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The regulation of crypto assets in Malta: The Virtual Financial Assets Act and beyond

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1. Introduction

This paper critically examines the regulation of crypto assets in Malta, which has become a jurisdiction of choice for operators in this field. It analyses the Virtual Financial Assets Act [VFAA] and the MFSA's approach to the regulation of this new field of financial services. The paper examines the manner in which the VFAA achieves the high-level objectives of financial regulation set by international standard setters, such as International Organisation of Securities Commissions (IOSCO), being: [i] investor protection, [ii] market integrity and [iii] financial stability. The central argument of the paper is that the VFAA establishes a framework that supports the innovation and new technologies for financial services in the area of crypto assets, whilst ensuring the effective achievement of the mentioned objectives of regulation.

An important development in the carrying out of transactions over the internet has been the emergence of a new type of cryptographically encrypted digital assets, commonly referred to as crypto assets. Depending on their embedded features, crypto assets may be broadly categorised as cryptocurrencies, security tokens or utility tokens. Cryptocurrencies are used as a means of payment for goods and services and countries, such as Japan, have legally recognised them as a form of payment.[1] They are also used for investment in other crypto assets, including offers of security tokens, which are generally issued to raise funds for specific projects by start-ups.

Indeed, such offers are a practical alternative funding source for new or innovative businesses that would generally not be in a position to raise capital through traditional funding channels, as they would be at an early stage of development or are considered excessively risky and/or too small. For example, the development of the Ethereum blockchain, which is an operating system that features smart contracts, was funded by an online public crowd-sale during July–August 2014, with the participants buying ether token.

Crypto assets and their associated technologies, notably Distributed Ledger Technology ("DLT"), are rapidly evolving and becoming more prevalent. At the time of writing of this paper there were more than 1600 crypto assets available over the internet having a market capitalisation in excess of USD 275 billion[2] and more than 400 exchanges in the world, with a number of them being based in the European Union. Internationally, the equivalent of around Euro fifteen billion in funding has been raised through seven hundred twenty seven initial coin offerings issued in the first eight months of 2018.[3] However, various risks are associated with the trading therein, which have been identified by European and international bodies.

The novelty of the pertinent sector, combined with a lack of clear understanding of its disruptive impact over the existent financial services cosmos, has generally prevented jurisdictions from reaching a consensus on whether, how and to what extent these should be regulated.[4] However, the significant rate of failure of entities having issued an initial coin offering,[5] is a clear justification for the establishment of a regulatory framework to achieve the public interest. In view of the absence of a harmonised approach, and in order to ensure effective investor protection, market integrity and financial stability, a number of jurisdictions, including Malta, have decided to address the aforementioned regulatory issues on a national level.

The academic literature on blockchain and crypto assets has grown at a very fast pace during the last year.[6] This paper complements the existing literature by examining the legislative and regulatory developments in Malta, which is the EU's smallest member state by population. The point is made that Malta's framework for the regulation of crypto assets achieves the aforementioned objectives of financial regulation through a predominantly principles-based approach, which ensures technology neutrality without stifling innovation. Since the market capitalisation of crypto assets has not reached such point to be classfied as systemically relevant,[7] the objective of financial soundness is analysed in this paper only at micro level.

This paper has been prepared after carrying out research and analysis of information from various reports, articles, websites and other sources referenced throughout the body of the paper. It has benefited from the experience of the authors in

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this field, who have worked directly on the proposed legislative and regulatory framework in Malta and have attended numerous meetings with local and international practitioners in the field of crypto assets. The authors have also attended a number of conferences organised in this field by both national and international organisations, including *inter alia* Europol, as well as meetings with various regulatory bodies and notably with the European Securities and Markets Authority (ESMA).

In addition to this introductory section, this paper is divided into three additional parts. Part 2 describes the international debate and the various regulatory approaches adopted worldwide vis-à-vis the DLT sector. Part 3 outlines the Maltese approach and critically analyses the extent to which the VFAA achieves the objectives of regulation in a proportionate manner. Part 4 examines the manner in which the Maltese framework addresses anti money laundering and funding of terrorism in the context of crypto assets, especially with regard to VFA Agents that are the first line of defence to ensure the integrity of Malta's financial market. Some general concluding remarks, are made at the end of the paper.

2. International debate and approach

This section of the paper reviews the reactions of international and national regulators to the development and growth of crypto assets. A number of regulators are pushing an agenda which does not support the further development of this field of financial services. This, in view of risks to investor protection. Others want to encourage its growth in a regulated environment. This section attempts to briefly look into the different approaches taken primarily at international level in this regard.

