

DISCUSSION PAPER ON INITIAL COIN OFFERINGS, VIRTUAL CURRENCIES AND RELATED SERVICE PROVIDERS

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MALTA FINANCIAL SERVICES AUTHORITY

THESE PROPOSALS ARE NOT BINDING AND ARE SUBJECT TO CHANGES AND REVISIONS FOLLOWING REPRESENTATIONS RECEIVED FROM LICENCE HOLDERS AND OTHER INVOLVED PARTIES. IT IS IMPORTANT THAT PERSONS INVOLVED IN THE CONSULTATION BEAR THESE CONSIDERATIONS IN MIND.

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1 INTRODUCTION

1.1 Background Information

An important development in the carrying out of transactions over the internet has been the emergence of a new type of digital currency, commonly known as virtual currencies ('VCs'). VCs should be distinguished from fiat currencies, which are defined by the Financial Action Task Force ('FATF') as "the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country".¹ The most typical examples of VCs are cryptocurrencies, including *inter alia* Bitcoin, Ether and Litecoin.

VCs and their associated technologies² are rapidly evolving. There were more than 1300 cryptocurrencies available over the internet as of 28 November 2017. Initial Coin Offerings ('ICOs'), which provide an alternative source of funding for businesses have also seen a significant global growth over the last 18 months. A European Parliament report states that "Virtual currencies are a marginal phenomenon at present, but it is possible that they will become increasingly important."³

1.2 Scope

The purpose of this Discussion Paper is to present to the industry a proposed policy to be adopted by the MFSA for the regulation of the ICOs, VCs and service providers involved in ICO and/or other VC activity.

The aim of the MFSA's proposal is to devise a policy framework that supports the innovation and new technologies for financial services in the area of VCs whilst ensuring effective investor protection, financial market integrity and financial stability.

¹ Financial Action Task Force, Virtual Currencies: Key Definitions and Potential AML/CFT Risks (June 2014)

² Notably DLT.

³ Opinion of the Committee on Legal Affairs [18.01.2017] for the Committee on Economic and Monetary Affairs and the Committee on Civil Liberties, Justice and Home Affairs on the proposal for a directive of the European Parliament of the Council amending Directive [EU] 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC.

2 DEFINING FEATURES

2.1 Defining features of Initial Coin Offerings

An ICO is an innovative method of raising funds from the investing public, using so-called ‘coins’ or ‘tokens’. ICOs are used to raise money for different types of projects. In an ICO, a business or individual issues proprietary coins or tokens and offers them to general public in exchange for fiat currencies, such as the euro, or VCs, such as Bitcoin.⁴

The features and purpose of the coins or tokens vary across ICOs. Some coins or tokens serve to access or purchase a service or product that the issuer develops using the proceeds of the ICO. Others provide voting rights or a share in the future revenues of the issuing venture. Some have no tangible value. Some coins or tokens are traded and/or may be exchanged into fiat or VCs at specialised coin exchanges after issuance.⁵

ICO campaigns are conducted online, through the internet and social media. The coins or tokens are created and disseminated using distributed ledger technology (“DLT”).⁶ Effectively anyone who has access to the internet can participate in an ICO.

2.2 Defining features of Virtual Currencies

A universally applicable definition for VCs has not yet been established, but VCs are sometimes referred to as digital cash. The FATF defines them as being “a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor it is not a valid and legal offer of payment) in any jurisdiction. It is not

⁴ ESMA, Statement: ESMA alerts investors to the high risks of Initial Coin Offerings (ICOs), [ESMA50-157-829](#) (November 2017)

⁵ *ibid*

⁶ Distributed Ledger Technology is a consensus of replicated, shared, and synchronized digital data geographically spread across multiple sites, countries, or institutions. There is no central administrator or centralised data storage. A peer-to-peer network is required as well as consensus algorithms to ensure replication across nodes is undertaken. One form of distributed ledger design is the blockchain system, which can be either public or private. But not all distributed ledgers have to necessarily employ a chain of *blocks* to successfully provide secure and valid achievement of distributed consensus: a Blockchain is only one type of data structure considered to be a distributed ledger.

issued nor guaranteed by a central body in any country and it fulfils the above functions only by agreement within the community of users of the virtual currency”.⁷

FATF regards ‘digital currency’ as “a digital representation of either VC (non-fiat) or e-money (fiat)”⁸ whereas ‘cryptocurrency’ as “a math-based, decentralised convertible VC that is protected by cryptography - i.e., it incorporates principles of cryptography to implement a distributed, decentralised, secure information economy. Cryptocurrency relies on public and private keys to transfer value from one person (individual or entity) to another, and must be cryptographically signed each time it is transferred”⁹. From the above definitions transpires that digital currencies encompass both electronic money¹⁰ (‘e-money’) and VCs, with cryptocurrencies being a sub-category of the latter.

