypto and digital assets cannot be defined in a uniform manner. Without the examination of all individual circumstances and characteristics of the respective token, it is not possible to make a regulatory classification because of the diverse and different design of the numerous tokens that appear on the market.

One prerequisite for the regulations to apply would be that the token is a "financial instrument" within the meaning of section 1 (11), sentence 1 KWG. Although "crypto tokens" are not mentioned as a separate category in the KWG, in the sense of a technology-neutral interpretation, they may be included in the individual categories listed in section 1 (11), sentence 1 KWG, for example, in the category called "crypto-assets." It should be noted that, according to the German Federal Financial Supervisory Authority (BaFin), section 1 (11), sentence 1, No. 10 KWG is designed as a catch-all provision, as crypto securities may already fall under one of the other categories of financial instruments of section 1 (11), sentence 1 KWG because of their diverse design. This means that if the respective crypto token is already subject to one of the other categories in an individual case, a renewed license is not required.

This is advantageous for many banks, as they regularly already hold the necessary license to operate the custody business.

Whether the regulations apply is decided on a case-by-case basis and depends, again, on the legal structure of the token.

An NFT may fall under the definition of "crypto-assets" and then be regulated accordingly as a financial instrument under the existing regulatory framework, if it is created with the intention of generating monetary profits, and therefore the investment purpose is in the foreground when creating the NFT. This is also the case if the token holder ultimately acquires exclusively an asset position via the token ownership, but never takes possession of or uses the tokenized object itself. In such cases, it is also conceivable, for example, that the token may be classified as an "asset investment" under the VermAnlG.

Like NFTs, stablecoins can also be subject to the term "financial instruments" under German regulatory law. In particular, a classification as "units of account" or as "Crypto-assets" – according to the KWG or the German Securities Institutions Act – can be considered. This is because the legal definition also covers assets that are not alternative means of payment but serve investment purposes. Algorithmic tokens fulfill this purpose as a possible investment.

Also, crypto custody is covered by the existing regulations. The German Act Implementing the Amending Directive on the Fifth EU Anti-Money Laundering Directive (Gesetz zur Umsetzung der Änderungsrichtlinie zur fünften EU-Geldwäscherichtlinie) has introduced crypto custody business into the KWG as a new financial service. Pursuant to section 1 (1a), sentence 2, No. 6 of the KWG, crypto custody is defined as the custody, administration, and safeguarding of crypto-assets or private cryptographic keys used to hold, store, or dispose of crypto-assets on behalf of others, therefore qualifying as a so-called "financial service" under the KWG. In addition, crypto-assets themselves are also to be regarded as so-called "financial instruments" within the meaning of section 1 (11), sentence 1, No. 10 KWG, as crypto-assets are the digital representation of a value.

Therefore, with regard to the custody of crypto tokens, the custody is subject to authorization according to section 32 KWG. A corresponding license must be applied for at BaFin.

Just as the MiCA will demand in the future, financial service providers that wish to distribute banking and financial services products in Germany on a targeted basis must already have established a subsidiary (section 32 (1) in conjunction with section 33 (1), sentence 1, No. 6 KWG) or a branch (section 32 (1) in conjunction with section 53 KWG) in Germany in order to obtain the necessary license. In this respect, as well, the regulations in Germany are already in line with the new EU regulation.

Although Germany already provides a national regulatory network that covers crypto and digital assets, a common EU framework is welcome. Especially against the background of simplifying cross-border activities of financial service providers within the EU to achieve a stimulating effect on the crypto and digital assets sector, it is foreseeable that MiCA will bring real progress to the crypto financial industry market as a whole.

Authors

Simon Grieser
Partner
Frankfurt
sgrieser@reedsmith.com

Friedrich Lutter
Intern
Frankfurt
flutter@reedsmith.com

Crypto and other digital assets: United States

In the United States, the Securities and Exchange Commission and the Commodity Futures Trading Commission (CFTC) are the agencies that are most closely involved in the regulation of crypto and digital assets. The mission of the SEC is to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation.

