



DIGITAL CURRENCIES

Governance Group

MICA'S IMPACT ON DEFI

DCGG'S BRIEFING PAPER

Distributed Finance (DeFi) is a decentralised system which provides financial products on a public blockchain network, making them widely accessible, and removes third party intermediaries. The low barrier to entry and growing applicability of DeFi have put them at the cutting edge of digital finance.

The European Commission's Proposal on Markets in Crypto-assets Regulation (MiCA) is aimed at regulating the digital assets market at the European Union (EU) level.

MiCA predominantly focuses on centralised issuers, offerors, and service providers. It is not clear, however, how it may treat decentralised entities as those cannot be regulated effectively through regulation aimed at traditional centralised markets.

For that reason, the European Commission and the European Banking Authority are best positioned to address the regulation of DeFi after MiCA, with a dedicated policy approach. DeFi should be explicitly out of scope for MiCA.

Although in principle a clear and comprehensive regulation on digital assets could bring advantages such as legal certainty and increased consumer/investor protection, if the EU is to take a leading role in the global market of digital financial services, it should embrace innovations in the field and actively support rules that enable a friendly regulatory environment to a nascent industry.

This briefing paper explains what the main issues in MiCA are that present challenges for the DeFi industry, and why.

NON-IDENTIFIABLE ISSUER/LEGAL PERSON

MiCA could present a major challenge to DeFi in relation to its requirements for issuers to set up a legal entity. MiCA requires all players on the EU Market to be a legal entity in order to be granted the right to operate while needing to adhere to imposed legal obligations. This is done with the intent to enable enforceability. MiCA stipulates that in the absence of a legal entity, companies will be excluded from the EU Market.

This requirement is not able to fully capture the nature of the DeFi sector. Many DeFi projects are operated through automated processes, such as smart contracts, which are made at the level of individuals who are interested in converting their assets into a DeFi token that they have complete control over and which has a higher level of security than either other crypto-assets issued through a centralised entity or traditional finance alternatives. In essence, this will make it difficult for legislators to identify a responsible legal

person to bear the rights and obligations who isn't just an individual that only has control over the portion of DeFi tokens they created for themselves. As a network of individuals issuing their own tokens, there is no one, single entity that is responsible for the actions of the DeFi project, nor is there a project that can open an office in the EU, receive authorisation and comply with the legal requirements of MiCA.

Therefore, it should be made clear that requirements related to the centralised issuance of crypto assets should only apply to legal entities that have effective control over the issuing process. If there is a project where no effective control over the issuance process can be pinned to one entity, then no legal entity should be required to be created and should be exempt from MiCA issuance requirements.

Furthermore, it should be clarified that the issuers who are individual persons issuing their own DeFi tokens should be subject to exemptions from the requirement to set up a legal entity according to a threshold in MiCA that is similar to other issuance-related thresholds.

Another part of this problem is that the Commission's MiCA proposal poses for the DeFi industry is the requirement for a place of incorporation. However, this will prove to be an obstacle for the operation of DeFi for very similar reasons as above.

DeFi projects in most cases are operated by developers who are scattered in many countries and operate in a manner that empowers individuals to issue their own tokens, making it difficult to regulate in the traditional sense. This business structure is highly incompatible with the centralised placing of liability that the European Commission has put in MiCA. The Commission and the Co-legislators have attempted to address this by excluding DeFi from the scope of MiCA, which we think should be done explicitly.

Should this problem not be resolved by the legislators, they risk denying DeFi structures the opportunity to operate legally in the EU and restricting EU citizens' access to DeFi services.

RISK-MANAGEMENT AND COMPLIANCE PROCEDURES

The MiCA text requires DeFi issuers to set in place "robust governance arrangements", such as a well-defined organisational structure, concrete lines of responsibility, and clearly established administrative and accounting procedures. However, DeFi projects are, by nature, structures with dynamic management and procedures, as well as an active decision-making membership. As such, they are not structured in the same way as crypto assets of a centralised issuer. In line with this, MiCA appears better suited to regulate crypto-assets which have a centralised entity and more closely resemble the way the traditional finance sector works. This, however, does not reflect the case of DeFi issuers which do not meet requirements established with the intention of regulating one central entity.

In another example, DeFi projects can be risk managed through the system that individuals put up their own collateral when issuing a DeFi token. This also means that redemption is guaranteed as the individual can always access their collateral and redeem the DeFi token whenever they want.

In Conclusion: Hindrance of Innovation and No Future-Proofing

For the MiCA to live up to its stated objective to support innovation and encourage competitiveness in the EU, it needs to adequately reflect the developments in the nascent DeFi industry. However, in its current form the planned measures in the MiCA would appear to go against this objective by stifling innovations in DeFi space and restricting those use cases which are not set up and overseen by a centralised entity. MiCA's

most considerable shortcoming is that it appears to not have considered how DeFi services can be compliant with the regime or supply adequate guidelines for this. The increased uncertainty and risk build up into an additional cost to a young and innovative DeFi industry. The regulation generally needs to provide a higher level of trust in new and innovative market participants, in order to take advantage of blockchain and crypto assets activities and realise the full potential of decentralisation and innovative use cases. This could not only be favourable to the EU economy, but also contribute to jumpstarting the EU's global leadership in digital finance.

Finally, requirements under MiCA are clearly do not take into consideration important aspects of DeFi projects' structures and thus, cannot be future-proof when it comes to the dynamism of these structures.