Depending on their end-use, VCs may be structured in various ways, thereby embedding different properties. Therefore, a ‘one-size-fits-all’ definitional approach poses great challenges for both the industry as well as the regulators worldwide. In this regard, a typology is required in order for these challenges to be addressed.

Furthermore, and in view of the embryonic stage of the VC industry, it is deemed prudent to adopt a classification as technology-neutral as possible in order to capture future developments as well.

For the purposes of this Discussion Paper, the VCs are subdivided into (1) coins and (2) tokens; with the latter being further subcategorised into (a) securitised and (b) utility tokens. This categorisation, as illustrated in *Figure 2.2-1*, has been based on a combined reading of *inter*

⁷ Financial Action Task Force, *Virtual Currencies: Key Definitions and Potential AML/CFT Risks* (June 2014)

⁸ *ibid*

⁹ *ibid*

¹⁰ “Electronic money” as defined in accordance with Directive 2009/110/EC (European Union, 2009, p. 11) 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 as defined in point 5 of Article 4 of Directive 2007/64/EC, and which is accepted by a natural or legal person other than the electronic money issuer.

alia the Blockchain Policy Initiative Report¹¹ and the policy statement issued by the European Securities and Market Authority (‘ESMA’) on 13 November 2017¹².

The term ‘coins’ effectively reflects the FATF’s definition of VCs and refers to Bitcoin and other cryptocurrencies (such as Ether and Litecoin). Whereas both coins and tokens are created to make use of their respective underlying technology, coins detach themselves from this function and become a payment instrument.¹³ Consequently, their value is typically derived by the interaction of supply and demand.

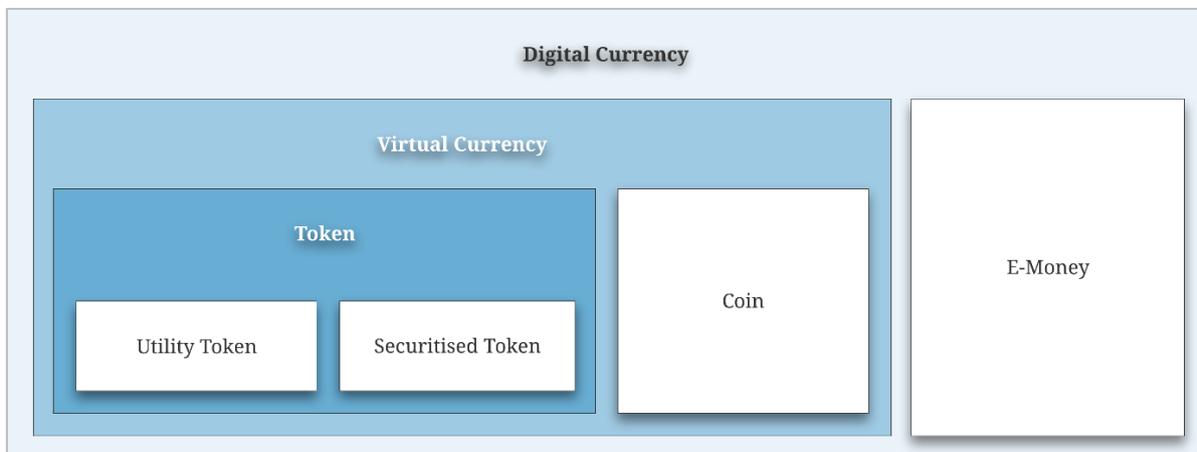


Figure 2.2-1: Categorisation of Digital Currencies

On the other hand, the term ‘tokens’ usually refers to the virtual assets offered through an ICO and, as mentioned above, are further subcategorised into (a) securitised and (b) utility tokens. ‘Securitised tokens’ are defined as those embedding either underlying assets (akin to commodities) or rights (e.g. quasi-equity rights) and effectively refer to those tokens that qualify as financial instruments (for further details please see Section 4 of this Discussion Paper). ‘Utility tokens’ are further defined as those providing either platform/application utility rights or protocol access rights, without any underlying.