The SEC's approach to whether a digital asset is categorized as a security derives from application of the test set forth in the 1946 Supreme Court decision, *SEC v. W.J. Howey Co.* (referred to as the Howey Test). The Howey Test determined whether an asset constitutes an "investment contract," one of the enumerated types of instruments defined in the securities laws. The test states that an investment contract involves (i) an investment of money, (ii) in a common enterprise, (iii) in which the investor is led to expect profits, (iv) derived from the entrepreneurial or managerial efforts of one or more third parties.

The mission of the CFTC is to promote the integrity, resilience, and vibrancy of the U.S. derivatives markets. The CFTC seeks to protect the American public from fraudulent schemes and abusive practices in those markets. Under the Commodity Exchange Act (CEA); the CFTC has oversight over derivatives contracts, such as futures, options, and swaps, that involve a commodity. The CEA defines "commodity" to include agricultural products, "all other goods and articles," and "all services, rights, and interests...in which contracts for future delivery are presently or in the future dealt in."

While the SEC has suggested that many digital assets are securities, arguably, the two most important digital assets – bitcoin and ether – have been recognized as commodities by both the CFTC and the SEC.

In the United States, crypto and digital assets remain largely unregulated, with the crypto community often complaining that regulators have been regulating by enforcement. That appears to be rapidly changing in favor of more regulatory clarity.

On March 9, 2022, President Biden signed an executive order addressing the risks and benefits of digital assets – including whether the United States should establish its own Central Bank Digital Currency. "The rise in digital assets creates an opportunity to reinforce American leadership in the global financial system and at the technological frontier, but also has substantial implications for consumer protection, financial stability, national security, and climate risk," said the Biden administration in a White House press release. The administration stressed that "[t]he United States must maintain technological leadership in this rapidly growing space, supporting innovation while mitigating the risks for consumers, businesses, the broader financial system, and the climate. And, it must play a leading role in international engagement and global governance of digital assets consistent with democratic values and U.S. global competitiveness." The executive order represents the Biden administration's first step toward regulating the cryptocurrency market, which SEC Chair Gary Gensler has compared to the Wild West.

The executive order sets forth six key priorities for government oversight of cryptocurrencies: (1) consumer and investor protection; (2) financial stability; (3) mitigating illicit finance; (4) U.S. leadership in the global financial system and economic competitiveness; (5) financial inclusion; and (6) responsible innovation. While the executive order is a first step toward additional rules and regulations for digital assets, it does not provide any concrete guidance. The order, however, is likely to lead to additional regulation in the near future.

Since the executive order, regulators and legislators have begun to make their intentions clear.

On April, 4, 2022, SEC Chairman Gary Gensler provided remarks at a capital markets conference on the future of crypto and digital assets. Gensler compared crypto trading and lending platforms, whether centralized or decentralized, to traditional securities exchanges regulated by the SEC, and made clear that crypto platforms need to be registered and regulated to protect investors.

Gensler also discussed how stablecoins, a class of cryptocurrencies often backed by stable reserve assets, raise three important sets of policy issues. Gensler said that most crypto tokens are "investment contracts" (in other words, securities) under the Howey Test. Gensler emphasized the importance of getting crypto tokens registered with the SEC and requiring issuers of crypto tokens to comply with the SEC's disclosure requirements, noting that "[a]ny token that is a security must play by the same market integrity rulebook as other securities under our laws."

Gensler's comments on stablecoins are particularly interesting, because most critical observers of the United States' regulatory regime believe stablecoins to be within the purview of the CFTC, not the SEC. For example, in October 2021, the CFTC issued an order settling charges against the stablecoin Tether for making misleading statements in connection with the reserves for USDT, its stablecoin pegged to the price of the U.S. dollar.

Meanwhile, United States legislators seem to favor an approach that would bring much of the regulatory oversight for crypto and digital assets under the CFTC's umbrella. On June 7, 2022, U.S. Senators Kirsten Gillibrand, a Democrat, and Cynthia Lummis, a Republican, introduced the first major bipartisan crypto legislation. The bill would give the CFTC exclusive jurisdiction over digital assets, subject to certain exclusions. "Digital asset[s]" are defined as a natively electronic asset that confers economic, proprietary or access rights or powers, and that is recorded using cryptographically secured distributed ledger technology. It later defines virtual currency as a digital asset that is used "primarily" as a medium of exchange, unit of account, or a store of value not backed by an underlying financial asset.

