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SUBJECT: EBF position on Crypto-assets and Initial Coin Offerings (ICO)

1. Introduction

Banks are keen to serve customers' needs vis-à-vis new, innovative financial services and products, and to provide their clients with new asset classes, means of funding and new means of payments. In this respect, Distributed Ledger Technology (DLT) and Blockchain (a subset of DLT) technologies pose a great opportunity to develop new innovative services as well as to increase the efficiency, level of security and competitiveness of financial services.

DLT-based solutions are still at a nascent stage of development, and it is still difficult to assess what applications will develop, if it will ultimately garner a broad adoption and how they will impact European markets. However, as specific business models, products or services mature and are more widely adopted by consumers, it is important that authorities progressively address the relevant risks as they arise in order to maintain market integrity and innovation capacity, as to ensure a level-playing field. One such business model is crypto-assets and by association, Initial Coin Offerings (ICO). Considering the recent uptake of these products, we believe there is merit in taking specified regulatory actions to ensure the regulatory safeguards put in place to protect consumers and the broader financial system are not bypassed or compromised.

There is currently a widespread mixing of terminology in the area of crypto-assets. Although widely referred to as crypto-currencies in the market, regulators and EBF members have recently indicated their preference for the more generic and comprehensive term 'crypto-assets', not only to signal their belief that the primary use of these 'currencies' has been as an investment, but also to avoid the misleading interpretation that they can be used as a credible alternative medium of exchange or store of value[1].

[1] Many authorities have questioned the adequacy of crypto-assets to provide the standard functions of money nor as a medium of exchange and store of value, neither as a unit of account. As an example, the FSB in its report "Crypto-asset markets. Potential channels for future financial stability implications" (October 2018) states that: "Crypto-assets are not currently used as a unit of account, and the significant associated price volatility suggests that crypto-assets do not generally function as a reliable medium of exchange or store of value". The FSB defines crypto-assets as "a type of private asset that depends primarily on cryptography and distributed ledger or similar technology as part of their perceived or inherent value".

The distinction is important as different regulations and approaches are required for assets and currencies. This paper will refer to crypto-assets throughout, however we recognise that these definitions are not set and will continue to evolve with the market.

2. Crypto-tokens and Initial Coin Offerings (ICOs): Implications for financial markets

2.1. Crypto-tokens, an emerging asset class

In the last few years the number of different crypto-assets have increased significantly, including the emerging of crypto-tokens as an innovative virtual asset class. Differently from cryptocurrencies, crypto-tokens are bearer's assets which hybrid nature makes them available for several different purposes.

Two major types of tokens are becoming increasingly popular among investors: "security tokens" and "utility tokens". Security tokens are assets usually linked to financial instrument, representing a right to access ownership of this asset. While this type of token usually pays dividends, share profits, pay interest or generate profits for their holders, utility tokens aim at ensuring some utility in the decentralized application that a team is building and raising ICO for[2].

The impact of each specific crypto-token on consumers and markets will however depend on its ultimate use, characteristics, target market and level of adoption, among other things. Nonetheless, among the possible advantages that they could bring are:

- Easing the execution of Delivery Versus Payment (DVP) and the technology behind may allow the creation of an immutable ledger of owners. **We see crypto-tokens beginning to move from speculation to utility**, as more and more tokens have a specific use for businesses and end-users.

- **Allowing for greater product customisation.** A token could represent a wide array of rights in any possible combination, which could naturally be voting rights, ownership and revenue sharing. Although this might pose a risk within an unregulated ecosystem, employing tokens in a more secure and regulated network would allow for these advantages to come to fruition.

- Enabling access to a certain platform, use of a certain product and service or discount on a certain market offering. It is at present up to the entrepreneur to decide what the token represents.

There are already numerous propositions facilitating tokenisation and trade of a wide array of assets, such as commercial real estate, basket of securities and personal data. We expect the use cases for tokenisation to extend to various asset classes, leading to empowerment of both individuals and organisations.

