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# **Ex-Changing the legal framework**

## **Crypto Exchanges from a regulatory perspective**

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## **Abstract**

*From financial institutions to private investors, more and more people are getting interested in crypto assets these days, and Exchange Platforms play a crucial role for users willing to trade them. The recognition of the crypto asset market as such led to the rise of a long debate on how those new assets and the infrastructures in which they are placed should be treated from a regulatory perspective. The current regime corresponds to an adaptation of existing legislation, but no bespoke regime, in particular for Crypto Asset Service Providers is now in place, therefore undermining consumers and market integrity. The MiCAR represents a possible path towards the creation of a level playing field for market players as well as a way to fill in the gaps that characterize current EU regulation. How will Exchanges be affected?*

**Key words:** crypto-assets, exchanges, crypto asset service providers, MiCAR, MiFID

## Summary

<b>Introduction</b> .....	5
<b>Exchanges: a definition</b> .....	6
<b>Opportunities and risks</b> .....	7
<b>An adaptation of existing rules</b> .....	9
<b>A Fragmented panorama</b> .....	12
<b>Exchanges in light of the MiCAR Proposal</b> .....	13
<b>Coinbase Example</b> .....	17
<b>Final Remarks</b> .....	18
<b>References</b> .....	20

## Introduction

Exchange platforms are growing in number and the services they offer are getting more and more appreciated by the public.

Let's think, for example, at the recent events: for instance, Coinbase<sup>1</sup> advertised<sup>2</sup> its services during the Super Bowl, inviting over a billion of people to experience the crypto economy and got so much attention that during the minutes following the ad its server collapsed, making crypto even more mainstream.

However, Coinbase was only one of the main platforms advertising at this huge event: for this reason, this year's Super Bowl was dubbed "Crypto Bowl".

That's where we are today, but how did everything begin?

Back in 2009 Bitcoin white paper<sup>3</sup> release created the need for an environment that could enable people to trade it. The lack of a proper infrastructure led people to buy and sell Bitcoins in forums or in chats, which proved not to be safe at all: many times, counterparties in transactions decided not to honor their duties.

The first<sup>4</sup> exchange platform became accessible in March 2010 and posed itself as a market for people to buy and sell bitcoins: this improved trading conditions, enabling more and more users to trade. At a certain point *bitcoiners* became so many that the rough infrastructure was no more able to cope with such a number of users and trades.

This was just the beginning of a great process, that after many hacks, failures and issues related to fraudulent activities<sup>5</sup> brought a huge Exchanges panorama, in which a large number of crypto assets are exchanged, and a huge number of users buy and sell simultaneously, creating real communities.

Since 2011, many more<sup>6</sup> sophisticated exchanges established, building on the functionality of their rough predecessors, but providing far greater technical superiority and security measures. The business model was boosted by the existence of many more alternatives to bitcoin, commonly known as altcoins<sup>7</sup>, with increasing demand for trading pairs against both bitcoin and fiat currencies.

Of course, along with opportunities many risks and threats come by, leaving not only investors unhappy but also financial authorities, who found themselves in front of an innovative landscape, which was blooming and growing in a fast way.

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<sup>1</sup> Coinbase is one of the most famous crypto-asset service providers.

<sup>2</sup> More at <https://blog.coinbase.com/everyone-wins-at-super-bowl-lvi-wagmi-c0039452975f>

<sup>3</sup> Available at <https://bitcoin.org/bitcoin.pdf>

<sup>4</sup> It was called bitcoinmarket.com

<sup>5</sup> Available at <https://crystalblockchain.com/articles/the-10-biggest-crypto-exchange-hacks-in-history/>, <https://www.investopedia.com/articles/forex/042315/beware-these-five-bitcoin-scams.asp>, <https://en.cryptonomist.ch/2019/12/14/crypto-exchanges-closed-in-2019/>.

<sup>6</sup> To cite some, Coinbase, Binance, Kraken, Gemini

<sup>7</sup> Altcoins are cryptocurrencies other than Bitcoin. They share characteristics with Bitcoin but may have different features such as in the consensus mechanism to produce blocks or validate transactions or new or additional capabilities. Examples are Ethereum and Tether.

With the following, crypto exchange platforms will be presented, together with the risks and opportunities attached. Then, the current regulatory regime and the MiCAR Proposal will be reported: in light of this, Coinbase exchange platform services will be described.

### **Exchanges: a definition**

In order to better capture the risks and the opportunities stemming from such businesses, the concept of crypto-exchange platform needs to be explored.

Crypto exchanges are trading systems whose ultimate goal is to match demand and supply and the transfer of crypto assets after the initial placement phase thanks to a blockchain technology<sup>8</sup>.

We can distinguish between two uses of such venues: Crypto Exchange Platforms or commonly called “*Exchanges*” are trading systems performed via online platforms which enable their users to trade (buy and sell) crypto assets and the transfer of tokens after initial placement. On the other hand, “*Wallets*” are venues granting the custody of tokens.