Five types of digital assets are explicitly excluded from the CFTC's jurisdiction, and would be subject to the SEC's jurisdiction. The five types of digital assets subject to SEC jurisdiction include digital assets that grant the holder with any of the following rights with respect to a business: (1) a debt or equity interest; (2) liquidation rights; (3) interest or dividend payments; (4) a profit or revenue share derived solely from the entrepreneurial or managerial efforts of others; or (5) any other financial interest. In addition, the CFTC does not have jurisdiction over NFTs.

While the United States' regulatory regime remains in flux, it appears to be coming into focus quickly. Further, the Gillibrand-Lummis bill would appear to seek to make the United States attractive to crypto and digital assets by providing greater regulatory clarity.

Author

Mark Bini
Partner
New York
mbini@reedsmith.com

Crypto and other digital assets: UAE

The United Arab Emirates (UAE) has positioned itself at the forefront of virtual assets. In addition, according to reports, a comprehensive framework for all metaverse-related commerce and activity is in the works.

It is worth noting that the UAE is a federation of seven individual emirates, where each emirate is subject to individual rules and laws and all emirates are subject to federal law. In addition, there are several economic free zones in the UAE that have their own independent rules and legal frameworks. The most prominent free zones of the country are its two financial free zones – the Dubai International Free Zone (DIFC) and the Abu Dhabi Global Market (ADGM), which are separate, common law jurisdictions with their own common law courts and financial services regulators. The rest of the territory of the UAE (which for the purposes of this article is referred to as "onshore" UAE is subject to a civil law-based legal system (comprising a mixture of federal and Emirate-specific laws and regulations). Within this complex jurisdictional system, several different approaches to the regulation of crypto and digital assets have emerged and are developing.

Blockchain strategy

In April 2018, the federal government unveiled the Emirates Blockchain Strategy 2021 (EBS), setting out the nation's objective to create a framework and environment where blockchain technology will thrive. The government committed to transporting 50 percent of all government transactions into the blockchain by 2021, which it is estimated to lead to savings of:

- AED 11 billion in transactions and documents processed routinely
- 398 million printed documents annually
- 77 million work hours annually

The EBS was followed by the adoption of the Dubai Blockchain Strategy (DBS), which intended to establish a roadmap for the introduction of blockchain technology for Dubai and the creation of an open platform to share the technology with cities across the globe.

Abu Dhabi Global Market

The Financial Services Regulatory Authority (the financial services regulator of the ADGM) was the first UAE regulator to issue a comprehensive set of rules, guidance, and regulations. For carrying out activities in relation to virtual assets and cryptocurrencies and to introduce a bespoke framework for the regulation of spot virtual asset activities, including those undertaken by multilateral trading facilities, brokers, custodians, asset managers, and other intermediaries.

The new regulatory regime instated rules for the management of risks generally associated with virtual and crypto-asset-related businesses, including those related to market abuse and financial crime, consumer protection, technology governance, custody, and exchange operations.

Dubai International Free Zone

While the ADGM positioned itself as a pioneer in the crypto space, the DIFC, adopted a much more cautious approach. As a first step, in October 2021, following a consultation process, the Dubai Financial Services Authority (DFSA) – the financial services regulator in the DIFC – issued a new regulatory framework relating to investment tokens. In April 2022, the DFSA issued a consultation paper on a proposed regulatory framework for crypto-assets. It is expected that the new regulations will be published in the latter half 2022.

Onshore UAE (federal level)

Within onshore UAE, the responsibility for the regulation of virtual and crypto-assets is divided between the UAE Securities and Commodities Authority (SCA) and the UAE Central Bank (CBUAE).

SCA

The SCA is tasked with regulating crypto-assets, which are deemed to be a product or security.

