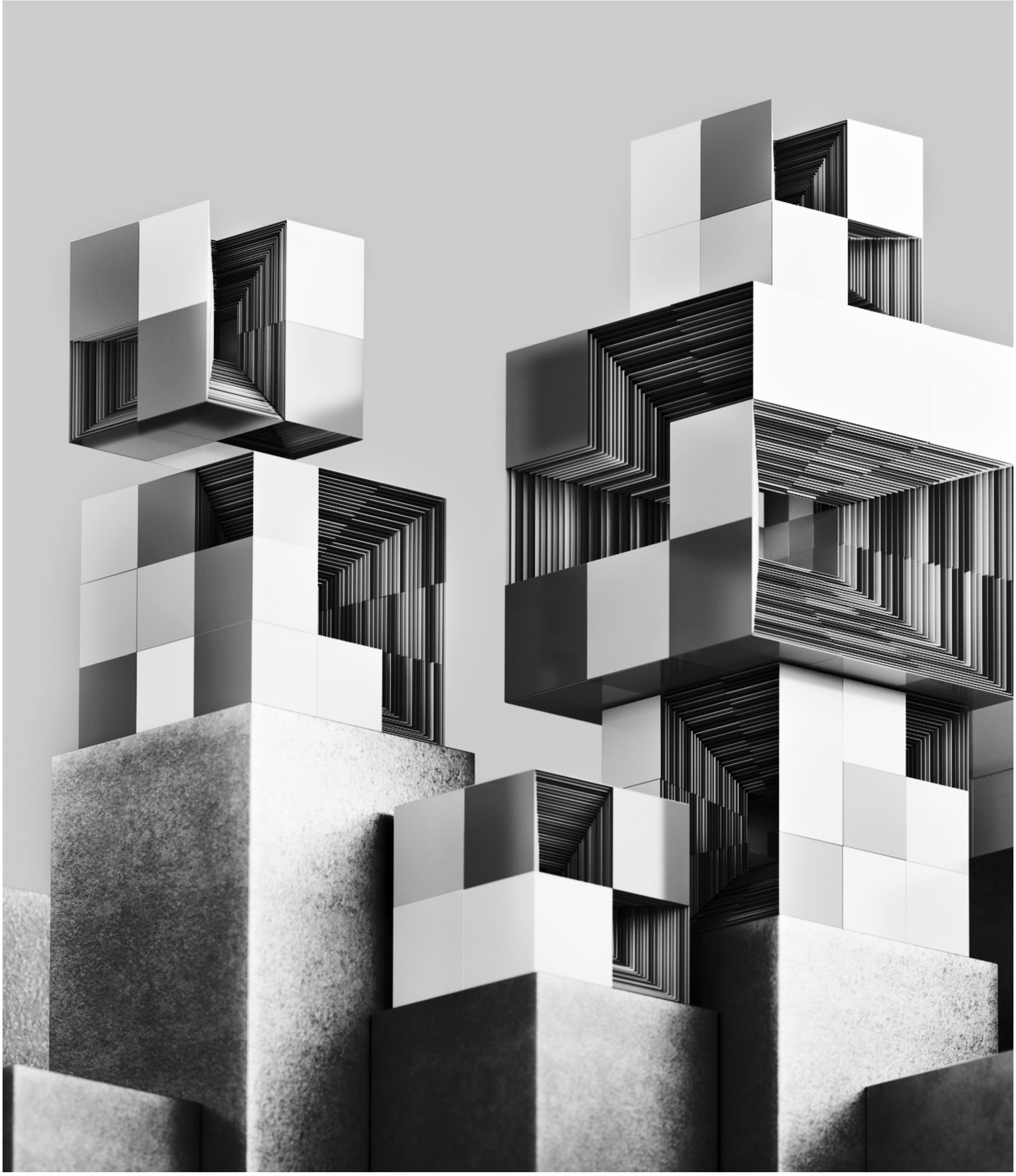
A&O SHEARMAN



MiCAR under *the microscope*

PART 7: PRUDENTIAL AND CAPITAL REQUIREMENTS FOR ISSUERS OF ARTS AND CASPS

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In this edition of our "MiCAR under the microscope" series, we examine the prudential requirements, with a specific focus on the capital requirements that are applicable to issuers of ARTs and EMTS and CASPs under Regulation (EU) 2023/1114 on Markets in Crypto-assets (**MiCAR**).