In particular, *Exchanges* can be organized mainly in three ways:

- Orders are matched through an order book;
- Users can trade among them directly, in form of peer-to-peer trading;
- The platform plays as a unique counterparty with the user, who is not allowed to trade directly with other parties.

As above-mentioned Exchanges shall not be confused with Digital Wallets. The first one embeds a transfer of crypto assets whereas the latter is referred to as a system that is able to record trades of digital assets in a wallet on behalf of the user, which is stored in the provider database<sup>9</sup>.

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<sup>8</sup> Blockchain consists in a distributed database that is shared and supported by users, also called nodes, who run a decentralized peer-to-peer network for the verification, authentication and exchange of data. The innovative feature of blockchain is that data are collected in blocks which once filled are closed and linked to the previous block with a crypto key or algorithm forming a chain. Blockchain can be either public or private: public blockchains are open access and allow users to freely take part whereas private blockchains allow only specific nodes participate to the blockchain.

<sup>9</sup> Wallet Providers entail the presence of private and public keys for the identification of each user in the blockchain, and for the interaction to check/transfer tokens.

## Opportunities and risks

During the last years the vast majority<sup>10</sup> of people approached crypto assets. Many people got interested in this phenomenon because it *was and still is* “fashionable”<sup>11</sup> whereas others were rather interested in the opportunities it was bringing to the market.

Starting from 2017 the crypto asset market could be defined as such, and users started to exploit its speculative side: it represented in fact an easy and innovative way to make money<sup>12</sup> out of bitcoins and altcoins.

However, this was not the main idea promoted by Satoshi Nakamoto in his white paper<sup>13</sup> on Bitcoin<sup>14</sup> dated back 2008. The famous creator aimed instead at providing an alternative<sup>15</sup> to the traditional financial intermediaries, which proved not to be trustworthy and credible in light of the Great Financial Crisis.

*“What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.”*

As we can see from the *white paper*, the main pillars of blockchain technology (“*Bitcoin*”) lay in fact in the creation of a network composed by cryptographed and decentralized blocks enabling to safely manage a data register where information is not alterable and thanks to which abuses and frauds are avoidable; the ultimate goal was to democratize the system, giving the power to users rather than continuing to rely on a central authority.

The main benefit of blockchain<sup>16</sup> lays in the *anonymity of users together with traceability of operations and transactions*<sup>17</sup>: as anticipated, blockchain is organized in ledgers from which operations and transactions cannot be cancelled without leaving behind a clear track. Ledgers are situated in a network across a series of nodes and thus are not stored all together in a unique centralized place, providing trust, traceability and security in systems that exchange data or assets.

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<sup>10</sup> According to Statista, in 2022 there were over 81 million wallets (of Bitcoin only). The exact number of users is not known but it is estimated that the user base grew by 190% between 2018 and 2020. This suggests that the number of users is increasing dramatically. More available at: <https://www.statista.com/statistics/647374/worldwide-blockchain-wallet-users/>

<sup>11</sup> Many holders tend to buy crypto assets because they are influenced by famous people. For instance, as reported by the newspaper Il Messaggero, crypto assets are widely used in Football teams – available at: [https://www.ilmessaggero.it/economia/news/bitcoin\\_criptoalute\\_valore\\_euro\\_miliardari\\_vip\\_cosa\\_sono\\_come\\_funzionano-6244662.html](https://www.ilmessaggero.it/economia/news/bitcoin_criptoalute_valore_euro_miliardari_vip_cosa_sono_come_funzionano-6244662.html). Moreover, Google trends highlights a huge interest for the topic as can be seen in the search for the keyword Bitcoin <https://trends.google.com/trends/explore?date=all&q=Bitcoin>.

<sup>12</sup> As stated by Fabio Panetta in his Speech at the Columbia University, people are pushed to invest in crypto assets because they are promised high returns. They are driven of course by a limited understanding of risks and fear of missing out. The speech is available at: <https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220425~6436006db0.en.html>.

<sup>13</sup> Nakamoto S., *A Peer-to-Peer Electronic Cash System*, 2008

<sup>14</sup> Bitcoin Blockchain

<sup>15</sup> *ibidem*

<sup>16</sup> Cryptocurrencies represent one type of application of blockchain, which can be the underlying of several applications in multiple sectors other than FinTech.

<sup>17</sup> This arises from the construction of the technology itself.

Exchanges benefits are mostly related to Distributed Ledger Technology<sup>18</sup> and in particular blockchain technology: DLT benefits highlighted by ESMA in 2017, which are now growing in number, are the following<sup>19</sup>:

- More efficient post-trade processes: accelerating the clearing and settlement of securities transactions;
- Enhanced reporting and supervisory functions: accurate and verifiable ledger sources in real time;
- Reduced counterparty risk and enhanced collateral management;
- Reduced costs for providers of financial services and ultimately their users.