In 2020, the SCA released its much-anticipated Decision No. 21/R.M of 2020 concerning the Regulation of crypto-assets (the SCA Regulations), which is intended to regulate the offering, issuing, listing, and trading of crypto-assets in onshore UAE, as well as associated financial activities.

The SCA Regulations apply to: (a) any person in the UAE who offers, issues, or promotes crypto-assets; (b) anyone who provides crypto custody services and/or operates a crypto fundraising platform and/or a crypto-asset exchange in the UAE; and (c) anyone who engages in other financial operations in the UAE in relation to crypto-assets (Article 3 of the SCA Regulations).

It does not apply to crypto-assets issued by the government and/or public undertakings, a currency, virtual currency, digital currency, unit of stored value, or any other payment unit issued through a system licensed, approved, and authorized by the Central Bank of the United Emirates (CBUAE) from time to time, and Securities held in dematerialized form that are not issued as crypto-assets.

Central Bank of the United Emirates

All onshore UAE currency-related transactions are regulated by the CBUAE. On September 30, 2020, the CBUAE revamped its regulatory framework applicable to digital payments by issuing the Stored Value Facilities Regulation (Circular No. 6/2020) (the SVF Regulations). The purpose of the SVF Regulations is to create a framework for the operation and regulation of crypto-assets.

Pursuant to the SVF Regulations, the CBUAE may authorize and license companies and organizations in the UAE that issue or provide SVFs, which is defined as “a facility (other than cash) for or in relation to which a Customer, or another person on the Customer’s behalf, pays a sum of money (including Money’s Worth such as values, reward points, crypto-assets or Virtual Assets) to the issue in exchange for the storage of the value of that money (including Money’s Worth)…(Article 1(27) of the SVF Regulations).”

Emirate of Dubai (onshore) – virtual assets regulatory authority

On February 28, 2022, the government of Dubai issued Law No. 4 of 2022 relating to virtual assets (the Virtual Assets Law). This landmark piece of legislation intends to cement the position of Dubai – and the UAE – as a key market for virtual assets and the commercial marketplaces they engender.

The Virtual Assets Law applies to the provision of services relating to virtual assets throughout Dubai, including all of its free zones, except the DIFC. The Virtual Assets Law governs non-fungible tokens, cryptocurrencies, and security tokens.

Notably, the Virtual Assets Law has established Dubai's Virtual Assets Regulatory Authority (VARA). VARA is tasked with providing a full range of services for virtual assets in coordination with the CBUAE and the SCA, including the licensing and regulation of entities carrying out activities in the virtual asset space, development of strategic plans and policies surrounding virtual asset activities, regulating and supervising the issue and offering of virtual assets and tokens, and prescribing regulations in relation to personal data protection and KYC/AML.

VARA is collaborating with its counterparts in various leading jurisdictions, such as the United States, Switzerland, the UK, Singapore, and Hong Kong with the aim of creating an interoperable set of regulations for activities in the metaverse that can be "passported" to any other jurisdiction. The ultimate goal of VARA is to ensure that any company operating under and complying with its regulations in Dubai can obtain recognition as a reliable and stable company in this space globally.

VARA's approach for the short- to medium-term is to identify and support Virtual Asset Service Providers (VASPs) and numerous other companies through its MetaHQ that import dimensions of virtual assets in their strategy. VARA's main goal is to support what it describes as game-changers, innovators, and market makers across ICT, financial and professional services, lifestyle, entertainment, and FMCG sectors, beyond the world of gaming and VASPs.

Numerous projects, initiatives, and developments are already being encouraged as the UAE is positioning to be a leader in the field of metaverse-related laws and regulation.

In the UAE, we can expect to see regulations being adopted, adapted and amended to keep pace with the rapid advance in the world of web3 and innovations in the metaverse. Any company looking to expand into the metaverse will find the UAE a tax-friendly business foundation with a supportive legislative framework.

Authors

Adela Mues
Partner
Dubai
ameus@reedsmith.com

Soham Panchamiya
Associate
Dubai
spanchamiya@reedsmith.com