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A Blockchain Reaction

Malta's proactive approach towards asserting itself as a leader in the regulation of virtual financial assets

Anyone taking even the slightest interest in FinTech over the past few years would be very much aware of the increased adoption of cryptocurrencies, ICOs and utility tokens as alternative methods of raising finance or creating a challenge to the world's standard 'fiat' currencies. These phenomena are not entirely new, with cryptocurrencies having risen from the proverbial ashes of the 2008 financial crisis. However, the increasingly widespread adoption of cryptocurrencies, which ostensibly create a medium of exchange that could challenge regular government issued money, have made them central to national and international efforts to address these phenomena through proper legislation and regulation. Perhaps – many argue – too little too late.

Along with cryptocurrencies, we find that Initial Coin Offerings, or the raising of funds through the issuing of coins that serve either as token-like instruments or as capital-like instruments, have also been a rising phenomenon, with 1136 ICOs being issued in 2018, as compared to only 2 in 2014 (source: https://www.icodata.io/stats/2018).

What has become sufficiently clear is that these crypto alternatives to traditional financial and payment instruments are unlikely to go away. Indeed, an observation of the trends over the past five years provides sufficiently clear indications that the development of these new asset classes will grow exponentially, with potentially negative effects if they are not properly regulated both at a national and at an international level. What is particularly disappointing is that, against this backdrop, the ECB has unequivocally stated (February 2018) that the regulation of cryptocurrencies is "not exactly very high" on its to-do list. (source:

https://www.cnbc.com/2018/02/07/bitcoin-ecb-says-regulating-cryptocurrencies-is-not-high-on-our-to-do-list.html)

In this article we will look at the recent legal and regulatory developments in Malta over the past eighteen months, targeted at implementing a specific and detailed framework for the regulation of crypto assets across the spectrum, and we will also consider the salient features of this legislation as it impacts issuers of virtual financial assets and operators in the industry value-chain.

Malta's DLT Regulatory Framework- The Three Legal Pillars

Between the 15th and the 20th July 2018, after twelve months of very intense work by the Malta Financial Services Authority ('MFSA') and a number of legal and regulatory practitioners, the Maltese Parliament approved three laws intended to give legal certainty with respect to blockchain and cryptocurrency technologies.

The three laws break down as follows:

1. The first of the three laws to be legislated was the Malta Digital Innovation Authority Act ('MDIA Act'), which established the Malta Digital Innovation Authority ('MDIA'),, tasked to promote consistent principles for the development of visions, skills, and other qualities relating to technology innovation, and for the exercise of regulatory functions regarding innovative technology arrangements including distributed or decentralised ledger technology, and related services. The MDIA has the role of granting formal recognition to innovative technology services providers or arrangements, such as smart contracts, by certifying them, giving users and service providers the necessary legal certainty regarding their use of certified DLT platforms, smart contracts and other technological arrangements.
2. The centrepiece of this three-pillared legislative initiative is the Virtual Financial Assets Act (the 'VFA Act'), which lays down the regulatory framework to regulate Initial Coin Offerings (ICOs) – which are designated as 'Initial Virtual Financial Asset Offerings' in the Act – and other Virtual Financial Assets. In essence the VFA Act captures cryptocurrencies, utility tokens and ICOs and also brings within its remit operators that provide services within the cryptocurrency ecosystem such as advisors, brokers, exchanges, trading platforms and custodians. In terms of the VFA Act the MFSA is empowered with regulatory and investigatory powers in relation, for instance, to ICOs or the trading of virtual currencies on an exchange.
3. The second law is the Innovative Technology Arrangements and Services Act ('ITAS Act'). This law provides the regulatory foundations for the development and regulation of innovative technology arrangements and innovative technology services. Regulatory responsibility for such arrangements and services has been placed under the auspices of the MDIA. The technologies at the centre of this law are essentially DLT technologies, smart contracts, decentralised autonomous organisations and any other innovative technology arrangements designated by the Minister responsible for the Digital Economy, and the mechanisms within the Act are intended to have a formalised process of certification of such technologies, thereby attributing higher levels of public trust to such technologies and innovations.

Whilst the MDIA Act become effective on the 15th of July when it was formally approved by the House of Representatives, the effective date for the VFA Act and the ITAS Act coming into force is the 1st November 2018 (the 'effective date'), with specific grandfathering procedures coming into play, enabling those undertakings already established and operational on the effective date the following time periods to comply with the new regulatory requirements:

- Any undertaking issuing an initial virtual financial asset offering ('IVFAO') must draw up a whitepaper complying with the requirements of the First Schedule of the VFA Act and register it with the MFSA within three months from the effective date.
- Any undertaking providing the services of a VFA agent (advising and assisting undertakings with IVFAOs or with the correct classification of assets to establish the correct regulatory treatment of those assets) is required to apply to the MFSA for registration within one month from the effective date.
- Any undertaking providing a VFA service (those services listed in the Second Schedule to the VFA Act in connection with virtual financial assets) is required to apply to the MFSA for a licence within twelve months from the date of coming into force.

