

Feature

KEY POINTS

- Crypto-derivative swaps potentially fall under ss (4), (9) and (10) of s C, Annex I of MiFID II.
- It appears prudent to adopt the viewpoint that at least cash-settled crypto-derivatives fall – if not squarely, then just about – within the regulatory perimeter.
- It is possible that physically-settled crypto-derivative forwards fall outside MiFID II.

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The regulation of OTC crypto-derivatives under MiFID II (Part 1)

In this Part 1, the authors discuss whether cryptocurrency derivatives constitute financial instruments under the Markets in Financial Instruments Directive 2014/65/EU (MiFID II). Part 2 will consider practical considerations, such as obtaining regular reference prices, the risks of accepting underlying cryptocurrencies as collateral and whether crypto-derivatives can be classified as “specified investments” and “controlled investments” under the UK’s Regulated Activities Order and the Financial Promotions Order.

INTRODUCTION

Bitcoin has its roots in anarchist and libertarian philosophies. Its programmers wanted to create a payment system that safeguarded individual privacy, cut out intermediaries and was sustained by its community of users. Bitcoin and its associated distributed ledger technology (DLT) achieved these aspirations. So well in fact that Bitcoin found its most enthusiastic users in those who wanted to move funds anonymously – drug users, money launderers and citizens of countries with exchange controls.

Bitcoin has come a long way since. Although it has not displaced currencies (and there are doubts whether it ever will), it has become a much-publicised investment asset, albeit with significant price volatility. The validation of its software has spawned a bewildering array of other cryptocurrencies (also referred to as “exchange tokens”), security tokens and utility tokens. Bitcoin has electrified conversations about the impact of technology on sectors as far flung as healthcare, banking, the law and agriculture.

Intermediaries, central banks and regulators – the very middlemen and authorities the original programmers were seeking to circumvent – are busy incorporating and regulating cryptocurrencies within their respective infrastructures and legal frameworks.

For the authors, the “mainstreaming” of this previously insurgent product is evident in the growth of cryptocurrency derivatives (subsequently referred to as “crypto-derivatives”). It is now possible to buy and sell Bitcoin futures on exchanges such as CME and

CryptoFacilities. In October 2019, Bloomberg reported that the average daily trading volume of Bitcoin derivatives was between US\$5bn and US\$10bn, which exceeded Bitcoin spot volumes by 10 to 18 times. It is certainly possible for crypto-derivatives to become an asset class in their own right.

SCOPE OF THIS ARTICLE

This article is divided in two parts.

This Part 1 discusses whether cryptocurrency derivatives constitute financial instruments under the Markets in Financial Instruments Directive 2014/65/EU (MiFID II). If the answer is “yes”, then firms dealing in crypto-derivatives need to consider whether they need to be authorised or whether they can benefit from any exemptions or exclusions under MiFID II.

The classification of crypto-derivatives as financial instruments triggers a host of other obligations, such as margining and reporting under the European Market Infrastructure Regulation (EMIR) as well as investor protections (eg disclosures, best execution, suitability and appropriateness assessments) and other conduct of business requirements under MiFID II.

Firms also need to navigate through practical considerations such as obtaining regular reference prices and the risks of accepting underlying cryptocurrencies as collateral. These obligations and considerations will be explored in Part 2 of this article along with whether crypto-derivatives can be classified as “specified investments” and “controlled investments” under, respectively,

the UK’s Regulated Activities Order and the Financial Promotions Order.

Crypto-derivatives do not fit neatly within MiFID II’s list of financial instruments. Nevertheless, there are sufficient grounds for concluding that at least cash-settled crypto-derivatives constitute financial instruments. Indeed, this is in keeping with the Financial Conduct Authority’s viewpoint. In a policy statement on cryptoassets, the regulator specified the following:

“Products that reference tokens, like derivative instruments, are very likely to fall within the regulatory perimeter as specified investments (either as options, futures or contracts for difference under the RAO). These products are also capable of being financial instruments under MiFID II.”

This article is restricted to over-the-counter (OTC) derivatives referencing cryptocurrencies (ie exchange tokens). This article does not discuss crypto-derivatives which are exchange traded (eg futures) or which reference other sorts of tokens such as security tokens and utility tokens.

The regulatory analysis of these other instruments can be very different. For example, security tokens linked to financial instruments (eg securities) are themselves financial instruments. Therefore, it is possible to conclude fairly easily that crypto-derivatives referencing them are also financial instruments. As discussed below, the analysis of cryptocurrencies referencing exchange tokens is not so straightforward given that the underlying exchange tokens themselves are not financial instruments.