REQUIREMENTS

As part of the MiCAR framework, ARTs and CASPs must comply with specific prudential and capital requirements that reflect the different nature and risks of their activities. These requirements vary depending on the market, credit, operational, and liquidity risk that each category entity faces. In the following sections, we will explain how these requirements apply respectively to ARTs, EMTs and CASPs.

1. Requirements for *issuers of ARTs*

1.1 RESERVE OF ASSETS

In order to cover their liability against holders of asset-referenced tokens, issuers of asset-referenced tokens must constitute and maintain a reserve of assets matching the risks reflected in such liability.
The reserve of assets must be used for the benefit of the holders of the asset-referenced tokens when the issuer is not able to fulfill its obligations towards the holders, such as in insolvency. These reserves must be legally ring-fence separated from the issuer's other assets, so that they are not exposed to the issuer's insolvency risk. Each token must have a dedicated reserve, and if the issuer fails to redeem the tokens, the holders can claim the reserve assets. The issuer can only use the reserve to invest in the assets that it receives from issuing the tokens (such as bank deposits or commodities) and some highly liquid and low-risk financial instruments (such as some UCITS) that meet the criteria set by the EBA.

According to the EBA's Final report on the draft RTS to specify the highly liquid financial instruments in the reserve of assets, the issuer must ensure that the reserve has sufficient liquidity to meet redemption demands. Normally, at least 20% of the reserve (or 40% for significant tokens) must consist of assets or cash that can be sold within one day, and 30% (or 60% for significant tokens) within five days. Additionally, at least 30% of the reserve (or 60% for significant tokens) must be deposits with credit institutions in the same currencies as the tokens. The issuer must also diversify the reserve across different credit institutions, subject to limits based on the institutions' size.

Pursuant to article 43(1) MiCAR an ART or EMT is considered significant where at least three of the following requirements are met:

- The number of holders is larger than 10 million.
- The value of the token issued, its market capitalization or the size of the reserve of assets of the issuer of the token is higher than EUR5 billion.
- The average number and average aggregate value of transactions in that token per day during the relevant period, is higher than EUR2.5 million transactions and EUR500m respectively.
- The issuer of the tokens is a provider of core platforms services designated as gatekeeper in accordance with Regulation (EU) 2022/1925 (**Digital Markets Act**).
- The significance of the activities of the issuer of the tokens on an international scale, including the use of the tokens for payments and remittances.
- The interconnectedness of the tokens or its issuers with the financial system.
- The fact that the same legal person or other undertaking issues at least one additional asset-referenced token or e-money token, and provides at least one crypto-asset service.

The same rules for reserve of assets apply to e-money institutions that issue significant EMTs of "significant" value, and to those that issue non-significant EMTs if a competent authority decides that this is necessary to deal with certain risks related to liquidity, operations and other factors. Otherwise, issuers of EMTs must keep at least 30% of the funds from EMTs in separate accounts with credit institutions.

The remaining funds must be invested in assets that are secure, low-risk and highly liquid, that have minimal exposure to market, credit, and concentration risks, and that have the same official currency as the EMT. The EBA has issued a final draft of technical standards that define what counts as a highly liquid financial instrument. According to this, highly liquid instruments include Level 1 liquid assets with a 0% haircut as per the delegated regulations for the Capital Requirements Regulation (the liquidity coverage ratio), Level 1 covered bonds in the liquidity coverage ratio, and financial instruments that are linked to assets or commodities or their derivatives, except for ARTs that are linked to something other than a country's official currency.

In addition to these reserve requirements, issuers of both ARTs and EMTs must prepare and keep a plan for recovery and redemption in case they do not meet the obligations for keeping assets in reserve or redeeming the tokens and must have transparent and robust policies that govern how they issue and redeem tokens, how they safeguard and manage the reserve assets, how they stabilize the token value and how they value the reserve assets.

