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Look Ahead Calendar - PolicyPartner

- Institutional investor's perspective on European crypto regulation: a quick roundup
- US legislation: challenge to SAB 121 and expansion of Secret Service responsibilities
- Hong Kong's multi-level approach to crypto regulation
- BA and the DeFi Education Fund submitted an amicus brief in the Kraken case

Institutional investor's perspective on European crypto regulation: a quick roundup

EU:

Application of MiCA:
Already-compliant institutions can leverage existing frameworks when operating in MICA territory (ex. Business continuity, trade reporting, etc.) While the principles in MiCA may have concreate parallels to MiFID, the actual supervision is an unknown as the technical details and implementation are still to come.

Institutions have a head start
Firms operating under MiFID face similar requirements and can draw from experience and in place systems. Conversely, digitally native firms face a steeper learning curve, the creation of new licensing frameworks, and completely new regulators. We continue to believe MiCA has a built "head start" for tradfi firms, especially in the issuance of ARTs (stablecoins).

Process and next steps:
ESMA needs to submit the finalized RTS to the European Commission after consideration of comments (closed). Once adopted, the commission and the EU co-legislators (EU Council and Parliament) will have a two-month window to approve or reject the RTS. Once approved, there is a two-month window for the law to be published and enacted. This is a reoccurring challenge in EU law - level-2 standards are published after the date of application of level-1 standards which can necessitate a "no-enforcement" period from the National Competent Authorities. **The possibility of a small delay is likely.**
Likelihood of "no-enforcement" period for stablecoins depends on an NCA and whether they want to grant a transitional period for CASPs. Jurisdictions that are moving up the implementation deadlines are likely a sign of welcoming market participants – to view the status of transition periods in each EU jurisdiction refer to a recent PolicyPartner **note**.

Investment firms
Investment firms and credit institutions already authorized under existing laws enjoy the benefit of not having to authorize under MiCA. However, MIFID requires notification by financial

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institutions (FI) to competent authorities. While the registered FIs are exempt from registration, other requirements under MiCA apply (ESG, reporting, etc.)

Institutional points of interest:

- MIFID institutions interaction with MiCA Assets and unclear delineation between traditional financial instruments and crypto assets
- ESG disclosure requirements
- Disproportional custodial liability requirements for crypto
- Cross-border market access
- Prudential treatment of crypto assets and proposal of the Basel committee
- Institutional changeovers both in the EU and UK

UK:

Fault lines between traditional capital markets regulations and coming digital assets rules

UK is behind the EU in developing a digital assets regulatory regime. While there are policy indications from the government, it is not specific enough for firms to launch operations and feel confident in compliance.

The UK has set forth in two phases – phase-one to focus on stablecoins, phase-two to focus on other crypto assets. Stable coins are to be addressed first and regulation of other crypto assets will borrow from concepts developed.

Regulatory treatment of tokenized crypto assets which currently qualify as "transferrable securities" under MiFID remains an outstanding concern. Such assets will not benefit from the same regulatory treatment as traditional financial instruments in their lifecycle as the FCA's proposal to introduce new custody treatment of securities tokens proposes differing treatment. For example, the proposed rules would require UK investors to use only use UK-based custodians that have additional authorization for security tokens. Currently, a UK-based investor has greater optionality for selecting custodians.

Other FCA themes:

- Delineation between treatment of wholesale vs retail clients –government has indicated that there will be more lenient rules for wholesale clients (mostly in terms of disclosure requirements and not in terms of market access).
- Approach towards permissioned vs permissionless blockchains – government's high-level approach is that it is open to facilitate innovations.
- While the UK regulatory approach insulates regulation from the changing of political control, the upcoming elections could cause changes in the FCA approach

Stablecoins in the UK

FCA is proposing a prescriptive regime on the use of overseas stablecoins (USDC, USDT) requiring a UK payment arranger to ensure that the firms comply with the rules, effectively

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creating a UK-based intermediary. If the overseas issuers do not appoint a payment arranger, UK clients and investors may lose access to the global market.