Moreover, being crypto exchanges digital interfaces, they can easily channel resources bridging the demand and supply of an asset. Furthermore, crypto assets service providers may contribute to the fostering of competition and enhancing the Single Market, providing a new and better experience for users and hopefully increased financial inclusion<sup>20</sup>.

Although crypto assets and so crypto assets exchanges yield great opportunities to the financial system, there may be concerns on the risks they carry.

First of all, crypto exchange platforms were often the locus where laundering activities<sup>21</sup> took place: this is why the ESAs encouraged to include them in the list of obliged entities under AML as it will be described later.

Second, the risk to operational resilience since, as highlighted by ESAs Call for Advice on digital finance and related issues of February 2021<sup>22</sup>, platform infrastructures, which typically collect and store vast amounts of personal and financial consumer data, represent an attractive target for cyber-attacks<sup>23</sup>.

Last but not least, the EBA but in general ESAs proved to be particularly concerned about consumer protection: on its report of 2019 the EBA highlighted risks<sup>24</sup> relating to consumer protection arising from crypto asset service providers.

Among them:

- Lack of conduct of business rules and disclosure about crypto assets risks;

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<sup>18</sup> Distributed Ledger Technology (DLT) can be briefly described as the technological infrastructure and protocols that allows simultaneous access, validation, and record updating in an immutable manner across a network that's spread across multiple entities or locations.

<sup>19</sup> The Distributed Ledger Technology Applied to Securities Markets. ESMA Report, February 2017.

<sup>20</sup> *ivi*

<sup>21</sup> According to Chainalysis, a Crypto compliance and investigation software, in 2019, criminals laundered around \$2.8 billion in Bitcoin through cryptocurrency exchanges.

<sup>22</sup> Available at:

[https://www.eba.europa.eu/sites/default/documents/files/document\\_library/Publications/Reports/2022/1026595/ESA%202022%2001%20ESA%20Final%20Report%20on%20Digital%20Finance.pdf](https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1026595/ESA%202022%2001%20ESA%20Final%20Report%20on%20Digital%20Finance.pdf)

<sup>23</sup> Some notable examples include hacking thefts to Coincheck in 2018 and to KuCoin in 2019.

<sup>24</sup> EBA report on crypto assets available at:

<https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2545547/67493daa-85a8-4429-aa91-e9a5ed880684/EBA%20Report%20on%20crypto%20assets.pdf> , page 16.



- Lack of suitability checks;
- Lack of governance arrangements to ensure risks are appropriately managed and mitigated;
- Lack of compensation schemes protecting the customers of the entity;
- Lack of a legal framework determining the rights and obligations of each party, especially liabilities rules.

However, the most common risks emerging from exchange platforms are linked to the very nature of crypto assets. This can be clearly seen in the numerous ESAs joint warnings, opinions and advices on crypto assets.

For instance, the last ESAs initiative (March 2022) “#BeCryptoAware”<sup>25</sup> aims at promoting awareness about the risks of crypto assets, especially among young people who might be underestimating them. Among them, extreme volatility and bubble risk, absence of protection and misleading information as well as their inappropriateness for investment or retirement planning<sup>26</sup>.

However, not only user protection is at stake, but also prudential aspects of platforms are not properly addressed.

This is why the European Commission was and still is working on an ad hoc regime for crypto-assets service providers, which as of today are covered by existing regulations only in part.

### **An adaptation of existing rules**

The increasing interest in crypto assets captured regulators and supervisors’ attention too.

Surely nobody believed that crypto would gain such an economic value and market share: as of 2021 the number of crypto assets was larger than 10.000 units, with a capitalization of 2 billion euros<sup>27</sup>.

Following 2017, authorities started to attempt to regulate crypto assets as they were increasingly capturing the interest of people.

Authorities opted for an *adaptation* of in existing legislation that could somehow be suitable to regulate this area as well.

However, as it will be later explained, most of the applicable rules regulate the *asset exchanged* rather than the *platform through which assets are bought or sold*.

Rules can be divided into two main groups: *preventive law* and financial *substantive law*.

*Preventive law* consists in the adoption of some *precautions* to diminish risks and enhance the soundness of businesses activities. Crypto assets service providers are directly addressed by the anti-money laundering legislation. At European level the piece of legislation regulating anti-money

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<sup>25</sup> The initiative was promoted via social media and sends back to ESAs warnings. Available at: <https://www.eba.europa.eu/eu-financial-regulators-warn-consumers-risks-crypto-assets>

<sup>26</sup> *ivi*

<sup>27</sup> Annunziata F., Conso A., Di Giorgio A., Lucchini A., Seri L.M., Carozzi M., Borsa P., Braccioni P., NFT L’arte e il suo doppio – non fungible token: l’importanza delle regole oltre i confini dell’arte.

laundering is the AML Directive. The current version in force is AMLD V, which is an amendment of AMLD IV.

The AMLD provides a definition of Virtual Currency: '*virtual currencies*' means a digital representation of value that is not issued by a central bank or a public authority, nor attached to a legally established currency, which does not possess the legal status of currency or money, but is accepted by natural or legal persons as a means of exchange or for other purposes, and can be transferred, stored or traded electronically.