The regulatory approaches across the globe vary significantly, ranging from a complete ban to a laissez-faire regime. For example, the People's Bank of China banned earlier this year ICOs and shut down domestic exchanges,[8] whereas the Securities and Exchange Commission, through the application of the "Howey Test",[9] takes the view that crypto assets that in substances have the features of securities, should be treated as such and therefore subject to traditional financial regulation.[10] According to the SEC, although a crypto asset itself is simply code, however depending on the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – it can be considered as a security, because it evidences an investment contract.[11] Therefore, the SEC has concluded that treating such assets as securities is logical. Another securities regulator in the US, the Commodities Futures Trading Commission, regulates crypto assets as commodities, thereby putting them on the same level as, for example, oil and coffee.[12]

The French Government is considering the introduction of a specific voluntary regime for the regulation of initial coin offerings, to be supervised by the French securities and markets regulator the AMF.[13] The French legislative proposal, provides for approval by the French AMF of "utility" ICOs that meet certain conditions in relation to transparency, disclosure, the security of invested funds and anti-money laundering. The AMF will as a result be issuing a "white list" of those ICO that have been approved which will be supplemented by a "black list", of fraudulent ICOs, where regulatory and enforcement action has been taken by this regulator.[14] In addition, the AMF is considering a possible regime applicable to [i] exchanges; [ii] intermediaries; [iii] safekeeping and [iv] additional customer protection provisions, e.g., banning active marketing of crypto-assets to retail.[15]

At international level, a recent communiqué of the G20 Finance Ministers and Central Bank Governors highlights issues of investor protection, market integrity, tax evasion and AML/CFT, and called for constant review by the international standard-setting institutions.[16] In this connection, international bodies such as the Financial Action Task Force (FATF), the Financial Stability Board (FSB) and the IOSCO have been studying the development of crypto asset markets and have already published a number of documents that stipulate standards which are applicable to this field of financial services.

IOSCO is currently developing a resource toolkit for ICOs, which will assist securities regulators globally to consider the facts and circumstances of an ICO through a "look through" or "substance over form" approach. It will set out an overview of ICOs, the risks, a risk assessment process as well as tools to ensure ICOs can be effectively assessed and investors safeguarded. In 2015 the FATF issued "Guidance for a risk-based approach to virtual currencies". This provides recommendations on the application of a risk-based approach to anti-money laundering and counter financial terrorism which tailors the existing regime to virtual currencies by requiring the assessment of the relevant risks and calibrating the level of due diligence required in this regard.[17] This organisation is now taking action to further improve the understanding of risks resulting from trading in virtual currencies.[18]

In 2017, the FSB published a document entitled "Financial Stability Implications from Fintech: Supervisory and Regulatory Issues that Merit Authorities' Attention", which document assess the financial stability implications of Fintech, including virtual currencies, that merit regulators' attention from a financial stability perspective.[19] IOSCO on the other has issued statements which indicate the potential consumer detriment that may result from investments in unregulated crypto currencies.[20] Having reviewed the documents published by the organisations and followed closely the work they have carried out to date, it is reasonable to argue that while outlining the risks relating to this new area of financial business, these international institutions have not discouraged its further development, but have on the other hand started a process for the setting of regulation that would mitigate the relevant risks.

The approach taken by these international organisations is different from that suggested by Agustin Carstens, the General Manager of the Bank of International Settlements (BIS), who earlier on this year described crypto assets "as a combination of a bubble, a Ponzi scheme and an environmental disaster" and who encouraged financial regulators to clamp down to contain the risks related to this asset class.[21] This position is close to that taken by Andrea Enria, the Chairperson of the European Banking Authority (EBA), who, whilst referring to the work being carried out by the EBA in this field, stated that regulated financial institutions, such as banks,

should be prevented from buying, holding or selling crypto currencies – and possibly also from establishing direct or indirect connections with managers of crypto-currencies –, so as to segregate and avoid contagion.[22] It is reasonable to suggest that as far as Carstens and Enria are concerned, crypto assets form a significant risk to financial market integrity and consumer protection and should, as a result, be suppressed.

Others have expressed strong concerns re investor protection with regard to crypto currencies[23] through speeches, investor alerts, bulletins, statements and public warnings. In this connection, it is worthwhile mentioning the position taken by the Belgian Financial Services and Markets Authority (FSMA),[24] the Dutch Authority for the Financial Markets (AFM)[25] and the UK Financial Conduct Authority (FCA),[26] which institutions have warned investors on the risk of investing in crypto currencies and discouraged their financial sector from getting involved in crypto assets. However, other institutions and authoritative policy makers have taken a different and more positive approach towards a regulatory solution. Christine Lagarde, the Managing Director of the International Monetary Fund, on number of occasions, highlighted the advantages of crypto assets and encouraged policymakers to keep an open mind and work toward an even-handed regulatory framework that minimises risks while allowing the creative process to bear fruit.[27] This is also the position taken by Yves Mersch, a member of the Executive Board of the European Central Bank (ECB), who specifically recommended that regulatory action to extend licensing and supervision rules to crypto assets facilitators should be explored.[28]

Lagarde and Mersch, and similarly minded policy makers, have recognised the financial innovation benefits of crypto currencies, while at the same time acknowledging the risks presented, which risks may be mitigated through regulation and supervision that is proportionate, thereby allowing the industry to develop further. As pointed out by the BIS in its Annual Economic Report for 2018 since cryptocurrencies are global in nature, only globally coordinated regulation has a chance to be effective.'[29] Lagarde also expressed a similar view earlier on this year.[30] However, there is presently no international consensus on a harmonised or convergent regulatory framework that should apply in this regard. In the meantime, Asian countries, such as Japan,[31] and European countries such as, France,[32] Malta, and Switzerland,[33] have opted to become regulatory torchbearers in this embryonic sector until such time when international consensus is reached and a more harmonised regime is put in place.