We estimate that, for a token economy to emerge and because of the transnational nature of this activity, there are some key elements that need to be considered:

- **Transparency is a prerequisite**. Customers need to fully understand what they buy, and how they can keep track of the underlying asset if there is one.
- **International impact**: the token economy operates across borders and will require enhanced cross-border cooperation to effectively address risks.

[2] https://coinsutra.com/security-tokens-vs-utility-tokens/

- **Legal certainty**: As regulatory uncertainty is one of the major challenges both for investors and innovators, a regulatory framework for different kinds of crypto-assets is needed to fill this gap. In addition, a uniform legal definition 'security' would be helpful at EU level for ensuring a common regulation of every crypto-asset that has this function and nature, even if such definition would have to be carefully assessed.
- **Cybersecurity**: customers need a secure way to keep access to their tokens and trade them with others, both within and outside the EU.

2.2. Initial Coin Offerings (ICOs)

One prominent use case for crypto-tokens are Initial Coin Offerings (ICOs). ICOs represent a **new way to raise funds publicly**. An ICO is also called a 'token generation event', through which companies sell tokens to the public and receive crypto tokens or fiat money in return.

ICOs may offer a **new mean of funding that surpasses crowdfunding in terms of speed, reach and presence of a secondary market, and has at the same time entry barriers lower than those of the traditional IPO or venture capital**. As a result, this may constitute an important source of funding for smaller companies, especially if the risks to consumers/investors are transparent and due consumer protection frameworks are put in place. This is the primary reason why we expect the concept of Initial Coin Offerings to gain further ground.

To summarize, **ICOs have the potential to address problems experienced in accessing funding** similar to that of crowdfunding for early stage companies. In the course of 2018, ICOs raised $12 billion, while last year they raised $7 billion. Since the start of 2017, they have raised the huge amount of $20 billion[3].
However, **ICOs present significant challenges** as they have, so far, been particularly vulnerable to fraud. This said, in the European context especially, it is worth keeping in mind that they have the potential to be a method of raising capital, an area where Europe is currently struggling to compete with the US and its deeper pools of capital.

In light of the growing scams, hacks and cyber incidents that are targeting ICOs, it's worth mentioning a new type of crypto-token offering that is gaining ground and might potentially be preferred to ICO in the short term: Security Token Offering (STO). Differently from ICOs, which are offering tokens mainly focused on utility, STOs only offer security tokens that have to be backed by a tangible asset, such as a company's profits or shares. Although the more tangible value of security tokens might make them apparently less exposed to scams and speculation than utility tokens, those tokens offered through STOs still pose the same risks inherent to their hybrid nature.

Nevertheless, both the limited adoption and capacity of STOs worldwide and the scepticism from part of the cryptocurrency community, which criticized securitization as a mean of centralization and identification, lead to the conclusion that STOs still cannot be considered an alarming phenomenon in the long term.

[3] https://cointelegraph.com/news/research-20-billion-raised-through-icos-since-2017

3. Risks for customers and financial stability

Consistent with recent warnings issued by National and European Regulators, we share their concerns regarding certain crypto-assets related to the following risks, affecting particularly consumers:

- Extreme volatility and speculation, including the risk of total loss of the investment;
- High risks of money laundering and terrorist financing;
- Absence of framework and infrastructure to safeguard consumers, including insufficient or misleading disclosure;
- Lack of liquidity and price transparency;
- Possible operational disruptions/stability; and
- Scarcity of reliable exchanges.

In light of this, we recognize a **number of challenges in the use of crypto-tokens, especially with regard to their exposure to fraud, speculation, lack of AML/CFT compliance, etc**. These vulnerabilities can be identified also within the ICO market, in which the magnitude of speculation is a challenge in itself, as many investors may make decisions not based on the intrinsic value of the underlying proposition.

It has become obvious that the crypto-asset market is characterized by high volatility and that customers need to be made aware of the associated risks. Nonetheless, banks also recognise the traction and interest in the marketplace.