US legislation:

Challenge to SAB 121 is considered during HFSC markup
The bill to repeal 121 passed the house Financial Services Committee vote. If this bill moves to the floor or is passed on the floor, we believe the SEC may be pressured to withdraw the rule – especially if Democrats back the measure. The left leaning/anti crypto think tank released a statement on the process. It also included a few words of support for keeping it, overall, pretty weak statement and indicative of 121 standing on shaky ground.

Unfortunately, left leaning House Democrats were vehemently opposed to removing SAB 121 during the hearing. We were hopeful democrat concessions would nudge the SEC to withdrawal the rule, this seems less likely now. While some opponents mustered technical and legal reasoning to vote against the measure, Rep. Brad Sherman was more direct – he thinks bitcoin is a danger to the US government and the US dollar, SAB 121 impedes the proliferation of BTC, so that is good, so let's keep it.

What we think Rep. Sherman and other opponents from the left miss is that BTC is good for the people of the United States but not for the United States government, and that's OK. If the policy objective is to prevent bitcoin, any means to achieve that goal are available. The typical rule and comment process that SAB 121 would have been eviscerated under, was bypassed. Acting within the bounds of the law isn't a constraint. For this reason, we remain surprised that the SEC approved the spot ETF applications – the cat is out of the bag!

Support for more investigations into MSBs / BSA regulated institutions.
A bill passed the committee to give the Secret Service authority to pursue investigations of "institutions" sponsored by Rep. Fitzgerald, a republican from Wisconsin. PolicyPartner believes that an expansion of these investigative authorities to firms covered under the BSA could impact Tether eventually.

Hong Kong's multi-level approach to crypto regulation
The Hong Kong Monetary Authority (HKMA) and the Financial Services and the Treasury Bureau (FSTB) proposed legislation to create a licensing and regulatory regime for fiat-referenced stablecoins (FRS) in Hong Kong. **Feedback on the proposal is due by February 29, 2024. China becoming more open to the use of crypto could become a very important theme.**

Under the proposed licensing regime, issuers of crypto assets must incorporate in HK, have several marketing restrictions, as well as align with the Basel Committee's criteria for Group 1b – crypto assets. The aim is to align international standards with practices

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in Hong Kong and to attempt following the FSB's stablecoin guidelines. Further, the securities regulator is planning to introduce a sandbox for stablecoins and have a transitional arrangement for existing FRS issuers to adapt to the new regime.

As part of a parallel effort to improve investor protections, the HK Treasury Bureau indicated an intention to regulate OTC venues. Unregistered or shadow OTC venues are likely to be at risk of conducting illicit activity or be out of compliance with AML standards. The effort highlights the multi-level approach the country is taking to fill in gaps in crypto regulation in the HK market.

In 2022, the HK authorities outlined a licensing framework for VASPs, which granted a transitional period for VASPs until February 29, 2024. The HK Treasury Bureau indicated that "All existing service providers which have not submitted their application by 29 February, or have received a "No-deeming notice", must begin ceasing operations and complete the process by 31 May this year, or within three months since the issuance of the notice.".

BA and the DeFi Education Fund submitted an amicus brief in the Kraken case

While our note on the Coinbase case does not mention the brief submitted by DEF in that docket, the brief had profound impact on how the judge viewed the arguments in the case – Judge Failla mentioned the paper repeatedly in questioning directed to the SEC. While the SF district court judge overseeing the Kraken case may not be as receptive, the arguments are clearly well constructive and are worth a read. Paul Clement led the declaration – Mr. Clement is a heavyweight lawyer who regularly argues before the Supreme Court.

Key points:

- Digital Assets are not inherently securities
- Digital Assets are not inherently contracts and contracts are not created from a belief the asset will rise in price, used as part of an ecosystem.
- Further, the brief argues that SEC behavior is confusing and lacking in fair notice.