The following section of the paper critically examines the Malta approach to the regulation of crypto assets and how this achieves the three high level objectives of financial services regulation.

3. Malta's legislative and regulatory approach

This section outlines and critically examines Malta's proposed framework for the regulation of crypto assets. It reviews the framework for the regulation of: [i] collective investment schemes investing in crypto assets which are the first set of rules adopted in Malta to regulate a financial activity linked to crypto assets; and [ii] operators in the field of crypto assets that qualify as virtual financial assets as defined in terms of Malta's Virtual Financial Assets Act, which is the legislation that regulates this area of business on the island.

3.1 Regulatory framework for collective investment schemes investing in crypto assets

Malta embarked upon its voyage towards achieving a comprehensive regulatory framework in which industry participants wishing to provide services in relation to crypto assets may operate, with the publication of supplementary rules applicable to Professional Investor Funds [PIFs] investing in crypto assets.[34] These rules aim at providing a robust regulatory framework that seeks to ensure investor protection and market integrity with regard to collective investment schemes that invest in crypto assets. In order to achieve these objectives, the supplementary rules introduce specific requirements both during authorisation stage, as well as on an ongoing basis, thereafter relating *inter alia* to competence, risk warnings, quality assessment, risk management and valuation.[35]

More specifically, and in view of the associated sectoral risks, great emphasis has been placed by the MFSA on the competence requirement applicable to every person acting as functionary to such PIFs. As part of its authorisation process, the MFSA takes into consideration all training received by a functionary in relation to crypto assets and their underlying technologies and evidence attesting any trading conducted in crypto assets on a personal account. In view of the nascent nature of the industry, the MFSA does not currently have a recognised list of courses but will take into consideration training received from reputable institutions/organisers and provided by knowledgeable trainers/speakers on the subject, including *inter alia* the MSc in Digital Currency degree programme offered by the University of Nicosia and the Bitcoin & Cryptocurrency Certification Course offered by Princeton University. Considering the rapid developments in this field, the Authority expects individuals to partake in further training or continuous development in the area of crypto assets in order to be able to keep abreast of developments in this sector.

One may reasonably argue that the aforementioned ongoing training requirement ensures that the investor protection objective is approached in a holistic manner. More specifically, taking into consideration that such training should encompass not only the various crypto assets available but also the underlying technologies, functionaries of such PIFs would be in a position to undertake not only investment risk assessments but also technology and cybersecurity assessments prior to investing in a particular crypto asset or using the services of a particular wallet provider or crypto exchange. Apart from safeguarding investors' funds, ensuring that a functionary is at all times able to undertake such multi-faceted assessment of crypto assets and service providers, will arguably further result in the proper functioning of, and instil confidence in, the financial markets.

The introduction of the regulatory framework applicable to PIF was the first step in the establishment of a more

comprehensive Maltese regime to deal with crypto assets and all relevant service providers.

3.2 Malta's Virtual Financial Assets Act

Subsequent to the regulation of PIFs investing in crypto assets, the MFSA published a Discussion Paper on Initial Coin Offerings, Virtual Currencies and Related Service Providers[36] (the "Discussion Paper"). The purpose of the Discussion Paper was to request stakeholders' views on a proposed policy to be adopted by the MFSA in relation to the regulation of the Initial Coin Offerings ("ICOs"), crypto assets and service providers involved in ICO and/or other crypto activity. In parallel, the Government was working on the establishment of a regulator responsible for technology, which would *inter alia* be responsible for the certification of the technology arrangements underlying crypto assets and the technological developments brought about by funding raised through ICOs.[37]

The main policy proposal presented by the MFSA to stakeholders was that of devising a regulatory and supervisory framework, which supports innovation and new technologies for financial services in the area of crypto assets, whilst ensuring effective investor protection, financial market integrity and financial stability. Experience suggests that the principle of proportionality is key to effective regulation. Proportionate regulation takes into account the business model, size, systemic significance, as well as the complexity and cross-border activity of licensed entities, which fall within the scope of the said regulation. As will be argued throughout the rest of this paper, achieving a robust and proportionate framework was and continues to be the underlying objective, which the MFSA is seeking to achieve with regard to the regulation of crypto assets.

The lack of regulation and enforcement in the field of crypto assets is resulting in a fertile playing ground for scammers, as in such an environment malpractice will most likely go with impunity.[38] In this connection, it is reasonable to argue that a financial sector that develops a reputation of malpractice and investor detriment may suffer a loss of consumer confidence. The Satis Group[39] report on crypto asset market has highlighted that seventy eight percent of ICOs in 2017 were identified as scams.[40] In the US several cases of fraud have been investigated and action taken by regulators, including the US Securities and Exchange Commission.[41] In this light, the industry's general feedback to the MFSA's discussion paper that in absence of a specific regulatory and supervisory framework, the interests of investors and the market cannot be safeguarded effectively[42] came as no surprise. On this basis, the MFSA commenced work on the VFAA, which was drafted by the Authority, and eventually submitted to Government for the initiation of the legislative process. The Virtual Financial Assets Bill was published in the Government Gazette of Malta No. 19,994 on 22 May 2018.[43]. Two corresponding bills, the Malta Digital Innovation Authority Bill[44] and the Innovative Technology Arrangements and Services Bill,[45] were also published in the same Government Gazette of Malta. The Maltese Parliament adopted these Bills in July 2018.