¹¹ Blockchain Policy Initiative Report, Tokens as Novel Asset Class (July 2017).

¹² ESMA, Statement: ESMA alerts firms involved in Initial Coin Offerings (ICOs) to the need to meet relevant regulatory requirements, [ESMA50-157-828](#) (November 2017).

¹³ Blockchain Policy Initiative Report, Tokens as Novel Asset Class (July 2017).

Q1. *Do you agree with the defining features of ICOs and VCs?*

Q2. *Do you agree with the classification of VCs into (1) coins and (2) tokens and the further sub-categorisation of the latter into (i) securitised and (ii) utility tokens?*

3 CURRENT REGULATION OF INITIAL COIN OFFERINGS, VIRTUAL CURRENCIES AND RELATED SERVICE PROVIDERS

As further explained under Section 4 of this Discussion Paper, certain VCs and activities in relation to VCs could fall within the scope of existing financial services legislation, such as the Investment Services Act¹⁴ ('ISA'). Other VCs and activities related to VCs are likely to fall out of scope of the existing framework and would hence currently be unregulated. Therefore, there is no regulatory framework which aims at achieving effective investor protection, financial market integrity and financial stability in the latter field.

***Q3.** Do you agree that, in the absence of a specific regulatory framework in relation to VCs and activities related to VCs that fall out of scope of the financial services legislation, investor protection, financial market integrity and financial stability are not being effectively safeguarded in this field?*

¹⁴ Chapter 370 of the Laws of Malta

4 POLICY GUIDELINES ON INITIAL COIN OFFERINGS, VIRTUAL CURRENCIES AND RELATED SERVICE PROVIDERS

The policy guidelines being proposed in this Discussion Paper follow the general principles of a policy statement issued by the European Securities and Market Authority (‘ESMA’) on 13 November 2017¹⁵. This states that firms involved in ICOs and/or other VC activity must carefully consider whether their activities constitute regulated activities in terms of EU or national legislation. In its statement ESMA explicitly notes that:

“Firms involved in ICOs must give careful consideration as to whether their activities constitute regulated activities. If their activities constitute a regulated activity, firms have to comply with the relevant legislation and any failure to comply with the applicable rules would constitute a breach.

Where the coins or tokens qualify as financial instruments it is likely that the firms involved in ICOs conduct regulated investment activities, such as placing, dealing in or advising on financial instruments or managing or marketing collective investment schemes. Moreover, they may be involved in offering transferable securities to the public. The key EU rules listed below are then likely to apply...”

Therefore, on the basis of the above, should a VC be classified as a financial instrument under Section C of Annex 1 of Markets in Financial Instruments Directive¹⁶ (‘MiFID’), and the activities of the firm involved in such VC constitute a regulated activity as listed in Section A of Annex 1 of MiFID, the applicable EU and respective national legislative and regulatory frameworks would apply. However, if it is determined that the relevant VC does not fall under the aforementioned definition of a financial instrument, the VC would therefore fall outside the scope of MiFID, other applicable EU legislation and the corresponding national legislation. In

¹⁵ ESMA, Statement: ESMA alerts firms involved in Initial Coin Offerings (ICOs) to the need to meet relevant regulatory requirements, [ESMA50-157-828](#) (November 2017)

¹⁶ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L 145/1

this regard, **the MFSA is proposing that, in order to achieve the objectives of financial regulation, certain VCs and activities pertaining to them would be licenced and regulated under a new legislative framework to be drafted by the MFSA and adopted by the Maltese Parliament, the Malta ‘Virtual Currencies Act’.**

The Virtual Currencies Act and any relevant subsidiary legislation would regulate the carrying on of business associated with VCs falling outside the scope of the existing EU and national financial services legislation and make provision for matters ancillary thereto or connected therewith. The Act would apply a principles-based approach to regulation supplemented by MFSA guidance, rather than detailed rules which would possibly stifle technological innovation.

