Paradigm

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European Securities and Markets Authority
201-203 Rue de Bercy, 75012 Paris
France

Paradigm response to ESMA consultation on draft guidelines on the classification of crypto-assets as financial instruments under the Markets in Crypto Assets Regulation (MiCA)

Paradigm welcomes the opportunity to provide feedback on ESMA's draft guidelines seeking to clarify the conditions and criteria for the qualification of crypto-assets as financial instruments.

Paradigm is a research-driven technology investment firm. We focus on crypto and related technologies at the frontier and invest in, build, and contribute to companies and protocols with as little as $1M and as much as $100M+. We often get involved at the earliest stages and continue to support our portfolio companies over time. We take a deeply hands-on approach to help projects reach their full potential, from the technical (mechanism design, security, engineering) to the operational (recruiting, go-to-market, legal and regulatory strategy).

Please find more information about our portfolio companies here.

Paradigm welcomes ESMA's openness under the draft guidelines on the classification of crypto-assets, which allows for a healthy debate on the appropriate classification of crypto-assets in the EU and looks forward to working with ESMA towards ensuring positive retail crypto investment practices across the EU.

The EU has developed one of the world's most comprehensive policies for crypto-asset regulation, which is why we are interested in how the EU and ESMA define the boundaries between crypto-assets and financial instruments under MiCA as a global standard setter.

Please find our feedback for consideration below.

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General Comments

ESMA's clarification of the boundary between crypto-assets governed by MiCA and those falling under financial instruments according to MiFID II is crucial for maintaining regulatory clarity and oversight in the dynamic crypto-asset market. With different regulatory frameworks for these asset classes across EU member states and varying treatment of financial instruments, clear classification is vital to prevent market fragmentation and over-regulation. Thus, clear delineation between financial instruments and crypto-assets is necessary to establish transparent guidelines, ensuring compliance among market participants and regulators.

We advocate for aligning classification criteria between MiCA and MiFID II across the EU to promote consistency, facilitate cross-border cooperation, and reduce risks of regulatory fragmentation. Inconsistent classification could hinder passporting and product launches across member states, complicating operations and compliance efforts. While classification is typically straightforward, there are nuanced cases where a standardised interpretation and efficient classification process would benefit the EU's crypto-asset economy in the long term. The key is ensuring consistent application and interpretation of classification by member state authorities, especially in complex cases but in a way that does not disadvantage smaller firms.

Paradigm has concerns that the way ESMA is currently looking at regulation means many crypto-asset tokens will either be deemed as a financial instrument or a hybrid token in circumstances where this is not merited. The aims of MiCA overall were to foster the use of innovative technologies by setting a regulatory framework that covers crypto-assets, crypto-assets issuers, and crypto-asset service providers. By starting from a perspective of financial instrument-first, designating a large swathe of crypto-assets as financial instruments results in significantly more authorisation requirements for firms that previously did not plan to obtain MiFID licences.

For many crypto firms, especially at the beginning of their operations, and as new market entrants already experience significant amounts of regulatory uncertainty and cost in funding licences, the need to obtain a MiCA, MiFID and potentially a payment licence entails substantial cost, time and energy—particularly where tokens, fungible or not, would normally be considered crypto-assets.

Specific comments

1. Do you agree with the suggested approach on providing general conditions and criteria by avoiding establishing a one-size-fits-all guidance on the concepts of financial instruments and crypto-assets, or would you support the establishment of more concrete conditions and criteria?

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Paradigm is of the view that some guidelines are needed to avoid a completely case-by-case and, more specifically, country-by-country determination on a token's status that may result in a fractured EU landscape. While we oppose a strict, one-size-fits-all approach to classifying financial instruments and crypto-assets, we have concerns about the uniform interpretation of the proposed guidelines among National Competent Authorities (NCAs). In scenarios where a crypto-asset could be viewed as a financial instrument in one EU member state and as a crypto-asset in another, potential inconsistencies arise. The draft guidelines propose a flexible method of asset classification, favoring broad criteria and principles over a single, standardized test. This approach emphasises evaluating each asset on a case-by-case basis to determine its regulatory status, introducing complexities that warrant further examination. A more balanced approach that leverages foundational principles that reduce variance may be warranted.