The VFAA creates a regulatory framework applicable in the field of crypto assets, specifically those that qualify as virtual financial assets as defined in terms of the said Act. The Act regulates the offering to the public of virtual financial asset, and sets a regulatory framework applicable to operators providing investment services in relation to such assets, when this activity is carried out in or from within Malta. The MFSA is the competent authority for the purpose of the Act and is required to cooperate with the Malta Digital Innovation Authority [MDIA] with regard to the regulation of this field of business.

The MDIA is established in terms of the Malta Digital Innovation Authority Act (MDIA Act).[46] It is an autonomous public institution which has been set primarily to regulate technology arrangements. The MDIA has a mixture of consumer protection and business development objectives in the field of innovative technology arrangements. The MDIA Act vests the MDIA with a wide array of functions which this authority must fulfil. These functions may safely be categorised into: [i] regulation; [ii] supervision; [iii] policy; [iv] education; and [v] business development. Within the context of the regulation of virtual financial assets, the MDIA is the competent authority for the purpose of the Innovative Technology Arrangements and Services Act,[47] which provides for inter alia the authorisartion of systems auditors that will have a specific role in ensuring the security against cyber-attacks of this area of business.

There are considerable security risks which may result from transactions in crypto assets, including the loss of investment and date breaches attributable to hacks of online trading platforms and individual crypto asset "wallets." Research on the causes of cyber-attacks assessed that more than ten percent of revenues produced by ICOs – or almost $400 million – were lost to such attacks. [48] Recently, a Japanese cryptocurrency market lost over $500 million in a hack of its systems.[49] To make the Maltese framework robust from a cyber security perspective, at the time of writing, the MFSA and the MDIA are discussing the manner in which experts that will be registered (systems auditors) with the MDIA under the ITAS Act will be required to assess and confirm the robustness of the technological components of operators that will be authorised by the MFSA under the VFAA, both at the outset as well as an ongoing basis thereafter. Whereas, it is evident that each of the aforementioned Acts regulate a different facet of the DLT spectrum, the detailed analysis of the MDIA and ITAS Acts fall outside the scope of this paper.

The VFAA distinguishes between four different classes of DLT assets, namely: [i] *financial instruments*, being those DLT assets qualifying as financial instruments under MiFID[50]; [ii] *electronic money*, being those DLT assets qualifying as electronic money under the E-Money Directive[51]; [iii] *virtual tokens*, being those DLT assets whose utility, value or application is restricted solely to the acquisition of goods or services, either solely within the DLT platform on or in relation to which it was issued or within a limited network of DLT platforms, which term shall exclude DLT exchanges; provided that a virtual token which is or may be converted into another DLT asset type shall be treated as the DLT asset type into which it is or may be converted; and [iv] *virtual financial assets*, being those DLT assets falling outside the scope of any of the previous three classes. It is this final DLT asset class that falls within the regulatory perimeter of the VFAA.

To provide legal certainty on the nature of DLT asset, the MFSA has published the financial instruments test which is an objective test that allows for a clear determination on the classification of a crypto asset in one of the above-mentioned classifications.[52] The MFSA financial instrument test is different from the US Howey test, as the latter test is subjective, the determination of which is not set on pre-established criteria but on a set of non-exhaustive questions that focus at establishing whether a crypto asset is offered as an investment contract and thus qualifies as a security. In addition, whilst the MFSA financial instrument test focuses on the rights and characteristics of the crypto asset being assessed,[53] the SEC's assessment of crypto assets focuses on the efforts and intentions of the issuers and the motivation of purchasing the digital asset.

With respect to DLT assets qualifying as financial instruments, the VFAA follows the general principles set out in a policy statement issued by ESMA on 13 November 2017[54]; taking into consideration the said principles as well as the technology-agnostic scope of financial services legislation, those DLT assets which embed features and, or functionalities similar to those of MiFID financial instruments, including *inter alia* transferable securities and derivatives, will warrant the same legislative and regulatory treatment. Therefore, irrespective of the novelty of the underlying technology utilised, issuers and intermediaries of such DLT assets will be required to abide with the applicable framework *in lieu* of the proposed VFAA. In relation to virtual tokens, it is evident from the above definition that the VFAA reflects the limited network exclusion enshrined in the Second Payment Services Directive.[55] Finally, virtual financial assets are to be understood as those DLT assets in relation to which (i) no implications vis-à-vis existing frameworks emerge and (ii) which are, or may be, traded on a secondary market.

Notwithstanding the foregoing, the determination that a DLT asset qualifies as a virtual financial asset is only one of the two components required to trigger the applicability of the VFAA's provisions. In order for a person to be captured by the VFA framework, the said person should further undertake an activity, or provide a service, included in the Second Schedule to the VFAA. The legislation has been drafted in conformity with the off-chain equivalence principle, thus rendering such dualism a *sine qua non* for its applicability.

Having analysed the scope of the VFAA, the following three sub-sections of this paper will examine the manner in which the VFAA and the subsidiary regulation and rules regulate offerings of virtual financial assets, VFA service providers, including exchanges and wallet providers, and VFA Agents, who have the role of submitting applications on behalf of the former.