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- Q4. Are you in favour of adopting a new legislative framework, specifically regulating the carrying on of business associated with VCs falling outside the scope of the existing EU and national financial services legislation (resulting in separate licencing, organisational and operational requirements)? Give reasons for your answer.*
- Q5. Are you of the view that the new laws should apply a principles-based rather than a rules-based approach to regulation? Give reasons for your answer.*
- Q6. Should certain types of utility tokens be exempted from the obligations under the proposed Virtual Currencies Act? Give reasons for your answer.*
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4.1 Financial Instrument Test

Based on the above, it is proposed that a test would be introduced determining whether the features of a VC, either on a stand-alone basis or within the context of an ICO, constitutes a financial instrument (*‘Financial Instrument Test’*) under MiFID and other relevant EU

legislation, specifically in the forms of: (i) transferable securities; (ii) units in collective investment schemes; (iii) commodities and (iv) their respective financial derivatives contracts and financial contracts for difference. *Figure 4.1-1* explains the VC determination.

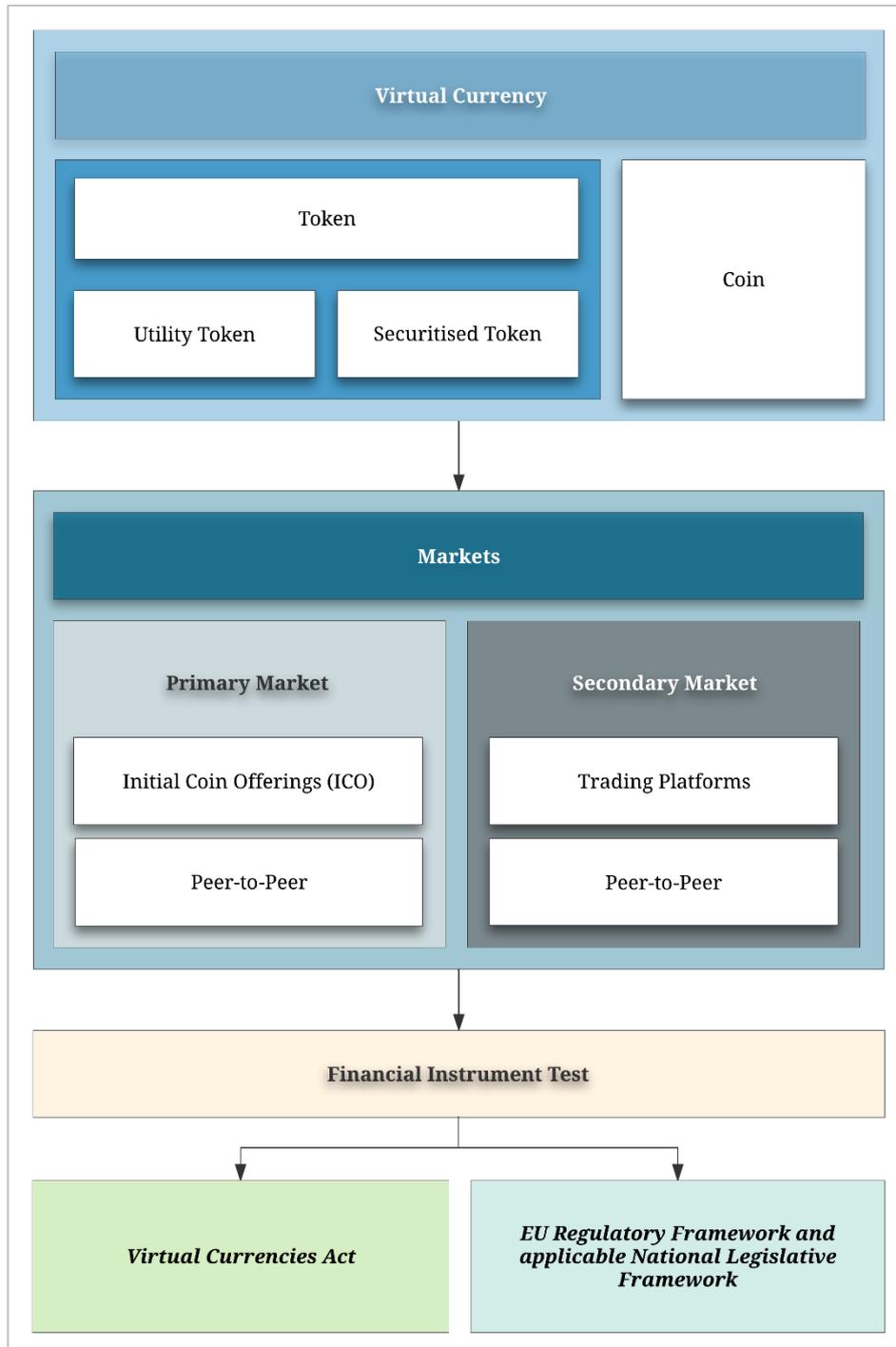


Figure 4.1-1: VC Determination using Financial Instrument Test

The test is currently being devised by the MFSA, and will form part of the proposed Virtual Currencies Act in order to determine the scope of activity and instruments that would fall under this Act.

Q7. Do you agree with the introduction of a test to determine whether a VC falls under the definition of a financial instrument under MiFID? Give reasons for your answer.

Q8. Are you of the view that, apart from the financial instruments identified under (i) to (iv) above, VCs could embed the features of other financial instruments as well?

4.2 Persons involved in Virtual Currencies Activity

This section should be read in line with the following overarching principle: persons involved in VC activity are required to be ‘fit and proper’, have the competence, sufficient knowledge and expertise, experience, business organisation and systems necessary in the field of information technology, VCs and their underlying technologies, including but not limited to DLT.

Q9. What are your views on this overarching principle?

4.2.1 Issuers of Initial Coin Offerings

As already indicated above, issuers of ICOs must carefully consider whether their activities constitute regulated activities. In such cases firms must comply with the relevant existing financial services legislation.¹⁷

¹⁷ ESMA, Statement: ESMA alerts firms involved in Initial Coin Offerings (ICOs) to the need to meet relevant regulatory requirements, [ESMA50-157-828](#) (November 2017).