AMLD contains a list of *obliged entities* which must satisfy anti-money laundering requirements; AMLD V introduced also *providers engaged in exchange services between virtual currencies and fiat currencies custodian wallet providers*<sup>28</sup> among the subjects.<sup>29</sup>

Therefore, provided that an exchange is exchanging assets that fall under the AMLD V definition of virtual currencies, it is subject to AMLD IV obligations.

From a practical perspective this means that Exchanges and Custodian Wallet Providers are required to perform Customer Due Diligence (CDD)<sup>30</sup> as reported in Art. 13 and following of DIRECTIVE (EU) 2018/843 as a foundation of the Know Your Customer (KYC) process, which requires entities to understand their customers' financial behavior and the kind of money laundering or terrorism financing risk they pose. Moreover, obliged entities shall keep track of transactions performed by their clients as well as submitting suspicious activities to the designated National Competent Authority.

*Substantive law* instead regards the law that directly regulates, *in this case, exchange platforms*: at the moment there is no ad hoc European piece of law that addresses crypto exchange platforms as such. Thus, as anticipated, authorities opted for an *adaptation of existing regulation to exchanged crypto assets*. To this purpose the most relevant piece of legislation is MiFID II<sup>31</sup>.

Crypto assets exchanged shall be classified according to their legal nature and more precisely, as suggested by the FINMA ICO guidelines<sup>32</sup> we shall distinguish between three types of crypto assets:

- *Utility tokens* - which allow users to perform determined activities in a digital infrastructure by means of a blockchain-based infrastructure. They provide the right of ownership of the token itself and may provide the right to access some goods or services.
- *Payment tokens* - which are intended to be used as a of payment for acquiring goods or services or as a means of money or value transfer; they correspond to the *cryptocurrencies*. They provide the ownership right of the token.
- *Asset tokens (or Investment tokens)* representing an investment asset – for instance as a debt or equity claim on the issuer. They are called security tokens since they share in fact the same

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<sup>28</sup> Custodian wallet provider means any entity that provides services to safeguard private cryptographic keys on behalf of its customers, to hold, store and transfer virtual currencies.

<sup>29</sup> DIRECTIVE (EU) 2018/843 amending Directive (EU) 2015/849.

<sup>30</sup> Customer Due Diligence consists in the collection of all relevant information needed to properly identify a customer's identity and to better assess the level of criminal risk they present.

<sup>31</sup> Market in Financial Instruments Directive (MiFID)

<sup>32</sup> Swiss financial markets authority; it was the first authority laying down a classification of assets. FINMA ICO guideline available at <https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/>

characteristics of equity, debt, and derivative instruments. This category is also comprehensive of tokens that allow a physical asset to be traded on the blockchain.

*Utility tokens* do not fall under any of the definitions provided by applicable European Financial Law and do not need to fulfill any legal requirement.

The same cannot be said regarding *Payment tokens* and *Investment tokens*.

*Payment Tokens*, which correspond to cryptocurrencies can be triggered by the Electronic Money Directive<sup>33</sup> category of e-money.

According to art. 2 of the Directive, '*electronic money*' means *electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions and which is accepted by a natural or legal person other than the electronic money issuer.*

This definition of E-money may cover that of *stablecoins*, which can be defined as *cryptocurrencies that aim to maintain a stable value relative to a specified asset, or a pool or basket of assets*<sup>34</sup> when backed 1:1 by a legal tender and when used as a means of payment.

However, *not all* cryptocurrencies may fall under this definition as some of them may not have an issuer<sup>35</sup>. This may cause loopholes, leaving some crypto assets completely unregulated in some jurisdictions.

*Investment tokens* fall under MiFID regulation as they would be part of the Financial Instruments<sup>36</sup> list under the transferable security<sup>37</sup> definition (Bonds, shares and *any other security* sharing bonds and shares features). Thus, the exchange platform in which they are exchanged would be considered a *trading venue*<sup>38</sup> according to the same Directive. To this purpose, the activity performed by such platforms would be reserved and thus, MiFID authorization would be triggered.

Thus, on the one hand some assets may be covered by existing regulation as mentioned above, but on the other hand ESMA underlined that most crypto assets fall outside the scope of EU financial

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<sup>33</sup> E-money Directive, Directive 2009/110/EC

<sup>34</sup> European Parliament briefing available at

[https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698803/EPRS\\_BRI\(2021\)698803\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698803/EPRS_BRI(2021)698803_EN.pdf)

<sup>35</sup> As a consequence of decentralization, the issuer may not be a legal person but the community as such.

<sup>36</sup> Available in Annex I Section C of MiFID

<sup>37</sup> Art. 1, comma 44 '*Transferable securities*' means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as: (a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares; (b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities; (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;

<sup>38</sup> *Trading venue means a regulated market, an MTF or an OTF; Multilateral trading facility or 'MTF' means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of this Directive; Organised Trading Facility or 'OTF' means a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of this Directive.*

services legislation. Therefore, some exchange platforms are operating outside any regulatory regime.