1.2 OWN FUNDS REQUIREMENTS

Besides holding a reserve of assets, issuers of ARTs need to comply with own funds requirements to address the risks to the financial stability of the wider financial system. These rules require issuers to maintain a minimum level of own funds, which is at least the highest of the following: EUR350,000, 2% of reserve of assets, or 25% of the fixed overheads from the previous year. The issuer's competent authority can increase this minimum by up to 20% if it considers that the issuer faces higher risks. For example, this could depend on the issuer's risk management systems and practices, the type or volatility of the reserve assets, the market value of the ART or the volume and value of transactions in the ART. Issuers of ARTs also have to conduct regular stress tests to assess how they would cope with "severe but plausible" scenarios that could create financial or non-financial stress (such as interest rate fluctuations or operational failures). Based on the stress-test outcomes and the risk outlook, the competent authority of the issuer can further raise the own funds requirement by 20-40%.

The requirements for ARTs aim to ensure that these tokens are safe, stable and reliable for users and that issuers have adequate financial and operational resilience. By holding a reserve of assets that matches the value and currency of the tokens, issuers can guarantee the redeemability of the tokens and protect them from insolvency risk. By complying with prudential rules and stress tests, issuers can demonstrate that they have sufficient capital and risk management capabilities to withstand adverse market conditions and operational disruptions. These requirements are proportionate to the size and significance of the ARTs and the risks they pose to the financial system and consumers.

Issuers of EMTs will be subject to own funds requirements on a national level in accordance with Directive 2009/110/EC (**E- Money Directive**).

2. Capital requirements *for CASPs*

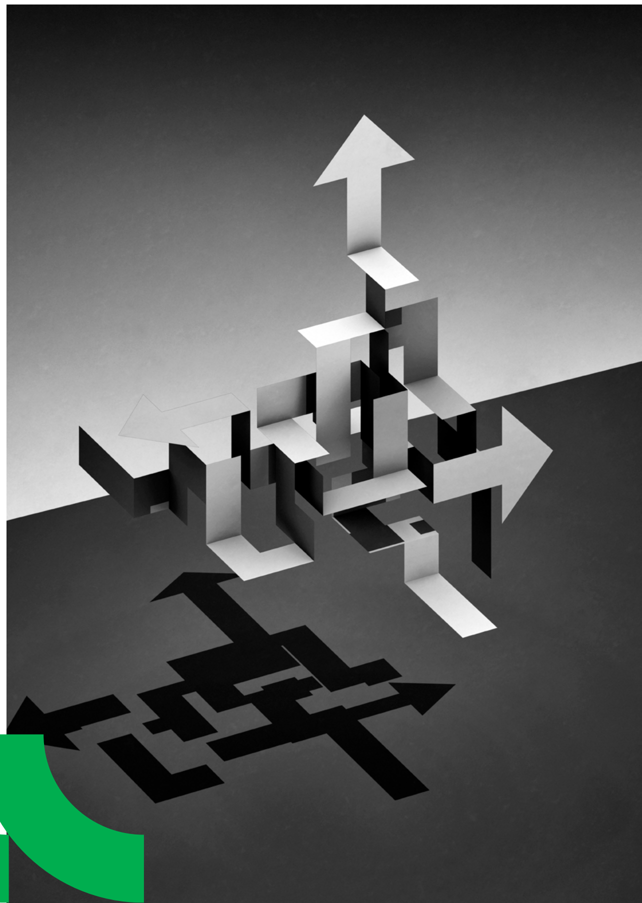
To ensure consumer protection, crypto-asset service providers must comply with certain prudential requirements. Those prudential requirements must be set as a fixed amount or in proportion to the fixed overheads of crypto-asset service providers of the preceding year, depending on the types of services they provide.

In particular CASPs shall, at all times, have in place prudential safeguards equal to an amount of at least the higher of the following:

(a) The amount of permanent minimum capital requirements specified below,
depending on the type of the crypto-asset services provided.