In circumstances where the *Financial Instrument Test* indicates that a VC issued through an ICO qualifies as a financial instrument, the issuer is required to comply with the relevant existing EU legislative framework, which may *inter alia* include the Prospectus Directive, the Markets in Financial Instruments Directive, and the Alternative Investment Fund Managers Directive and national legislation, as applicable.

On the other hand, where the application of the *Financial Instrument Test* determines that the VCs issued through an ICO does not qualify as financial instruments, the Virtual Currencies Act would be applicable. Similar high level regulatory principles on transparency and merit-based regulation as those currently applicable to securities seeking a listing on a regulated market would apply to ICOs in terms of the Virtual Currencies Act.

Q10. Do you agree that ICOs should be subject to high level regulatory principles on transparency and merit-based regulation as those currently applicable to securities seeking a listing on a regulated market?

4.2.2 Collective Investment Schemes

A collective investment scheme is a vehicle that invests capital acquired through the sale of units (shares) in a scheme¹⁸. A consultation document proposing a framework for professional investor funds investing in VCs was published by the Authority on 23 October 2017. The Authority considers issuing similar rules applicable to alternative investment funds ('AIFs') and notified alternative investment funds ('NAIFs') which invest in VCs. Collective

¹⁸ The Investment Services Act defines a collective investment scheme as meaning any scheme or arrangement which has as its object or as one of its objects the collective investment of capital acquired by means of an offer of units for subscription, sale or exchange and which has the following characteristics:

- (a) The scheme or arrangement operates according to the principle of risk spreading; and either
- (b) The contributions of the participants and the profits or income out of which payments are to be made to them are pooled; or
- (c) At the request of the holders, units are or are to be repurchased or redeemed out of the assets of the scheme or arrangement, continuously or in blocks at short intervals; or
- (d) Units are, or have been, or will be issued continuously or in blocks at short intervals.

investment schemes investing in VCs will not be allowed to be established as UCITS. As is currently the case, service providers to such collective investment schemes will be licensable under the Investment Services Act.

Q11. Are you of the view that the proposed framework for PIFs investing in VCs should be extended to AIFs and NAIFs investing in VCs?

Q12. How do you foresee the depositary function being undertaken in line with Article 21 of the AIFMD in relation to AIFs and NAIFs investing in VCs?