## A Fragmented panorama

Most of existing applicable law comes in the form of a *Directive*. As it is well-known, directives do not strike the objective of providing *full harmonization* since their transposition may differ from jurisdiction to jurisdiction.

Some Member States in fact implement Directives in a stricter way<sup>39</sup> whereas others meet the demanded objectives in a more lenient way, causing the opportunity for Regulatory Arbitrage to arise.

For example, MiFID is transposed in the Italian Legislation in the Italian Consolidated Financial Act and highlights the existence of a further category of assets: Financial Products.

Financial Products in Italian Financial Law are *Financial Instruments and any other form of Investment* possessing three features: the investment of capital, the promise of a return and the presence of financial risk. Most of times<sup>40</sup>, if a crypto asset qualifies as a Financial Product, it will require the same license required for Financial Instruments.

Back in 2018, ESMA conducted a survey aiming at mapping Member States approaches towards licensing and authorizing FinTech Business models in Europe<sup>41</sup>.

The survey highlighted that in most jurisdictions, exchange platforms, Virtual Currency (VC) brokers and firms raising capital through ICOs are the most commonly unregulated FinTech firms.

As anticipated, during the past years, the urge to regulate to some extent these firms brought to the naissance of single jurisdictions regulatory initiatives to cater the issues related to crypto assets and crypto assets service providers, leading to further fragmentation.

For example, Germany requires virtual currency exchanges and custodian services to ask for a license to the German Authority BaFin: such licensing opportunity was embraced by some exchanges<sup>42</sup> but some others<sup>43</sup> argued that obtaining a license in Germany would be too costly.

The divergent frameworks, rules and interpretations of both crypto-assets and crypto-asset services throughout the Union hinder the possibility for service providers to provide their services at EU level, forcing them to familiarise with multiple legislations and obtain numerous authorizations or registrations to comply with divergent national laws, sometimes adjusting their business model

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<sup>39</sup> Commonly referred to as Gold Plating

<sup>40</sup> The regime is the same as the Financial Instruments if the public is composed of *retail clients*; on the other hand, if the public consists of professional clients as described by MiFID, then authorization is not triggered.

<sup>41</sup> The Report addresses one of the five action points of the European Commission FinTech Action plan available at [https://www.esma.europa.eu/sites/default/files/library/esma50-164-2430\\_licensing\\_of\\_fintech.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-164-2430_licensing_of_fintech.pdf)

<sup>42</sup> E.g. Coinbase

<sup>43</sup> E.g. Kraken

throughout the Union, hindering the development of the Single Market and the scaling up of crypto-asset activities in the Union.

The lack of legal certainty makes Authorities particularly worried about the risks crypto assets pose to consumers and investors, but prudential requirements should not be overlooked too.

As claimed by the recent<sup>44</sup> and past<sup>45</sup> ESAs warning to investors concerning crypto assets, although exchanges and wallet providers must be registered in each Member State for Anti-money laundering purposes and although some Member States adopted national regulations towards the authorization of the above-mentioned service providers,

*“The majority of crypto-assets and the selling of products or services in relation to crypto-assets are unregulated in the EU. In these cases you will not benefit from the rights and protections available to consumers for regulated financial services, such as complaints or recourse mechanisms”<sup>46</sup>*

*“For example, if a VC exchange platform or a digital wallet provider fails, goes out of business, or is subject to a cyber-attack, funds embezzlement or asset forfeiture as a result of law enforcement actions, EU law does not offer any specific legal protection that would cover you from losses or any guarantee that you will regain access to your VCs holdings. These risks have already materialised on numerous occasions around the world.”<sup>47</sup>*

This is why authorities and regulators elaborated a proposal to regulate crypto assets in the Market in Crypto Assets Regulation (MiCAR)<sup>48</sup>.

## **Exchanges in light of the MiCAR Proposal**

The Markets in Crypto Assets Regulation proposal is part of the Digital Finance package, laid down with the aim to embrace innovation in digital finance while ensuring risks are correctly mitigated and addressed, allowing costumers and businesses to benefit from the opportunities arising.

In fact, the MiCAR arose from a the EBA and ESMA advice, which highlighted that on the one hand existing EU legislation may hinder the use and potential of DLT and, while on the other, it leaves many crypto assets unregulated, therefore undermining consumers and investors as well as market

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<sup>44</sup> Dated 17 March 2022, *The European Supervisory Authorities today warn consumers that many crypto-assets are highly risky and speculative. The ESAs set out key steps consumers can take to ensure they make informed decisions.*

<sup>45</sup> Dated 17 March 2021 and 12 February 2018.

