

Executive Summary

Ensuring market integrity while promoting crypto asset innovations and financial inclusion in Europe

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Introduction

Europe is at a crossroads: under immense pressure to fight off or at least delay attempts to capture the European retail payment market by companies such as Facebook with their infamous LIBRA/DIEM project, the Commission has proposed stringent regulation for crypto asset issuers and service providers with its MiCA regulation. At the same time, the European regulator is called upon to nurture the foundational innovation unfolding in the European crypto assets industry.

At first sight, these two goals seem incompatible: constitutional democracy forbids institutions to pass a Lex Facebook which discourages a singular company from disrupting the financial sovereignty of the Euro-Zone. Therefore, a general regulatory framework capturing all players in the crypto assets market appears to be unavoidable. Yet, any serious attempt to constrain all-powerful actors like Facebook seems to require a set of regulations that ultimately suppress any financial innovation based on distributed ledger technology, good or bad.

EUCI has been formed with the support of Europe's most innovative players in the Decentralized Finance (DeFi) market, to explain why there is in fact a middle ground that thwarts hostile attempts to obliterate the role of the Euro, while fostering the amazing innovation happening at the edges of decentralized financial networks.

Key proposals

CeFi and DeFi are fundamentally different and require different regulation accordingly

The most important insight for regulators revolves around the notion of control. While applications in the realm of "Centralized Finance" (CeFi) are based on the concept of a centralized issuer or provider of services, applications in the realm of "Decentralized Finance" (DeFi) presuppose the absence of any such entity. Today, MiCA focuses explicitly and implicitly on centralized applications. Yet, the sweeping regulation is seemingly unaware of the emerging use cases in the DeFi space and therefore erects insurmountable hurdles for players in that niche. Consequently, MiCA inadvertently puts Europe at a massive disadvantage vis-a-vis competing jurisdictions, especially the U.S, with respect to DeFi applications.

Step 1: Exclude DeFi applications from the scope of MiCA

To ensure market integrity while promoting crypto asset innovations and financial inclusion in Europe, the current MiCA draft has to be amended by introducing the concept of "effective control" exerted by a centralized entity. Concretely, MiCA's regulatory scope has to be limited to applications where an issuer or service provider retains the power to unilaterally issue, execute or indefinitely prevent a crypto-asset transaction.

Step 2: Start a dialogue with innovators in the DeFi space

European innovators in the DeFi space are very interested to start a dialogue with the European institutions. Through initiatives like an observatory, community calls and targeted interviews, Europe can get up to speed about the foundational developments in that space. EUCI is happy to serve as a connector to the relevant players.

Towards regulating Decentralized Markets in Crypto Assets (DeCA)

I. Leverage digital identity to co-innovate and co-regulate DeFi applications

A key element in regulating a decentralized mesh of services that are controlled by their users rather than by any centralized service provider is the concept of digital identity. Fortunately, the European Blockchain Partnership (EBP) has already started to draft a European self-sovereign digital identity framework (eSSIF), using Europe's own public services infrastructure (EBSI). Once the eSSIF framework is ready for broader usage, DeFi applications can start to incorporate those verified identities into their service infrastructure. Solving the identity issue would provide a major competitive advantage to DeFi applications in Europe, while providing European regulators with a tool to enforce KYC/AML obligations, taxation and market oversight.

II. Introduce a legal framework for Distributed Autonomous Organizations (DAOs)

The second pillar of regulating DeFi applications is the provision of a tailor-made framework for legal personhood of Distributed Autonomous Organizations (DAOs). Today, DAOs are the most popular way to deploy DeFi applications on open blockchain networks, while handing control over future updates of the decentralized smart contract infrastructure to token holders. Yet today, DAOs do not enjoy any form of legal recognition in Europe nor anywhere else in the world. Developing a framework for DAOs as collective management bodies of stakeholders presents a massive opportunity that should be grasped by Europe. Just like in the case of digital identities, such an infrastructure would both nurture the DeFi ecosystem while establishing regulatory reach in that arena.

III. Legitimize and secure independent node verification networks

Thanks to emerging DeFi use cases, open blockchain networks prove to be the most significant innovation brought about by distributed ledger technology. While Europe has yet to recognize this essential fact, the U.S. are already way ahead in this regard. In January 2021, the Office of the Comptroller of the Currency published a letter clarifying national banks' and federal savings associations' authority to participate in independent node verification networks (INVN) and use stablecoins to conduct payment activities and other bank-permissible functions.¹

Europe has a historical chance to not only recognize and legalize the use of open blockchain networks by regulated financial institutions but to also participate in the securing of these networks. By becoming a significant validator operating under a clear legal framework, Europe can gain massive influence in the future evolution of the underlying protocols, such as Ethereum and other significant networks.

¹ "While governments in other countries have built real-time payments systems, the United States has relied on our innovation sector to deliver real-time payments technologies. Some of those technologies are built and managed by bank consortia and some are based on independent node verification networks such as blockchains," said Acting Comptroller of the Currency Brian P. Brooks. "The President's Working Group on Financial Markets recently articulated a strong framework for ushering in an era of stablecoin-based financial infrastructure, identifying important risks while allowing those risks to be managed in a technology-agnostic way. Our letter removes any legal uncertainty about the authority of banks to connect to blockchains as validator nodes and thereby transact stablecoin payments on behalf of customers who are increasingly demanding the speed, efficiency, interoperability, and low cost associated with these products.", OCC, News Release 2021-2 | January 4, 2021.

What happens if we do not rectify MiCA

I. Dollarization of the Euro-Zone

It sounds dramatic and the situation in fact is. The digital conquest of dollar-referenced stablecoins has already begun. Today, the most dominant stablecoins used across the world in financial transactions of all kinds but increasingly also in traditional cross-border commerce either use dollar reserves or, in the case of purely synthetic assets, reference the dollar price. The tremendous utility of stablecoin technology paired with the low transaction fees push more and more companies and consumers to use dollar-based stablecoins. Europe has already fallen behind. There is not a single Euro-based stablecoin with significant volume. Meanwhile, the US Treasury is promoting the use of dollar stablecoins, fully aware of the positive ramifications for the dollar dominion.

II. Criminalization of millions of ordinary European citizens

If MiCA should go unchanged with respect to DeFi use cases, a truly bizarre situation would emerge: since crypto assets and services relying on decentralized infrastructure are fully issued and managed by its users - as opposed to a centralized entity as is the case with CeFi applications (which rightfully should be regulated by MiCA) - these ordinary users (mostly consumers) could be charged for violating MiCA regulations. Developers who build innovative smart contract applications could be charged as well, since they are a critical element in the decentralized ecosystem. To avoid prosecution, the DeFi space would turn its back towards Europe, anonymization technologies would find wider adoption and Europe would capture not even a tiny sliver of the foundational innovation created by DeFi.

III. LIBRA/DIEM would still be launched and for a lack of alternatives dominate B2C transactions

While stringent regulation may help to delay the introduction of LIBRA/DIEM, an all-powerful organization like Facebook will ultimately be able to comply with any market barrier introduced by MiCA. If until then there is no viable ecosystem of DeFi applications and crypto assets, issued and managed by users themselves in an open, connected ecosystem, there would be no alternative left for consumers desiring to transact digitally and cheaply. The result would be the very future that the Commission has set out to prevent.