3.2.1 Initial VFA offerings

ICOs constitute an innovative way of raising money from the public, whereby a business or individual issues crypto assets and puts them for sale in exchange of either fiat or crypto currencies. ICOs are seen as high-risk speculative investments exposed to numerous risks including *inter alia* inadequate information, cyber security and fraud. Moreover, taking into consideration the various ways ICOs may be structured, investors may not be afforded protection under existing frameworks. Whereas ESMA's guidelines included in the policy statement issued on 13 November 2017[56] shed certain legal and regulatory certainty in this regard, it is the authors' view that a vacuum is created where a crypto asset on offering does not qualify as a financial instrument, which creates ample regulatory arbitrage opportunities. It is this vacuum that the VFAA endeavours to address in order to achieve investor protection and market integrity in this terra incognita. Indeed, given the high investment risk and potential for fraud, countries such as China and South Korea banned ICOs in 2017.[57] In Malta, instead of banning ICOs altogether, requirements have been introduced to regulate ICOs through a full disclosure of the proposed project to be funded through the ICO in a whitepaper to be approved by the MFSA.

The VFAA encompasses those ICOs where the crypto asset on offering is classified as a virtual financial asset thereunder, termed as "initial VFA offerings". The VFAA addresses information inadequacy through the imposition of the high-level principles enshrined in the Prospectus Regulation[58] on such issuers. In particular, they are required under the VFAA to draw up a whitepaper[59] and register it, through their appointed VFA Agent, with the Authority prior to proceeding with an initial VFA offering. Similar to a prospectus under traditional financial services law, the purpose of the whitepaper is to provide investors with sufficient information on the virtual financial assets, their issuer and the proposed project; such a full disclosure regime is seen as a sine *qua non* for the formulation of an informed opinion on the prospects of an initial VFA offering. It follows that the impetus of the VFAA is to remove the information asymmetry between the issuers and investors, which is one of the primary basis for justifying financial regulation in general.[60]

According to TokenData, a website tracking ICOs, approximately 46 per cent of ICOs conducted within the span of 2017 have failed.[61] One may reasonably assume that one of the reasons for this failure rate was the information asymmetry between the issuers and the investors, irrespective of the fact that a whitepaper was available in all instances. Therefore, the VFAA is addressing the failures of the past through the introduction of remedies to the information asymmetry issues. The First Schedule to the VFAA includes a list of the minimum details required to be communicated to investors and further imposes the requirement for the inclusion of a summary drafted in non-technical language allowing those investors without technical expertise to adequately understand the nature of the issuer's proposed project. However, whereas the introduction of the aforementioned requirements unambiguously addresses the information asymmetry issue, it is argued that this is only a facet of the investor protection prism within the context of crypto asset crowd sales; therefore, and in order for such objective to be truly realised, the proposed VFAA imposes certain obligations vis-à-vis the technological component of such crowd sales as explained in further detail below.

Whereas risks relating to cyber security and fraud are partially addressed through the aforementioned disclosure regime, investors do not possess the required technical expertise to assess certain parameters of initial VFA offerings,

including *inter alia* the DLT protocol or platform developed or the smart deployed by the issuer, would not be in a position to make a truly informed investment decision. Therefore, the adoption of additional technological safeguards, mitigating loss-, theft- or misappropriation-related risks, is a prerequisite for effective investor protection in this field. It is maintained that the proposed framework satisfies this condition through the introduction of a requirement for an issuer's DLT infrastructure to be thoroughly vetted by a systems auditor prior to proceeding with an initial VFA offering. More specifically, the issuer is required, through its appointed VFA Agent, to appoint a person qualifying as a systems auditor under the ITAS Act, whether registered with the MDIA or not, to audit the DLT technology used within the context of its proposed initial VFA offering.[62] The audit shall be required to cover all the constituent parts of the utilised technology including *inter alia* the smart contracts and the wallets deployed. After being satisfied that the issuer's DLT infrastructure meets the required cybersecurity standards and is in line with the description included in the pertinent whitepaper, the systems auditor will be required to submit an attestation in this regard to the Authority.

To complement the above, given the high rate of failure, the MFSA is considering to introduce a maximum investment amount for an initial VFA offering of Euro 5000 per issuer over a period of 12 months, applicable to unsophisticated retail investors with regard to ICOs.[63] It is reasonable to suggest that such a regulatory requirement would ensure that those who do not have the knowledge and experience to understand the risks involved with regard to an investment in ICOs will still have the opportunity to partake in this business, however limitedly. One may also argue that such a requirement promotes diversification by such investors that would be forced not to put all their eggs in one basket. Therefore, this approach is positive on the one hand as it reduces the possibility of investor detriment in case of failures of ICOs, however, as has been argued, it makes the Malta legislative framework less attractive when compared to other jurisdictions where such a requirement is not applicable. Nevertheless, it demonstrates the MFSA's determination to achieve a high level of investor protection and market integrity in this area.

The next section analyses the Malta's approach to the regulation of persons providing intermediary services in relation to crypto assets and how this framework further strengthens investor protection, market integrity and financial soundness.