4.2.3 Investment Services Licence Holders

Investment services licence holders wishing to provide an investment service in relation to a VC will be required to conduct the proposed *Financial Instrument Test* on the relevant VC. Any service relating to a VC which qualifies as a financial instrument, should be provided in terms of the Investment Services Act. On the other hand, in terms of the proposed framework the provision of an investment service or activity in relation to a VC, which does not qualify as a financial instrument, would require a separate licence under the Virtual Currencies Act.

Existing investment services licence holders would be required to set up a subsidiary solely for the purpose of providing services and activities in relation to VCs that do not qualify as financial instruments. The subsidiary would require a specific licence under the Virtual Currencies Act. This is being proposed to ensure complete segregation from the ordinary business of the investment services licence holder, which mitigates the risk of contagion should there be failure in the VC business.

VCs which qualify as financial instruments under MiFID shall be assessed against the criteria set out under MiFID to determine whether the respective instruments should be classified as complex instruments or otherwise. As an investor protection measure, the MFSA however considers that a VC, which does not qualify as a financial instrument, shall automatically be

classified as an instrument akin to a complex instrument as defined under MiFID with protections equivalent to those set in terms of MiFID to be applicable. The Virtual Currencies Act and regulatory framework issued thereunder would provide for the investor protection measures specified above.

***Q13.** Do you agree that a VC that does not qualify as a financial instrument should automatically be classified as a complex instrument?*

***Q14.** Do you agree that existing investment services licence holders, wishing to provide services and activities in relation to VCs that do not qualify as financial instruments, should be required to set up a subsidiary solely for this purpose?*

***Q15.** What should be the applicable prudential, organisational and operational requirements for the subsidiaries of investment services licence holders in order to adequately address the VC-associated risks? To which risks are they most exposed?*

***Q16.** What should be the applicable conduct of business requirements for investment services licence holders engaging in VC activity?*

4.2.4 Exchanges

Commercial trading in VCs is mostly done via unregulated platforms, often called exchanges.

Following ESMA's reasoning, which necessitates the application of the key applicable EU legislation whenever a VC qualifies as a financial instrument¹⁹, where such a VC intends to apply for admission to trading on a secondary market, existing legislation such as the Prospectus Directive (amongst others) would apply. Such a VC would be able to list and trade

¹⁹ ESMA, Statement: ESMA alerts firms involved in Initial Coin Offerings (ICOs) to the need to meet relevant regulatory requirements, [ESMA50-157-828](#) (November 2017).

on a regulated market or a multilateral trading facility or organized trading facility, as defined in MiFID.

If a VC does not qualify as a financial instrument, the Virtual Currencies Act would provide for a framework for the regulation of the issuer and the exchange platform. MiFID trading platforms that might be interested in listing and trading VCs, which do not qualify as a financial instrument, would be required to set up a subsidiary solely for this purpose in relation to which a separate licence under the Virtual Currencies Act would need to be obtained.

Q17. Are you of the view that exchange platforms listing and trading VCs that qualify as a financial instrument should be regulated under the Virtual Currencies Act?

Q18. Do you agree with the requirement for MiFID trading venues, wishing to list and trade VCs that do not qualify as financial instruments, to set up a subsidiary solely for such purpose?

Q19. What should be the applicable prudential, organisational and operational requirements for such exchange platforms in order to adequately address the VC-associated risks?

4.2.5 Credit Institutions, Financial Institutions, [Re]insurance Companies and Retirement Pension Schemes

The consultation document on investment services rules for professional investor funds investing in virtual currencies, issued by the MFSA on the 23 October 2017, provides that: “Opinions expressed by regulators, including the European Banking Authority, discourage credit institutions, payment institutions and e-money institutions against buying, holding or selling VCs. This is essential to mitigate risks to financial stability. In this regard, credit institutions, financial institutions, [re]insurance companies, their subsidiaries or associated

companies and retirement pension schemes are excluded from dealing in VCs for their clients or their own account.”

4.2.5.1 *Credit Institutions*

The MFSA is considering whether it should revise its position to allow credit institutions to deal in VCs that do not qualify as financial instruments, solely on behalf of their clients, subject to the proposed requirement of setting up a subsidiary which ensures complete segregation from the credit institution’s regular business. The relevant subsidiary would be required to obtain a specific licence under the Virtual Currencies Act.