All such undertakings are permitted to continue their respective activities during the grandfathering period, provided that they notify the MFSA of the activity being undertaken immediately upon the coming into force of this Act on the 1st November 2018.

The passing of these laws evidences the responsive stance that Malta has adopted to address the increased interest in DLT-related business models and other innovative technologies across the board, providing an environment of clarity and certainty to those operators seeking a base for their operations. They highlight the government's undertaking to strengthen Malta's position on the DLT front and "solidify its reputation as a blockchain island" by regulating the DLT market in a way to ensure that the principles of proportionality, subsidiarity and the fundamental rights of members of society are adhered to and that the Maltese framework will effectively protect investors and provides market integrity as well as financial soundness.

We will look closer at the VFA Act as the central pillar of the three laws, which governs the classification of assets that will determine their legal, regulatory and to some extent also their tax treatment, and also regulates the service providers within the industry's ecosystem.

Classification of Virtual Assets

The VFA Act covers the issuing and handling of virtual financial assets, the provision of services relating to such virtual financial assets, and also identifies virtual tokens for the purpose of excluding these latter instruments from its regulatory scope. A central component of the regulatory framework is found in the 'Guidelines to the Financial Instrument Test' ('the Test') which were issued on the 24th July 2018 in terms of the powers granted to the Authority by Article 47 of the VFA Act.

The Test has been devised as a smart spreadsheet which is used as an effective tool to assist

operators and their advisors with the proper analysis and classification of a DLT asset, with the ultimate scope of categorising such asset into one of the following four three categories:

(i) A Virtual Token;

(ii) Electronic Money as defined under the Third Schedule to the Financial Institutions Act (Chapter 376 Laws of Malta),

(iii) a Financial Instrument as defined under the Second Schedule to the Investment Services Act (Chapter 370 Laws of Malta) ('ISA'), whether issued in Malta or otherwise, or

(iv) a Virtual Financial Asset ('VFA') or a Virtual Token ('VT') as defined under the VFA Act.

The spreadsheet adapts the required fields according to the information submitted, channelling the user to those questions that are relevant to the specific instrument undergoing the test. The guidelines and the spreadsheet are freely available to download from the MFSA's website at https://mfsa.com.mt/pages/viewcontent.aspx?id=680

The MFSA adopts a 'substance-over-form approach' with regards to the Test and focuses on the definitions included under European and Maltese legislation, including MiFID 2, PSD 2, the Investment Services Act, and the Financial Institutions Act.

The MFSA Financial Instrument Test applies to:

a) issuers offering DLT assets to the public in or from within Malta; and

b) any other person/s providing any service and/or performing any activity, within the context of either the VFA Act or traditional financial services legislation, in relation to DLT assets whose classification has not been determined for any reason whatsoever, even where the DLT asset was offered abroad.

Getting the Classification Right

The correct classification of every DLT asset is central to ensure that the appropriate regulatory treatment of that asset is established and complied with, avoiding the risk of legal obstacles, administrative penalties (up to Eur 150,000) or other measures obstructing the marketing and issuing of those assets on the market.

At a very high-level, the financial instrument test seeks to reach the following classifications or treatments:

– The DLT asset would be treated as a Virtual Token if it possesses the following elements:

- It is exchangeable either solely within the DLT platform on or in relation to which it was issued or within only a limited network of DLT platform; and
- a form of digital medium recordation whose utility, value or application is restricted solely to the

acquisition of goods or services.

These basic requirements can be further expanded to cover the following requirements, according to the format of the Financial Instrument Test:

- Must not have a Token Standard that allows the DLT asset to be converted into another DLT asset type;
- Must not have a Token Standard supporting Atomic Swapping or any other type of interoperability outside (i) the DLT platform on or in relation to which it was issued or (ii) a limited network of DLT platforms;
- The issuer must not list or admit a DLT asset to trading on an exchange, either locally or abroad;
- Is a form of digital medium recordation whose utility, value or application is restricted solely to the acquisition of goods or services.

Such tokens are not exchangeable directly for legal tender, bank credit, or other DLT assets – making them unidirectional- and would effectively fall outside the scope of the Act due to their 'voucher-like' nature. However, issuers of Virtual Tokens should also be seeking advice on the correct tax and VAT treatment of such tokens to avoid unpleasant surprises.

– The DLT asset would be treated as electronic money if it possesses the following elements:

- It is issued at par value on the receipt of funds by an issuer and be redeemable solely by the said issuer. Redemption should be possible at any time, at par value and without any possibility to agree a minimum threshold for redemption.
- It represents a claim on the issuer arising from the funds originally placed against the issuance of such DLT assets.
- It can be used for the purpose of making payment transactions (as defined in point 5 of Article 4 of Directive (EU) 2015/2366- PSD2) and should be accepted by a natural or legal person other than the issuer of the said DLT asset as a payment.

– The DLT asset would be treated as a financial instrument if it possesses the elements of those instruments set out in Section B of ANNEX I of MiFID II (transferable securities, money market instruments, units in a collective investment scheme, financial derivatives, emissions allowances).