At this stage, several factors and conditions related to crypto-assets, such as their lack of capacity to provide the standard functions of money, low reliability as a medium of exchange or store of value and the current small size of their markets compared to the global financial system, suggest that **crypto-assets do not pose an imminent and significant threat for financial stability**.

However, should the crypto-asset markets continue to evolve, these risks, inherent to the same nature of crypto-assets, could pose a credible threat to global financial stability. For this reason, the EBF shares regulators concerns on the need to monitor more effectively and closely the development of these markets[4].

4. Suggested regulatory approach from a banking perspective

The accelerating speed of technological innovation in the DLT area coupled with the growing interest from customers, regulators and policymakers has kept banks close to the development of the crypto-asset phenomenon and new alternative funding instruments such as ICOs. As a result, banks seek to ensure that any developments in this area would overcome the aforementioned challenges as well as the specific risks related to crypto-assets and ICOs. Banks expect to operate in a regulated environment, where a level-playing field is guaranteed: the principle same services, same risks, same rules should apply.

[4] FSB report "Crypto-asset markets. Potential channels for future financial stability implications" (October 2018).

A **clear understanding and classification of different crypto-asset categories** would be required to enable proper **regulation and supervision according to their characteristics and risks**. Some crypto-assets might require the **development of specific regulatory frameworks, while in other cases the current regulation would be sufficient** since they would fit into existing regulation on financial assets (e.g. security tokens). In any case, regulations should be open to be quickly integrated when new categories of crypto-assets will arise.
When regulating crypto-assets, it should also be considered that several risks can probably be dealt with in a manner that is quite similar to the way risks posed by traditional payment and investment instruments are handled: e.g. by organizing regulated markets for crypto-tokens, which offer guarantees and address issues in terms of: price transparency, submitting traders, platforms or issuer of crypto-tokens to AML regulation, copying rules on market abuse/manipulation to trading platforms for crypto-assets, and sufficient information disclosure to consumers. For some risks, decentralized technology, which is the basis of crypto-assets, can itself allow for different and more effective ways of achieving traditional goals, such as transparency in transaction and a reduced risk of data manipulation.

With special regard to ICOs, **investor protection and higher transparency are even more necessary to avoid fraud and ensure investors take informed decisions**. For this to happen, **clear definitions are needed and a targeted regulation should be applied depending on the type of token that is being offered**. In fact, **while there are no specific regulations for ICOs, existing legislations and regulatory frameworks may apply**: in those cases where tokens fall within the definition of "security", for instance, pre-existing regulations, such as Prospectus Directive, Companies Act, MiFID Regulations and AIFM Regulations, may find application.

In light of this and in order to ensure that the marketing of these assets offers the same guarantees as any other financial assets currently available and supervised by regulators, the EBF believes that the current regulatory framework need to be further assessed to identify areas in which the framework is already sufficient to address risks related to crypto-assets, as well as areas in which regulation is either absent or requires adjustments. The EBF asks for actions from supervisors and regulators to cover unregulated 'grey zone'.

To this end, we believe that priority should be given to guarantee consumer and investor protection against the risks inherent to crypto-assets through a technology-neutral approach.

Consumer/investor protection at the center

Consumers and investors must be duly warned of the risks involved with transacting and investing in crypto-assets. Awareness of these risks in the wake of innovation in financial services will be an important foundation to maintain and build upon in order to uphold consumer and investor protection. The risks mentioned in the recent ESAs' joint warning statement are both clearly identified and convincing[5]:

[5] According to the ESAs' joint warning statement issued in February 2018 to consumers, VCs are highly risky and unregulated products and are unsuitable as investment, savings or retirement planning products.

- It is important that these notices be effectively communicated and distributed to ensure that European consumers clearly understand the associated risks.
- Due to the significant interest shown by retail investors towards crypto-assets, further actions need to be taken to ensure that consumers are aware of the risks, e.g. when they transact or invest in this kind of assets. This should include providing clear and simple information on the nature of the contract and stating when a crypto-asset is to be considered an investment product (in which case its commercialisation would be subject to MiFID 2 -as to any other investment - which would provide an adequate framework for investor protection).
- Notification regimes and investor education programs should be implemented at EU level.