3.2.2 Service providers

The VFAA regulates persons providing intermediary services, such as crypto wallets, operation of crypto exchanges, brokerage and discretionary portfolio management, when such services are provided in relation to virtual financial assets. The VFAA sets out *inter alia* the licensing requirements, procedure and ongoing obligations applicable to such persons, which reflect the high-level principles enshrined in the existing EU financial services legislation in relation to the provision of investment services, financial markets and prevention of market abuse. The requirements which aim at preventing market abuse are particularly important given the allegations that crypto asset trading is prone to manipulation, specifically "pump and dump"[64] schemes.[65] VFA licence holders and will also subject persons for anti-money laundering purposes are therefore required to carry know your customer procedures as be required by the relevant regulation.[66]

Mirroring the requirements of traditional financial services frameworks, and considering that regulatory measures of a comparable standard are introduced, it may be logically supported that the proposed VFAA will achieve the objectives of financial services regulation. Namely, the proposed framework imposes a spectrum of prudential requirements including *inter alia* on administration, compliance, risk management, systems and security access protocols, financial resources, capital adequacy and professional indemnity insurance. Furthermore, a set of disclosure obligations is imposed on these persons, both at authorisation stage as well as an ongoing basis thereafter. More specifically, and similar to issuers as per above, where an applicant's business model involves an innovative technology arrangement, a systems audit will be required to be conducted and an attestation to be submitted to the Authority, forming part of the application in relation to a VFA services licence. Upon granting of the licence, a holder thereof will be required to periodically report to the Authority on its activities, exposures, cybersecurity risks etc. and submit several reports, including an annual certificate of compliance.

On the basis of the above, one may safely conclude that the issuers and licence holders are subject to a level of regulation which should on the one hand achieve the high-level objectives of financial regulation whilst at the same time leaving space for innovation as it does not apply a detailed rules based approach but merely applies the high level principles of EU law to this field of business. The following subsection examines the provisions applicable to VFA Agents which may be described as the first line of defence against market malpractice in this area, as, once registered, they have the role of filtering applicants for authorisation under the VFAA before the request for authorisation is submitted for MFSA's review.

3.2.3 VFA Agents

The VFAA requires both issuers and persons wishing to provide a VFA service to appoint a VFA Agent duly registered under the VFAA. Whereas issuers are required to have at all times in place a VFA Agent, it is reasonable to argue that, given the nascent nature of this area of business, it is logical for other regulated persons to have the expertise of a VFA Agent at their disposal even post licensing. Nonetheless, in terms of the VFAA all relevant compliance activity of an issuer, including *inter alia* the submission of any information and documentation whatsoever to the Authority, is to be conducted solely through the appointed VFA Agents. The VFAA sets out *inter alia* the registration requirements, procedures and ongoing obligations applicable to such agents. In this regard, it is relevant to point out that the main role of VFA Agents is the undertaking of compliance checks, both prior to approval of an issuer's white paper and an applicants licence, and with regard to the former, on an ongoing basis thereafter.

In view of the nature of such role, VFA Agents are expected to have robust due diligence procedures, systems and controls in place in order to screen prospective issuers and persons wishing to provide a VFA service as well as to ensure that such persons are fit and proper for such purpose and, as explained in the next section of this paper, from an anti-money laundering/ combating funding of terrorism (AML/CFT) perspective. Whereas VFA Agents will not be required to be resident in Malta in order to be eligible for registration under the VFAA, certain local substance requirements shall be applicable to those applicants residing outside Malta.

VFA Agents are expected to play a pivotal role under the VFAA. Comprising the first line of defence against the risks associated with this embryonic sector, the Authority will place significant reliance on the quality of the services provided by such persons. In this regard, they shall be required to meet high fitness and properness standards. One may make the point that if the MFSA manages to enforce high standards with regard to the registration of the agents and their ongoing supervision, it is likely that they will act a strong first filter for this area of business, thereby strengthening overall, investor protection, market integrity and financial soundness.

The subsequent section of the paper critically examines Malta's proposed AML/CFT framework in relation to crypto assets and why this goes beyond the boundaries of the Fifth Anti-Money Laundering Directive (5AMLD).[67]

3.2.4. Anti-money laundering/combating funding of terrorism

The DLT ecosystem presents a number of money laundering and terrorist financing (ML/TF) risks as have been identified by various international bodies, including *inter alia* the FATF.[68] For example, it is possible for illicit actors to go through a service like Shapeshift, which offers cryptocurrency trading without any identification or verification requirements, therefore allowing the conversion of ill-gotten cryptocurrencies into anonymized privacy coins. The most common privacy coin is Monero, which ensures a high standard of anonymity through the deployment of the "Ring Confidential Transactions" and "Stealth Addresses" techniques.[69] Europol has identified Monero as one of the most prevalent crypto currencies in the underground[70] and the preferred means of payment of numerous Darknet markets. Monero was also utilised for the first time in 2017 as the ransom payment of choice by Kirk ransomware.[71]

Concerns on ML/FT related risks are international[72] and have led the European Commission's proposal on 5 July 2016 to amend the Fourth Anti-Money Laundering Directive (4AMLD) to further reinforce EU rules to combat ML/FT. On 26 April 2018, the European Parliament confirmed the latest text of the proposed 5AMLD, which amends 4AMLD with the aim of tackling risks associated with virtual currencies. The 5AMLD is the first legal instrument to be implemented at EU level to cope with risks in relation to virtual currencies. It introduces a definition for virtual currencies and brings custodial wallet providers and currency exchange platforms within scope. It defines virtual currencies as "a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically".