– The DLT asset would be treated as a Virtual Financial Asset if it undergoes the Financial Instrument Test and is not caught by any of the elements of the categories set out above, making the Virtual Financial Asset classification a residual one, after all the other tests have given a negative result. Instruments classified in this category are also well-advised to seek professional guidance on the correct tax and VAT treatment of such assets.

The completed Financial Instrument Test for each DLT asset must be signed by:

(a) the Board of Administration of the issuer, and endorsed by the VFA Agent;
(b) the Board of Administration of the issuer, and endorsed by the Compliance Officer in case of licence holders; or
(c) the VFA agent or legal advisor, as applicable, in case of unlicensed persons.

The Framework in Practice

Parts II and III of the VFA Act represent the central provisions of the Act, with the former dealing with Initial VFA offerings, and the latter dealing with Licensing Requirements for service providers undertaking activities relating to virtual financial assets.

Issuers are prohibited from offering virtual financial assets to the public in or from within Malta or from admitting that asset to trading on a DLT exchange unless it draws up a whitepaper which complies with specific requirements and which must be duly registered with the MFSA. VFA Agents are charged with various responsibilities centred around the suitability of issuers and the issuer's compliance with applicable rules.

Any advertisements relating either to an initial VFA offering or the admission of a virtual financial to trading on a VFA exchange is required to be clearly identifiable as an advertisement and the information contained in the advertisement shall not be inaccurate or misleading and shall be consistent with the information contained in the corresponding whitepaper.

Service Providers, on the other hand, are prohibited from providing, or holding themselves out as providing, any of the services listed in the Second Schedule of the VFA Act in or from within Malta without a valid licence granted by the MFSA under the Act. The list of services caught by this prohibition, and consequently requiring a licence, break down as follows:

1. **Reception and Transmission of Orders** – The reception from a person of an order to buy, sell or subscribe for virtual financial assets and the transmission of that order to a third party for execution.

2. **Execution of orders on behalf of other persons** – Acting to conclude agreements to buy, sell or subscribe for one or more virtual financial assets on behalf of other persons.

3. **Dealing on own account** – Trading against proprietary capital resulting in conclusion of transactions in one or more virtual financial assets.

4. **Portfolio Management** – Managing or agreeing to manage assets belonging to another person if those assets consist of or include one or more virtual financial assets or the arrangements for their management are such that the person managing or agreeing to manage those assets has a discretion to invest any of those assets in one or more virtual financial assets (whether or not issued in Malta).

5. **Custodian or Nominee Services**

(a) Acting as custodian or nominee holder of a virtual financial assets and, or a private cryptographic key; or

(b) Holding a virtual financial assets or a private cryptographic key as nominee, where the person acting as nominee is so doing on behalf of another person who is providing any VFA service under this Schedule or on behalf of a client of such person, and such nominee holding is carried out in relation to such service:

Provided that for the purposes of this paragraph any person who is authorised or otherwise exempt from authorisation in the terms of article 43 or 43A of the Trusts and Trustees Act shall not by virtue of holding such assets be required to have a licence in terms of this Act.

6. **Investment Advice** – Giving, offering or agreeing to give, to persons in their capacity as investors or potential investors or as agent for an investor or potential investor, a personal recommendation in respect of one or more transactions relating to one or more virtual financial assets.

For the purposes of this paragraph, a "personal recommendation" shall mean a recommendation presented as suitable for the person to whom it is addressed, or which is based on a consideration of the circumstances of that person and must constitute a recommendation to take one of the following steps:

(a) to buy, sell, subscribe for, exchange, redeem, hold or underwrite a particular virtual financial asset;

(b) to exercise or not to exercise any right conferred by a particular virtual financial asset to buy, sell, subscribe for, exchange, or redeem it;

A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public.

7. **Placing of Virtual Financial Assets without a firm commitment basis** – The marketing of newly-issued virtual financial assets which are already in issue but not admitted to trading on a DLT exchange, to specified persons and which does not involve an offer to the public or to existing holders of the issuer's virtual financial assets.

8. **The operation of a VFA Exchange**

It is also pertinent to point out that Part VI of the VFA Act also lays down rules on the Prevention of Market Abuse which are largely analogous to those found in traditional financial legislation, intended to address the potential mischief of insider dealing, the unlawful disclosure of inside information and market manipulation in relation to any transaction, order or behaviour concerning any virtual financial asset.

The provisions of the VFA Act are being further complemented by more detailed rules that are in the process of being issued by the MFSA to address specific aspects of the industry on a day-to-day operational level. It is also expected that the Maltese Inland Revenue Department will be issuing guidance on the tax and VAT treatment of specific virtual financial assets and of the related services associated with them – a development that will be widely welcome by industry and practitioners alike.

Conclusion

Malta's legal and regulatory framework has really placed this small island nation at the forefront of jurisdictions worldwide which have proactively undertaken initiatives intended to give clarity and direction to this new phenomenon of DLT based assets and the industry that has developed around these assets. Although the industry however has some way to go to develop and integrate, we look towards the future of this new industry with tremendous excitement to actively participate in the shaping of these new phenomena within a well-regulated framework.