<sup>46</sup> ESAs Warning 2022 available at

[https://www.eba.europa.eu/sites/default/documents/files/document\\_library/Publications/Warnings/2022/1028326/ESAs%20warning%20to%20consumers%20on%20the%20risks%20of%20crypto-assets.pdf](https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Warnings/2022/1028326/ESAs%20warning%20to%20consumers%20on%20the%20risks%20of%20crypto-assets.pdf)

<sup>47</sup> ESAs Warning 2018 available at: [https://www.esma.europa.eu/sites/default/files/library/esma50-164-](https://www.esma.europa.eu/sites/default/files/library/esma50-164-1284_joint_esas_warning_on_virtual_currenciesl.pdf)

1284\_joint\_esas\_warning\_on\_virtual\_currenciesl.pdf Note that this warning refers to VCs only whereas the 2022 Warning refers to crypto-assets, proving that the concept of cryptocurrency is outdated and that authorities are now concerned with the whole set of crypto assets.

<sup>48</sup> MiCAR Proposal is part of the EU Digital Finance package. The package also includes a proposal for a pilot regime on distributed ledger technology (DLT) market infrastructures, a proposal for digital operational resilience and a proposal to clarify or amend related EU financial services rules.

integrity. In addition, as above-mentioned, some Member States have recently legislated on issues related to crypto assets leading to market fragmentation.

MiCAR objectives are high level and can be summed up as follows: the seeking of legal certainty<sup>49</sup>, to support innovation and competition<sup>50</sup>, to ensure customer and investor protection as well as market integrity<sup>51</sup> and finally to grant financial stability<sup>52</sup>.

This translates in ensuring consistency with existing provisions in the policy area and to fill in the gaps in the regulatory and supervisory framework. In fact, as anticipated, some exchange platforms fall under MiFID trading venues and thus are already regulated: however, this is not linked to the exchange per se but to the crypto-asset classification. To this purpose the MiCAR consists in a bespoke regime for those platforms (and crypto assets) that *do not fall under any EU law*<sup>53</sup> and thus raise concerns to the authorities.

What is appreciable about MiCAR is that, as the acronym suggests, the piece of law proposed will be a Regulation and thus will be directly applicable<sup>54</sup> in all Member States leaving no room for regulatory arbitrage caused by transposition as opposed to the majority of FinTech legislation in place.<sup>55</sup>

In order to fulfill the aforementioned objectives, the MiCAR is structured as follows.

*Title I* includes the subject matter, the scope of the regulation and useful definitions. It underlines the difference between crypto assets service providers and issuers, which will be then treated differently in the subsequent titles. What can be noted is that *Title I* mirrors somehow the MiFID: the legislator capitalizes the experience in financial service regulation and transfers the approach to crypto assets when addressing transparency and disclosure in relation to issuance, operation, organization and governance of crypto-asset service providers as well as consumer protection and market abuse<sup>56</sup>.

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<sup>49</sup> In order to enable the crypto-asset market to develop within the EU, a sound and well-defined legal framework crypto-assets that are not covered by existing financial services legislation is needed.

<sup>50</sup> Promoting the use of DLT and the development of crypto assets means creating a safe and proportionate framework to support innovation and fair competition.

<sup>51</sup> Crypto-assets not covered by existing financial services legislation share with well known financial instruments many risks.

<sup>52</sup> Some categories of crypto assets, such as that of 'stablecoins', may potentially become widely accepted and systemic. For this reason, safeguards to address threats to financial stability and orderly monetary policy that could stem from 'stablecoins' are necessary.

<sup>53</sup> MiCAR aim is not to substitute existing rules. Indeed, it aims at integrating existing EU legislation: therefore, platforms and assets that are already regulated under MiFID or PSD will not fall under its scope.

<sup>54</sup> While drafting the MiCAR, several approaches were considered. Among them, the "opt-in" regime and the "full harmonization" one. The choice went to the latter, provided that it could ensure the creation of a pan European market for crypto assets that would represent a high-level achievement for service providers. While the first regime could be less burdensome for small issuers and service providers that can decide not to opt in, the second one would ensure a higher level of legal certainty, investor protection, market integrity and financial stability, and would reduce market fragmentation across the Single Market. Full harmonisation represents a more coherent approach compared to an opt-in regime.

<sup>55</sup> Largely composed of directives, that for their very nature leave room to discretion (PSD, EMD, AMLD, MiFID).

<sup>56</sup> Also in the MiCAR the Commission makes use of delegated acts to the ESAs, requiring them to draft technical standards to better capture specificities and developments.

*Title II* regulates the offerings and marketing to the public of crypto assets other than asset-referenced tokens and e-money tokens, setting out general duties when it comes to offerings of crypto assets to the public.

Interestingly enough, with this Title the regulator makes a market practice mandatory: in general, the vast majority of market players used to publish an informative paper<sup>57</sup> about the asset offered similarly to the prospectus. This highlights again the influence from financial markets legislation.

*Title III* extensively regulates the issuers of asset-referenced tokens, with a particular attention to conduct requirements and prudential requirements when it comes to the authorization given their particular nature<sup>58</sup>.