A custodial wallet provider is further defined as "an entity that provides services to safeguard private cryptographic keys on behalf of their customers, to hold, store and transfer virtual currencies". Finally, virtual currency exchanges are defined as those providers "engaged in exchange services between virtual currencies and fiat currencies", thus excluding crypto-to-crypto exchanges. Exchange service and wallet providers will have to register with the national Financial Intelligence Unit, and thus be subject to Customer Due Diligence (CDD) requirements.

Whereas the 5AMLD is not required to be transposed into national law prior to the end of 2019, in view of the aforementioned ML/FT risks associated with this niche industry, one could reasonably argue that the VFAA and its underlying framework could not be viewed as impervious to ML/FT unless reflecting the 5AMLD's high level standards. Malta has therefore taken the decision to extend the Prevention of Money Laundering and Funding of Terrorism Regulations' (PMLFTR)[73] scope, the domestic legislative instrument transposing the 4AMLD,[74] to encompass persons not currently covered thereunder. Such extension, however, goes beyond the 5AMLD, whose scope does not capture certain service providers, including *inter alia* crypto-to-crypto exchanges and issuers of initial VFA offerings.

The aforementioned inclusion is argued to be essential in view of both the novel business models that are surfacing as well as recent regulatory developments. More specifically, the majority of crypto exchanges nowadays provide crypto-to-crypto trading pairs (e.g. BTC/ETH, USDT/BCH etc.) and other traditional financial services activities have also emerged in relation to crypto assets (e.g. brokerage, discretionary management etc.). On another note, and in view of ESMA's guidelines included in the policy statement issued on 13 November 2017,[75] one could argue that a conundrum would be created vis-à-vis AML/CFT requirements in certain instances. In this regard, the scenario is envisaged where crypto assets qualifying as financial instruments (MiFID) are traded on crypto-to-crypto exchange A whereas crypto assets qualifying as virtual financial assets (VFAA) are traded on crypto-to-crypto exchange B. Whereas exchange A would be subject to the full spectrum of AML/CFT obligations emanating from its MiFID license, exchange B would be exempt from such requirements.

In light of the above considerations, it can be logically supported that even the 5AMLD's extended scope hardly constitutes an effective panacea; whereas it certainly is a step in the right direction, we argue that only by going beyond the said provisions may the ML/FT risks associated with this niche sector be effectively mitigated. This approach is also in conformity with the findings of the report prepared by the Policy Department for Economic, Scientific and Quality of Life Policies,[76] pursuant to which the exclusion of a number of key players from the 5AMLD's scope will lead to blind spots in the fight against money laundering, terrorist financing and

tax evasion. It is exactly these blind spots that Malta endeavours to shed light upon through the VFAA, as is further analysed below.

Without prejudice to the generality of the foregoing, the VFAA brings issuers, VFA Agents and VFA service providers within the definitional scope of a "subject person" in terms of article 2 of the PMLFTR. This means that such persons will be required to carry out CDD measures, the extent of which currently is the subject of debate. Whereas consensus has been reached in relation to the AML/CFT obligations applicable to VFA service providers, being identical to those pertaining to persons undertaking "relevant financial business" under the PMLFTR, VFA Agents and issuers merit further analysis.

The VFAA distinguishes VFA Agent appointments between those in relation to issuers and those in relation to VFA service providers. The relationship between VFA Agents and the issuers in relation to which they are appointed will be of a professional nature, having an element of duration. We therefore argue that this would fall within the definitional scope of a "business relationship" in terms of sub-regulation 2 (1) of the PMLFTR. However, such element of duration will be absent in the second type of appointment and therefore one may reasonably suggest that the relationship to be established between VFA Agents and applicants should be deemed as an "occasional transaction" in terms of sub-regulation 2(1) of the PMLFTR.

In those instances, where a business relationship is established, a VFA Agent, pursuant to sub-regulations 7(1)(d) and (2) of the PMLFTR, will be subject to *inter alia* the requirement for ongoing monitoring of such relationship; such requirement consists of [i] transaction monitoring and [ii] ensuring that the documents, data or information held by it in relation to the issuer are kept up-to-date. This notwithstanding, an exemption from the full scope of the applicable CDD requirements is proposed due to the particularities of the pertinent business model. More specifically, since the VFA Agent will not have any visibility whatsoever in the issuer's bank account or wallet/s, it is recommended that he is exempted from the transaction monitoring requirement. This notwithstanding, he would still be expected to keep up-to-date documents, data or information in relation to the issuer since this would be crucial in discharging his obligations under the pertinent framework.

Whereas the relationship between a VFA Agent and an applicant for a VFA services licence would fall, as mentioned above, within the definitional scope of an "occasional transaction", it is currently being proposed that the triggering of the applicable CDD requirements is detached from monetary thresholds. This would be in line with the Financial Intelligence Analysis Unit (FIAU)'s position in relation to the incorporation of companies and the provision of tax advice, activities that may be reasonably argued to pose comparable risks to VFA Agent services. More specifically, VFA Agents will act as gatekeepers tasked with preventing illicit actors from infiltrating the financial system. Due to the low monetary thresholds involved, CDD requirements are not envisaged to be triggered in most instances; one may therefore argue that only by delinking the applicability of CDD measures from minimum monetary thresholds can a robust AML/CFT framework truly be achieved.