A key feature of the guidelines is the hierarchical framework where MiFID II criteria are initially applied to determine if a crypto-asset meets the definition of a financial instrument. If not, MiCA applies, provided the crypto-assets are fungible, leaving those falling outside these parameters beyond EU regulatory oversight. Despite this seemingly clear distinction, NCAs may face significant challenges in effectively implementing this structure consistently across time and space.

The complexity of asset evaluations, coupled with potential resource constraints and differing interpretations of classification criteria, heightens the risk of inconsistent regulatory outcomes across jurisdictions. Such challenges may lead NCAs to adopt a conservative approach, primarily classifying assets under traditional financial instrument categories defined by MiFID II, potentially stifling innovation and impeding the growth of the EU's crypto-asset market. Our view is that classifying an asset or token as financial-first impacts smaller players in the market disproportionately and goes against the objectives of MiCA to provide a comprehensive crypto regime across the EU.

Furthermore, the dynamic nature of crypto-assets and their underlying technologies poses additional hurdles in aligning them with traditional financial regulatory frameworks. While ESMA acknowledges that technological infrastructure should not dictate classification, applying this principle in practice is problematic. Additional principles-based guidelines could be helpful to ensure consistent classification of crypto-assets across all regulatory contexts. At a minimum, there should be a mechanism for NCAs and ESMA to share opinions and reconcile differences with respect to their classification of certain crypto-assets.

By providing additional specificity on the conditions and criteria for classifying crypto-assets, ESMA can promote a level playing field, boost investor confidence, and stimulate innovation in the rapidly evolving crypto-asset sector. This collaborative effort will not only facilitate regulatory compliance but also contribute to a more resilient and transparent ecosystem conducive to the sustainable growth of the EU's crypto-asset markets.

2. Do you agree with the conditions and criteria to help the identification of crypto-assets qualifying as transferable securities? Do you have any additional condition and/or criteria to suggest? Please illustrate, if possible, your response with concrete examples.

In our examination of ESMA's draft guidelines, Paradigm has identified a discrepancy that warrants careful examination to ensure clarity and consistency in regulatory guidance. The draft guidelines, particularly paragraphs 112 and 141, appear to present conflicting approaches to classifying crypto-assets, specifically in the context of identifying a crypto-asset as a transferable security.

Paragraph 112 outlines criteria for classifying a crypto-asset as a transferable security, emphasising the importance of transferability, interchangeability, and the possession of rights akin to other traditional securities. This section suggests a comprehensive evaluation where a crypto-asset must meet all outlined criteria, aligning with the MiFID II definition of transferable securities. This implies a holistic approach to classification, requiring a crypto-asset to satisfy a set of specific criteria fully.

Conversely, paragraph 141 introduces a hierarchical methodology for the classification of hybrid crypto-assets, proposing an initial assessment to ascertain if the crypto-asset fulfils the criteria of a financial instrument. Should the crypto-asset exhibit characteristics of a financial instrument, similar to those described in paragraph 112, these features are to be given precedence in the classification process. This implies a prioritization of certain attributes over others, deviating from the all-encompassing evaluation approach suggested in paragraph 112. This shift towards a hierarchical assessment raises questions about potential inconsistencies in how crypto-assets are classified and the overall clarity of the guidelines.

Given the potential for these discrepancies to generate confusion and inconsistent outcomes in the classification of crypto-assets, we respectfully urge ESMA to re-examine the guidance provided in these paragraphs. Our recommendation is for ESMA to offer consistent guidelines that reconcile the differences between a comprehensive and a hierarchical evaluation approach. Clarifying this aspect of the guidelines will greatly assist market participants in understanding and applying the criteria for classifying crypto-assets as transferable securities or other financial instruments, thereby enhancing the transparency and predictability of regulatory standards in the rapidly evolving crypto-asset market.

Q4: Do you agree with the conditions and criteria to help the identification of crypto-assets qualifying as another financial instrument (i.e. a money market instrument, a unit in collective investment undertakings, a derivative or an emission allowance instrument)? Do you have any additional conditions, criteria and/or concrete examples to suggest?

In response to ESMA's proposed criteria for classifying crypto-assets as derivatives under MiFID II, we recognise why ESMA may have chosen the approach. However, we anticipate significant practical challenges in its application. This is primarily due to the framework of MiFID II, which was originally tailored for traditional financial instruments and may not accommodate the distinct characteristics of crypto-assets. This misalignment raises crucial questions about the suitability of applying such criteria to crypto-assets, given their inherent differences from conventional financial instruments.