Similarly to *Title III*, *Title IV* deals with E-money Tokens, describing requirements from the authorization of issuers to the drafting of the whitepaper.

*Title V*, which is of major interest for the sake of this Paper, sets out the provisions on authorization and operating conditions of crypto asset service providers and will be better addressed later.

*Title VII* lays down the powers and competences of the various authorities as regards e-money tokens and asset-referenced tokens from a supervisory perspective whereas *Title VIII* discusses the exercise of delegated acts from the Commission to the ESAs.

*Title IX* includes the transitional and final provisions, including the obligation for the Commission to produce a report evaluating the impact of the Regulation.

The MiCAR is going to be the *substantive law piece* that addresses crypto-assets service providers among which we find exchanges. Exchanges are part of what the MiCAR defines Crypto Asset Service Providers (CASP). They are defined as follows:

*Crypto-asset service provider means any person whose occupation or business is the provision of one or more crypto-asset services to third parties on a professional basis*<sup>59</sup>.

They are listed in Article 3 of the Proposal:

*(a) the custody and administration of crypto-assets on behalf of third parties;*

*(b) the operation of a trading platform for crypto-assets;*

*(c) the exchange of crypto-assets for fiat currency that is legal tender;*

*(d) the exchange of crypto-assets for other crypto-assets;*

*(e) the execution of orders for crypto-assets on behalf of third parties;*

*(f) placing of crypto-assets;*

*(g) the reception and transmission of orders for crypto-assets on behalf of third parties*

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<sup>57</sup> Called White paper

<sup>58</sup> The very feature of ART requires more precise regulation: in particular, some rules about the underlying apply, for example concerning the composition and maintenance as well as stabilization.

<sup>59</sup> Article 3, paragraph 1, recital 8

*(h)providing advice on crypto-assets;*

As above-mentioned, crypto asset service providers are extensively regulated in *Title V*.

First, the Proposal imposes requirements on all CASPs: they are prudential and conduct safeguards, organizational requirements, the relationship with the supervisory authorities, rules on the safekeeping of client's crypto assets and funds, the establishment of a compliant handling procedure as well as rules when it comes to outsourcing for the performance of operational functions.

As regards the prudential regulation, the organizational requirements and information to authorities, the MiCAR resembles the SSM Regulation, highlighting the structural standards the crypto asset service provider must comply with in order to be authorized and continue to operate. Authorization is provided by the designated National Competent Authority. A register of Crypto Asset Service providers will be kept by ESMA.

As for the conduct requirements, safekeeping, and conflicts of interest, the MiCAR relates similarly to MiFID. CASPs have the *Obligation to act honestly, fairly and professionally in the best interest of clients and information to clients*<sup>60</sup>. Rules on the safekeeping of clients' crypto-assets and funds include the obligation for providers to safeguard client's ownership rights over the crypto assets and to prevent the use of a client's crypto assets on own account; as regards the funds, they shall be placed with a central bank or a credit institution where they must be adequately separated from the CASP funds.

Moreover, CASPs are required to set a compliant handling procedure, thanks to which clients should be able to file complaints free of charges and they should avoid in all ways to take additional operational risk when outsourcing their operational functions.

The Proposal also sets out ad hoc requirements<sup>61</sup> for the specific services included in the list of crypto assets services above.

Such requirements go hand in hand with the specific services provided by CASPS and aim at appropriately addressing the weaknesses and/or in general the very features characterizing them, promoting adequate safety and soundness.

For example, as for trading platforms for crypto assets, article 68 states that they shall not deal on own account and shall have in place effective systems, procedures, and arrangements to ensure resiliency and guarantee orderly trading under distress. Instead, as for CASPS enabling the exchange of crypto assets against fiat currency or exchange of crypto assets against other crypto-assets, attention is drawn to information and data which should be released, such as the relevant prices of crypto assets and the source or the method used for the determination of price.

The above-mentioned highlights how the MiCAR on the one hand reaps the experience gained from the financial market regulation<sup>62</sup> and transfers it to the crypto asset world but also seeks to address specificities in a detailed manner.

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<sup>60</sup> Article 59

<sup>61</sup> Title V, Chapter 3 Articles 67-73

<sup>62</sup> For example, from MiFID, SSM, Prospectus Regulation, Market Abuse



## Coinbase Example

In order to have a deeper understanding on how regulation is applied in Europe as of today, Coinbase exchange will be briefly analyzed.

Coinbase is one of the most popular exchange platforms worldwide; it provides both *E-Money services* and *Digital Currency Services*.

As for the *E-Money Services*, they are provided to European users by Coinbase Ireland and they include the E-Money Wallet, which is a hosted digital wallet enabling to store electronic money issued by Coinbase Ireland *denominated in fiat currency*; moreover, it allows payment services enabling the user to send and receive E-Money.