Address Anti-Money Laundering risks

With the high level of anonymous crypto-assets trading, it is important to address also the related Anti-Money Laundering and Counter-Terrorist Financing (AML/CTF) risks. If not, criminals and terrorists could exploit new opportunities provided by crypto-assets to launder their proceeds or finance their illicit activities, and consumers/investors may find it particularly challenging to bring any crypto-token-based revenues into the ordinary financial system. Specifically, regulators should thoroughly review the AML risks associated with the various stages in a crypto-asset lifecycle, and related activities, and provide clear direction as to their treatment, promoting a safe adoption by all players.

This work should include addressing the risks related to the players in this space (exchanges, custodians, etc.). It will be important to establish clear regulatory requirements and supervision criteria regarding the kind of activities/services that they provide, for example security measures, types of crypto-assets operated, the associated due diligence process and Know Your Customer (KYC)/ Know Your Transaction (KYT)/ AML/CFT processes. In this regard, although the recent entry into force of the 5th Anti-Money Laundering Directive (AMLD5) made custodian wallet providers and ICO-issuers obliged entities, some players that are not financial institutions but provide services comparable to banking or investment services, are still not subject to such regulations nor license requirements.
At international level, it's worth taking into consideration also the recent work carried out by the Financial Action Task Force (FATF)[6] as well as the G20 commitment reached in December 2018[7] to regulate crypto-assets for AML/CTF purposes and provide further clarity on the related definitions.

Technology neutrality: Focus on the impact on financial activity rather than on the technology

The current absence of a coherent international regulatory framework addressing the risks posed by crypto-assets available on the market also hinders further investments and development of DLT technology, which is often implemented by the banking sector in a separate way from currencies or tokens. This is to the detriment of consumers, companies and the broader financial system, and should therefore be an urgent priority for regulators and policy makers.

[6] http://www.fatf-gafi.org/publications/fatfrecommendations/documents/regulation-virtual-assets.html

[7] https://g20.org/sites/default/files/buenos_aires_leaders_declaration.pdf

Authorities should recognise that various products / services traded through DLT platforms will likely have discrete risk profiles and implications for the markets and that, consequently, each use case should be viewed separately. This will prevent a level of regulation that could unintendedly hinder the development of other DLT-based services.

Any actions should apply to the financial activity undertaken rather than the technology used. Only in circumstances where it is inherent to the specific characteristics of a technology, should regulation consider those specifications in order to address unnecessary barriers which may preclude innovation. Given the global nature of the technology, international coordination will be required.

Further research needed

Risks related to illiquidity, volatility and the lack of price transparency are present in a considerable number of existing assets in this field. Further investigation is needed to develop ways to ensure they do not harm consumers, market integrity and financial stability. A continued study on the possible and innovative uses of DLT technology or new way to use DLT should be encouraged for identifying cost-saving opportunities and achieving new operational improvements that are not yet exploited today, such as the possibility to create decentralised applications.

KEY RECOMMENDATIONS

- **Ensure an adequate level of consumer protection and transparency by warning investors of the risks involved with transacting and investing in crypto-assets.**
- **In order to avoid overregulation and ensure that the marketing of these assets offers the same guarantees as any other financial assets currently available and supervised by regulators, assess further the current regulatory framework:**
  a) to promote the use of the current regulation if it is already sufficient to address risks related to crypto-assets (e.g. regulating security tokens under the existing regulation on financial assets).
  b) to identify if regulation is either absent or require adjustments.
  c) take actions to cover unregulated "grey zone".
- **Address the specific AML risks associated with the various stages in a crypto-asset lifecycle by establishing clear regulatory requirements and supervision criteria.**
- **Encourage continued research on the possible and innovative uses of DLT technology and new way to use DLT for achieving new operational improvements and identifying cost-saving opportunities.**

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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