For example, the requirement for a crypto-asset to serve as a digital representation of a contract in order to qualify as a crypto-derivative may be interpreted inconsistently among authorities. While some crypto-assets may indeed represent contractual arrangements, others lack such explicit characteristics. The reliance on the existence of agreements between parties as a criterion for classification also poses challenges due to the decentralized nature of many crypto-assets. This decentralization changes the nature of identification and enforcement of agreements because smart contracts, as technical protocols that deterministically execute logic, offer an alternative to traditional contracts.

Considering these factors, there is a need for further dialogue and adjustment of guidelines to more accurately address the complexities of crypto-assets. This ensures that regulation effectively safeguards investor protection and market integrity without impeding innovation. Overregulation risks dissuading new participants from entering the market, potentially impacting the sector's competitive landscape and innovative potential. Therefore, we advocate for a regulatory approach that recognizes the distinctive features of crypto-assets, striking a balance between investor protection and the promotion of innovation and competition within the industry.

When faced with uncertainty, regulatory authorities may have a tendency to over-classify crypto-derivatives as financial instruments under MiFID II, despite the fact that they are fundamentally different from a technical perspective.

6: Do you agree with the conditions and criteria proposed for NFTs in order to clarify the scope of crypto-assets that may fall under the MiCA regulation? Do you have any additional conditions and/or criteria to suggest? Please illustrate, if possible, your response with concrete examples

We understand that the level one text of MiCA does not cover NFTs in specific detail, and we have significant concerns that the proposed conditions and criteria, if implemented, would amount to an unintended broadening of MiCA's regulatory purview that would ultimately hamper innovation in the EU.

As currently drafted, the proposed guidelines do not provide enough detail for businesses and NCAs to clearly and consistently make determinations as to whether a specific NFT is considered a crypto-asset and therefore subject to MiCA. This could have particularly dire consequences in areas like gaming, arts and media, and consumer products.

Our primary source of concern stems from the fact that ESMA's proposed guidelines introduce the new concept of "genuine uniqueness" as a criterion for determining if a crypto-asset is fungible or non-fungible (and therefore within the scope of MiCA) in paragraph 67. We believe that the concept of "genuine uniqueness" is problematic in the abstract and that the subsequent paragraphs in the guidance would create further confusion and divergence from what was intended under MiCA.

In particular, the discussions in paragraphs 69 and 70 place a heavy emphasis on correlative financial value in determining whether one or more NFTs are fundamentally unique. By asserting an NFT can become "fungible" purely because its value may be influenced by other NFTs in a series, the proposed guidelines fail to acknowledge that much of art derives its value from its relation to other art and cultural objects. For example, each painting in Claude Monet's series of approximately 250 Water Lilies is non-fungible, even though they come from the same series, share features and characteristics, and have somewhat interdependent value.

Categorization under MiCA also depends on interchangeability (or lack thereof) as a factor in determining uniqueness according to the proposed guidance. We have significant concerns about how this would be implemented and the downstream consequences from a practical perspective. Here, paragraphs 70 and 71 suggest that NFTs that are issued as part of a series are more likely to be determined to be fungible and must be studied on a case-by-case basis by the NCAs. Absent further clarification, this is likely to result in the vast majority of serialized NFTs being considered as fungible and an overall lack of consistency across EU member states.

Additionally, paragraph 68's discussion of unique token IDs overlooks a critical feature of these unique identifiers – the ability to trace ownership history. Like many artistic and cultural artifacts, the ownership history of an NFT is part of what makes it unique. NFTs with unique identifiers are not fungible by their nature—particularly because their ownership history travels with the NFT and is available for all to see. A piece of antique furniture derives its character and importance based on who it was owned by—this ownership history is embedded into NFTs with unique identifiers and differentiates NFTs that may otherwise appear visually identical. These unique identifiers also allow for identification of counterfeits and stolen NFTs, which may also appear superficially identical to other NFTs, but whose ownership history make clear they are not.

Further, an NFT that affords its owners admission to an event could also be considered a crypto-asset under the current drafting. By extension, the issuer of such an NFT, which could be

an art gallery or music venue, may be subject to regulation under MiCA. Although these NFTs may be interchangeable within the total set issued, their existence confers a right to an exclusive experience that is not accessible to non-owners. ESMA describes a similar scenario in paragraph 72, however, the text does not provide any discussion of the regulatory treatment that would follow.