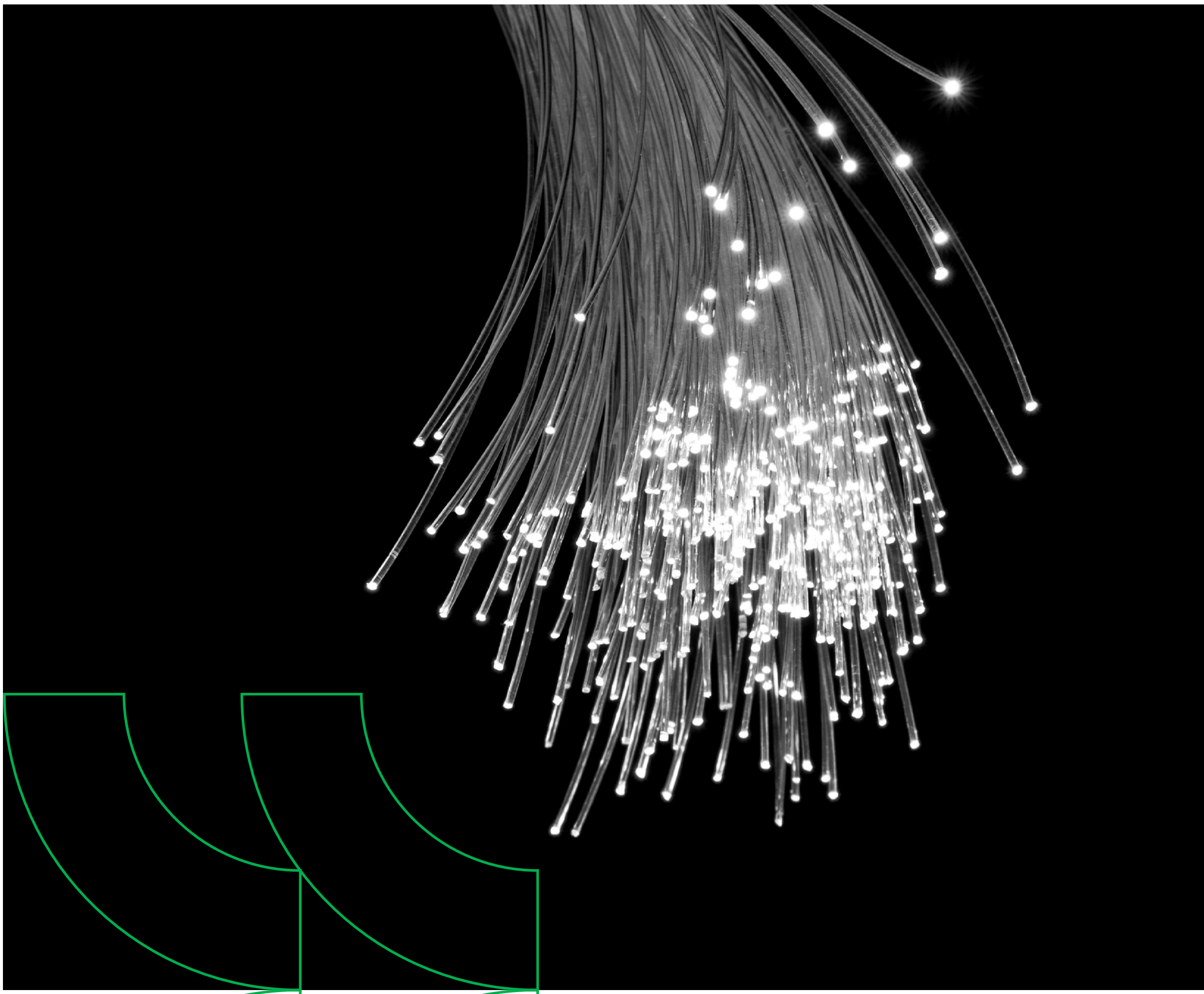
(b) One quarter of the fixed overheads of the preceding year, reviewed annually.

The level of initial minimum capital is set by reference to the proposed crypto-asset services to be provided.



ACTIVITY	MINIMUM CAPITAL REQUIREMENT AND PRUDENTIAL SAFEGUARDS.
CASPs providing execution of orders, placing, transfers, receipt and transmission of orders, advice or portfolio management	Minimum capital requirement of EUR50,000
CASPs providing custody and exchange services	Minimum capital requirement of EUR125,000
CASPs operating a trading platform	Minimum capital requirement of EUR150,000

They can meet this requirement by holding Common Equity Tier 1 items as defined by the Regulation (EU) No 575/2013 (**CRR**), or by having an insurance policy or a similar guarantee that covers the EU areas where they offer crypto-asset services. The policy or guarantee must protect them from risks such as losing documents, misleading clients, breaching rules, failing to manage conflicts of interest, having system disruptions, being negligent with clients' crypto-assets and funds, and being liable for clients' asset losses.



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