Identification and verification of the applicant for business and beneficial owner/s as well the establishment of source of wealth and source of funds (where a business relationship is established) is of utmost importance. Especially in this field, where crypto currencies are usually utilised for the development of a project, it is imperative to verify that such funds have not gone through *inter alia* darknet marketplaces or mixers/tumblers, thus obfuscating their origin.

As stated above, a *sine qua non* for a robust AML/CFT framework is the creation of numerous sources of intelligence resulting in an audit trail. Apart from the VFA Agent, the issuer comprises another such source and therefore the offering of virtual financial assets is proposed to be treated as an occasional transaction. This notwithstanding, there are several challenges associated with linking the applicability of CDD measures to the prescribed EUR 15,000 minimum threshold. Firstly, where such threshold is not exceeded, the issuer will merely have to identify an investor without verifying his/her identity, residential address, source of wealth or source of funds; this essentially means that the issuer would have to rely on the said investor's honesty. Considering the vast array of available software privacy tools, including *inter alia* The Onion Router (TOR),[77] the value of such identification is arguably very limited. These privacy tools further hinder an issuer from meeting his obligation to aggregate below-threshold transactions to confirm whether, and at what point in time, the full CDD requirements are necessitated in relation to a particular investor, thus resulting in ineffective safeguards against smurphing techniques. In order to address these deficiencies, alternatives that are currently being debated in relation to initial VFA offerings include the decrease of current thresholds to EUR 2,000 and the imposition of the identity verification requirement irrespective of monetary thresholds.

In addition to the aforementioned monetary thresholds within the context of occasional transactions, the Authority is also in discussions with the FIAU on whether specific thresholds should be introduced, below which simplified due diligence would be automatically applicable. Furthermore, the proposal for an AML/CFT audit of an applicant's systems and controls is being discussed, both at the outset as well as on an ongoing basis thereafter, which will *inter alia* attest to the overall integrity and effectiveness of the applicant's systems AML/CFT and controls.

The manner in which the aforementioned AML/CFT requirements are going to be implemented in practice is the subject of an ongoing tripartite dialogue between the MFSA, the FIAU and the industry. Considering that these discussions primarily focus on the source of wealth and source of funds, certain software transaction monitoring tools currently available in this niche field, including *inter alia* Chainalysis,[78] Elliptic,[79] Ciphertrace[80] and Neutrino,[81] are being identified and reviewed. One of the factors that the MFSA will be taking into consideration in determining whether or not to register a whitepaper or grant an authorisation will be the applicants AML/CFT systems and controls in order to meet their prescribed requirements as subject persons. Having such systems and controls in place is viewed as

paramount since ML/FT risks on DLT may be adequately addressed only through technological solutions. Especially in view of darknet marketplaces and tumblers/mixers like Coinmixer,[82] having a robust technological solution addressing such issues will ensure both that innocent investors are safeguarded against receiving illicit funds in their wallets as well as that such obscure funds are prevented from entering the financial markets. One may also argue that the Malta approach will result in numerous, invaluable sources of intelligence for law enforcement agencies which currently do not have visibility within "black box" permissible structures used by *inter alia* numerous crypto exchanges.

The approach taken by Malta and the MFSA in relation to AML/CFT in the field of cryptoassets clearly demonstrates the will to safeguard financial market integrity and to ensure that gaps in the current European framework applicable in this regard are properly addressed at national level.

4. Conclusion

This paper examined the legislative and regulatory framework introduced in Malta in relation to crypto assets and the manner in which it achieves the high-level objectives of financial regulation. The central argument of the paper is that the VFAA establishes a framework that achieves these objectives whilst leaving space for innovation.

Whereas the VFAA is viewed as a robust legislative instrument introducing legal and regulatory certainty in the field of financial services, there are additional DLT aspects that need to be resolved if Malta wishes to position itself amongst the leading jurisdictions in this area. One such aspect is the field of taxation. Issuers and other operators in the field of crypto assets require clear guidelines from the national tax authorities, in the absence of which tax evasion opportunities will arise. Furthermore, sector-specific guiding principles are also required vis-à-vis the application of the General Data Protection Regulation as well as the eIDAS Regulation, which, albeit technology neutral, need to be approached under the DLT prism. In the absence of such guidelines and principles, one may reasonably argue that the fear of regulatory action will be hanging like the sword of Damocles over the heads of operators in this field, thus stifling innovation.

No matter how holistic Malta's approach is, the truth of the matter is that it remains a home-grown regime, bound by sovereignty limitations that do not go hand in hand with the DLT's ubiquitous nature. In view of private international law implications, it is questionable as to whether investor protection, market integrity and financial soundness may effectively be ensured in the absence of international consensus on a harmonised or convergent regulatory framework. Therefore, whereas Malta's proposed framework is definitely a step towards the right direction, one may reasonably argue that the Bellerophon to the DLT chimera lies only at an international level. ■

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