Instead, as for the *Digital Currency services*, Coinbase Europe allows to hold one or more hosted Digital Currency Wallet to store, track, transfer, and manage the balances of supported digital currencies and the Digital Currency exchange service which enables users to obtain prices for the purchases and sales of Digital Currencies and carry out any such purchases or sales on the Site.

In particular, Coinbase allows to buy and sell Digital Currencies using E-money, central banks issued currencies, and other types of Digital Currencies present in the Digital Currency Wallet.

From a regulatory point of view, in Europe, Coinbase is subject to the anti-money laundering legislation for which KYC, record keeping, and suspicious activity reporting are required as the exchanged assets fall under AML definition of Virtual Currency and thus the activity of digital currency exchange service providers and digital currency wallet service providers are in the list of obliged entities.

As for the E-Money Wallet (*Fiat Wallet*), Coinbase is subject to the European Money Directive and thus licensed in Europe as an Electronic Money Institution which was first authorized in Ireland and then passported<sup>63</sup> to the other European member states.

However, from a financial substantive law perspective, as reported in the Coinbase User Agreement<sup>64</sup>, "*Coinbase Europe is not a regulated financial service provider and is not registered with or regulated or authorised by the Central Bank of Ireland, the Competition Consumer and Protection Commission or any other regulatory body in Ireland for financial services and so you will not be able to avail of regulatory protections associated with such regulated entities such as investor or deposit protection schemes or access to the Financial Services and Pensions Ombudsman in relation to the Digital Currency Services*", highlighting the lack of a bespoke, common regulatory standard across the European Union.

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<sup>63</sup> Coinbase is an authorised electronic money institution authorised by the Central Bank of Ireland with register number C188493 and listed on the EMI register available at <http://registers.centralbank.ie/>.

<sup>64</sup> Coinbase User Agreement available at: [https://www.coinbase.com/legal/user\\_agreement/ireland\\_europe#eligibility](https://www.coinbase.com/legal/user_agreement/ireland_europe#eligibility)

Coinbase grasped the German authority<sup>65</sup> licensing process initiative for institutions wishing to provide virtual currency exchange and custody services to German customers and successfully obtained the authorization,<sup>66</sup> providing a safer environment for German users<sup>67</sup>.

When MiCAR will come into place, Coinbase will not be addressed as an exchange only in the jurisdictions which applied a bespoke regime: MiCAR is going to address Coinbase as a CASP, requiring both prudential and organizational standards and, for example, obligations to establish a compliant handling procedure.

Moreover, thanks to MiCAR Coinbase will not need to stick to different regulatory landscapes proposed by single jurisdictions, instead it will be able to easily passport its services to other member states, through the right of establishment and the freedom to provide services.

## Final Remarks

Although it is argued that MiCAR will come into force already outdated and notwithstanding the fact that some aspects of the proposal still have to be clarified and integrated<sup>68</sup>, MiCA Regulation Proposal presents itself as a real game-changer from a financial law perspective.

In fact, MiCAR as part of the EU Digital Finance package represents a big step for the European Union for the establishment of the Single Market, embracing innovation consistently with high standards of safety and resilience, and reducing operational costs, legal complexity and legal uncertainty and thus boosting the scaling up of crypto asset activities in the Union.

Posing itself the objective of integrating existing rules, it provides benefits for the service providers, for the users and for the Union as a whole.

MiCAR is going to provide a level playing field across the European Union, trying to reduce regulatory arbitrage opportunities arising from Member States bespoke initiatives to crypto-assets regulations, leading to a highly coordinated and harmonized approach.

Providers will be able to enjoy the Single Market features available to other financial services thanks to the possibility to passport across the Union and will not need to adapt anymore to specific jurisdiction requirements arising from the above-mentioned bespoke regimes.

Participants engaging in crypto-assets related activity will be subject to the same standards granted for other financial services, allowing consumers to benefit from a higher degree of protection thanks, for example, to complaints and recourse mechanisms requirements. Falling exchanges or in general

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<sup>65</sup> Bundesanstalt für Finanzdienstleistungsaufsicht, *BaFin*

<sup>66</sup> More at <https://cryptonomist.ch/2021/06/29/coinbase-licenza-germania/?amp=1>

<sup>67</sup> As can be seen from the German User Agreement Changes available at <https://help.coinbase.com/en/coinbase/other-topics/legal-policies/summary-of-german-user-agreement>

<sup>68</sup> As reported by Dirk A. Zetsche, Filippo Annunziata, Douglas W. Arner and Ross P. Buckley in their Working Paper *The Markets in Crypto-Assets Regulation(MICA) and the EU Digital Finance Strategy* available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3725395](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3725395)

crypto assets service providers under the scope of MiCA, they may be held liable to their clients for loss of crypto assets resulting from a malfunction or hacks as opposed as of today.

Once the MiCAR will be in force, next steps will regard the promotion of a higher level of digital and financial literacy to help consumers make effective use of the wide set of financial services available so as to make responsible choices that meet their expectations, raising confidence and trust in the digital financial system as well as their personal financial outlook.

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