MiCA Regulation: clarification of the provisions relating to the segregation of funds by DASPs is necessary

Context

Regulation (EU) 2023/1114 of the European Parliament and of the Council on markets in crypto-assets (MiCA) aims to strengthen the protection of investors holding crypto-assets. To this end, it specifies that customers' right of ownership over their crypto-assets must be guaranteed, particularly when the latter are held by a digital asset service provider (DASP). The activity of DASPs holding their customers' funds is thus firmly regulated.

While the European regulation is silent on the ways in which DASPs must take ‘adequate measures’ to ‘protect clients’ property rights‘, it does stipulate that DASPs’ own funds and clients' funds must be clearly separate and distinguishable. Thus, Article 75.7 of the MiCA Regulation states that :

> « *Crypto-asset service providers holding and administering crypto-assets on behalf of clients shall segregate holdings of crypto-assets on behalf of their clients from own-account holdings and shall ensure that the means of access to their clients' crypto-assets are clearly identified as such.* ***They ensure that, in the distributed ledger, their clients' crypto-assets are held separately from their own crypto-assets.***
>
> ***The retained crypto-assets are legally separated from the crypto-asset service provider's assets,*** *in the interest of the crypto-asset service provider's customers in accordance with applicable law, so that the crypto-asset service provider's creditors cannot assert any rights to the crypto-assets retained by the crypto-asset service provider, in particular in the event of insolvency.*
>
> ***The crypto-asset service provider shall ensure that the crypto-assets held are functionally separate from its assets.***.»

The legislator's desire to ensure the protection of investors is legitimate and is shared by crypto-asset service providers who have chosen to comply by obtaining MiCA approval. Nevertheless, the operational procedures for segregating funds have yet to be specified, and the need for DASP to *‘functionally’* separate customers' crypto-assets from the company's assets raises questions about its technical feasibility.

The specific features of the crypto-asset market, as well as the diversity of business models and segregation mechanisms implemented within the DASP population, make it tricky to apply a uniform interpretation whereby the separation between client funds and those held by the firm itself should be strict and discontinuous. Such an approach, which is technically unworkable, could have the counterproductive effect of preventing compliance by a significant proportion of the market participants targeted by the regulations.

It will therefore be up to the European Securities and Markets Authority (ESMA) and the national authorities responsible for examining applications for MiCA authorisation to provide the necessary clarifications to ensure that this provision remains applicable and provides effective protection for investors.

Problematic

<u>In the case of a service provider offering a service of exchanging crypto-assets for other crypto-assets (broker-dealer activity with interposition of own account)</u>

Crypto-asset service providers in this business earn their income from fees charged for transactions carried out on behalf of their customers. In order to carry out a transaction involving the exchange of crypto-assets for other crypto-assets, the funds pass through the service provider's own account, from which a percentage (also in crypto-assets) is deducted as a service fee. For a given period during a transaction, the service fees that contractually belong to the service provider are therefore inseparable from the funds belonging to the customer for the conversion.

<u>In the case of a service provider offering an order execution service for crypto-assets on behalf of clients (order reception and transmission activity, which is not a broker-dealer)</u>

This service involves receiving orders from customers and transmitting them to platforms responsible for executing the transfer effectively. In this case, as in the previous one, service charges are levied in crypto-assets. This situation therefore also results in a mix between the customer's transfer order and the service charges levied by the service provider.

<u>In the case of a service provider operating a crypto-asset trading platform (exchange activity)</u>

Crypto-asset trading platforms (or exchange platforms) put buyers and sellers in direct contact with each other. To manage trading operations, they bring together order executions and funds held within a single cryptographic address, in the manner of an omnibus account.

As in the two previous cases, however, the platform takes a percentage of the funds traded in crypto-assets in order to remunerate its services. Within the same portfolio, therefore, there is a mixture of funds accruing to the service provider as a service fee and funds accruing to the customer for the exchange of crypto-assets for other crypto-assets.

<u>In the case of a service provider offering a crypto-asset portfolio management service</u>

Managers administer their clients' portfolios and carry out transactions on crypto-asset marketplaces on their behalf on a daily basis. They must therefore pay the various fees attached to each transaction on the blockchain, as is the case for other service providers. They also charge their customers management fees.

Depending on the income recognition method used (daily, weekly, monthly, quarterly or annually), the funds belonging to the service provider in respect of operating and service fees appear, for the defined period, in the same portfolio as the funds under management belonging to the customer. For example, a manager may carry out transactions on behalf of his clients on a weekly basis but only deduct the percentage of the funds relating to the management fee due to him on an annual basis.

<u>In the case of a service provider offering a staking service</u>

In the case of staking, several participants place their assets on deposit with a validator with the aim of generating income in exchange for locking in their funds over a set period. The funds placed by the provider are therefore, by their very nature, mixed in the blockchain protocol, and it is functionally impossible to separate them in real time.

Distinguishing between assets belonging to customers and those belonging to the service provider can prove complex, particularly when it comes to charging transaction fees and paying out the gains from staking. In fact, the validator with whom the funds have been placed may deduct a percentage of the funds deposited in its system or of the rewards paid to participants as a transaction fee (*gas fee*). This is done randomly and therefore cannot be predicted. When the fees are recognised, the percentage of funds deducted from the provider is therefore mixed up with the funds to be paid to customers, who are in the same portfolio.

<u>Crypto-asset markets operate differently from traditional finance</u>

Furthermore, modeling the fund segregation arrangements applicable within traditional financial institutions on the DASPs would fail to take into account the specific features of the crypto-asset market linked to the use of blockchain technologies.

Indeed, a traditional financial institution has an account into which it receives customer funds and a segregation account into which it transfers them in order to segregate them. This transaction does not generate any costs for the institution and must be carried out by the end of the working day following that on which the funds are received.

With regard to this fund segregation scheme, it seems appropriate to highlight the particularity of the crypto-asset market. Crypto-asset service providers do not carry out transfers using wallets linked to the accounts of a single institution. They carry out transfers directly on the blockchain (*on-chain*), which generates fees for each transaction, including gas fees. Service providers who frequently carry out small-value transactions will therefore have to incur significant costs, particularly on certain blockchains where fees are high, in order to carry out transfers of a sometimes minimal value. In practice, these transactions are regularly aggregated into a single transaction by the service provider, who therefore only has to pay the fees once, thereby reducing the costs for the company. Aggregating transactions makes the DASPs business model sustainable and is structurally incompatible with real-time segregation of funds.

The provisions of the MiCA regulation should therefore be clarified so that they are adapted to this innovative sector, without lowering the level of requirements or undermining the objectives.

Proposal

Require crypto-asset service providers to segregate holdings of crypto-assets on behalf of their clients from holdings for their own account within **a minimum period of five working days,** provided that the sums involved are less than the company's own funds.

A clarification along these lines would make it possible both to guarantee the protection of savers, since the ability to return their funds would be ensured by the company, and to enable DASPs to comply, in practice, with their fund segregation obligations.