Q20. Do you agree that credit institutions should be allowed to deal in VCs on behalf of their clients?

Q21. Do you agree with the requirement for credit institutions, wishing to engage in such activity, to set up a subsidiary solely for such purpose?

Q22. What should be the applicable prudential, organisational and operational requirements for the subsidiaries of such credit institutions in order to adequately address the VC-associated risks?

4.2.5.2 *Financial Institutions*

The regulation of electronic payment services is subject to regulation under the Financial Institutions Act²⁰ (‘FIA’) which transposes the Payment Services Directive²¹ and the Electronic

²⁰ Chapter 376 of the Laws of Malta

²¹ Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC

Money Directive²². The FIA regulates *inter alia* the activities of payment and electronic money institutions.

The provision of regulated payment services by payment or electronic money institutions requires that the relevant service is provided in a fiat currency, or digital representation thereof. Additionally, the provision of electronic money services requires that the stored monetary value in electronic money is represented by a claim on the issuer thereof that may not be possible under a VC scenario. This is further reiterated in the European Banking Authority's opinion, pursuant to which VCs "are not issued by a central bank or a public authority, nor necessarily pegged to a fiat currency. This element of the definition differentiates VCs from fiat currency issued by central banks or public authorities. Currency issued by a central bank or public authority is considered fiat currency, regardless of its (physical or digital) form. The difference between electronic money and a virtual currency is that the latter is not necessarily attached to a fiat currency, i.e. it does not have a fixed value in a fiat currency and, furthermore, is not necessarily fixed to be redeemed at par value by an issuer".²³

Any person making use of VCs as an instrument of payment for goods or services must therefore be aware that the FIA does not cater for risks associated with VCs or regulate intermediaries facilitating the carrying out of these types of transactions.

It is recommended that financial institutions are allowed to provide payment services in relation to VCs solely on behalf of their clients, subject to the proposed requirement of setting up a subsidiary which ensures complete segregation from the financial institution's regular business. The relevant subsidiary would be required to obtain a specific licence under the Virtual Currencies Act.

²² Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC

²³ European Banking Authority, EBA Opinion on 'virtual currencies', EBA/Op/2014/08 (July 2014)

Q23. Are you of the view that financial institutions should be allowed to provide payment services in relation to VCs solely on behalf of their clients?

Q24. Do you agree with the requirement for financial institutions, wishing to provide payment services in relation to VCs that do not qualify as a financial instrument, to set up a subsidiary solely for such purpose?

Q25. What do you think should be the applicable prudential, organisational and operational requirements for the subsidiaries of such financial institutions in order to adequately address the VC-associated risks?

4.2.5.3 [Re]insurance Companies and Retirement Pension Schemes

It is proposed that [re]insurance companies and retirement pension schemes would still be prohibited from dealing in VCs for their clients or their own account.

Q26. Do you agree with the Authority's proposal to prohibit [re]insurance companies and retirement pension schemes from dealing in VCs for their clients or their own account?

4.3 Anti-Money Laundering Provisions

Any person who carries out an activity or provides a service in relation to or involving VCs which qualify as financial instruments, which activity or service requires a licence or other form of authorisation under any one of the financial services laws, would fall under the definition of 'subject person' and therefore would be subject to the provisions of the Prevention

of Money Laundering and Funding of Terrorism Regulations²⁴ ('PMLFTR'). It is proposed that persons that will be licensed under the Virtual Currencies Act should also be considered as subject persons under the anti-money laundering / combating funding of terrorist framework and therefore having to comply with the PMLFTR.

Q27. What are the inherent AML/CFT risks associated with VCs and activities in relation to VCs?

Q28. What measures can be put in place to mitigate AML/CFT risks associated with VCs to adequately safeguard and maintain investor protection, market integrity and financial stability?

²⁴ Prevention of Money Laundering and Funding of Terrorism Regulations, Subsidiary Legislation 373.01.

5 CONCLUDING REMARKS

The MFSA is seeking feedback from the industry before proceeding with detailed proposals for a legal framework on ICOs, VCs and related service providers.

The consultation is open from 30 November 2017 until the 11 January 2018. Industry participants and interested parties are invited to send their responses to this Discussion Paper and related feedback on vcfunds@mfsa.com.mt by not later than **11 January 2018**.

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Malta Financial Services Authority
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