Finally, this article does not address any change to the UK’s regulatory framework as a result of Brexit.

CRYPTO-DERIVATIVES AS FINANCIAL INSTRUMENTS

The MiFID II Directive has a finite list of financial instruments (s C, Annex I). Sections (4)

to (10) of this list lay out derivatives.

For ease of reference, the full text of s (4) and (8) to (10) is as follows:

“(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;

...

(8) Derivative instruments for the transfer of credit risk;

(9) Financial contracts for differences;

(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, *as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF [organised trading facility], or an MTF [multilateral trading facility];*” (Italics added for emphasis)

A quick read shows that the instruments in these sections have various contract types and associated characteristics. For example, s (4) can apply to an option (a contract type) referencing securities that is either cash or physically settled (both characteristics). Section (10) can apply to a swap (a contract type) referencing climatic variables that are cash settled (both characteristics).

The reader may have noticed that the authors have omitted to set out the text of s (5) to (7). This is because these sections only apply to instruments whose reference underlying is commodities. The reference underlying of a crypto-derivative is the relevant cryptocurrency. (For example, the reference

underlying of a physically-settled Litecoin forward is the Litecoin cryptocurrency.)

As discussed below, the established consensus is that cryptocurrencies are not commodities and so we can be certain that these sections are irrelevant to crypto-derivatives.

Even with this helpful reduction, it still requires a degree of (convoluted) interpretation to determine whether the remaining sections (the “Relevant Sections”) apply to crypto-derivatives. This is largely due to uncertainty as to whether the reference underlyings of crypto-derivatives (ie their cryptocurrencies) fall within the underlyings specified in these Relevant Sections.

We now look at contract types and characteristics specified in the Relevant Sections in more detail.

Contract types

The Relevant Sections set out a range of contract types such as swaps, options, futures, forward rate agreements, contracts for differences (CFDs) and credit derivatives. When taken together, the range is broad enough to capture the vast majority of derivatives traded in the markets. However, certain Relevant Sections only apply to specific contract types. For example, s (8) is restricted to credit derivatives. Unlike s (10), s (4) covers forwards but not futures. Furthermore, s (10) appears to be a “catch all” as it mentions “any other derivatives contracts”.

Characteristics

At the risk of generalising, the Relevant Sections hinge upon the following three key characteristics:

- (i) the reference underlying;
- (ii) whether the instrument is OTC or exchange traded;
- (iii) the settlement method of the instrument.

Only certain Relevant Sections specify all three of these characteristics in respect of a contract type but each such section specifies at least one of them.

Reference underlying

Perhaps the most pivotal characteristic is the reference underlying. Most of the Relevant Sections will only catch an instrument if it

is of a certain contract type that references a particular underlying.

As already mentioned, a crypto-derivative’s underlying is the relevant cryptocurrency. A large number of underlyings are manifestly irrelevant (eg securities, interest rates, yields, emissions allowances, climatic variables). Furthermore, we can say with certainty that cryptocurrencies are also not currencies and commodities.

For the time being at least, cryptocurrencies do not exhibit the requisite attributes of money. Their use as a means of exchange is severely restricted and their volatility make them presently non-viable as a store of value. Furthermore, they do not satisfy the MiFID II definition of a commodity (ie “any goods of fungible nature that are capable of being delivered”). This is because cryptocurrencies appear to be intangible assets showing non-fungible attributes; each transacted cryptocurrency can be separately identifiable on the records of a distributed ledger.

What is less clear is whether cryptocurrencies can somehow be (financial) indices or (financial) measures (as mentioned in s (4) and (10)). The authors’ viewpoint is that, where a crypto-derivative’s reference price is derived by the calculation agent using a methodology from multiple public sources (eg to account for trading activities across different exchanges), then it is possible for the cryptocurrency (or an output using its multiple prices) to be construed as an index or measure.

Support for this viewpoint can be found in Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 relating to MiFID II (Delegated Regulation). Article 8(g) provides colour regarding the second limb of s (10) and it liberally speaks of an index or measure “related to the price or value of, or volume of transactions in any asset, right, service or obligation”.

It is worthwhile to note that the EU Benchmarks Regulation (BMR) defines an index as:

“any figure: (a) that is published or made available to the public; (b) that is regularly determined: (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and (ii) on the basis of the value of one or more underlying

Feature

Biog box

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assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys.” (italics added for emphasis)

Whilst the BMR certainly provides for additional requirements before a benchmark referencing an index becomes subject to the regulation's requirements, for our purposes we can see that the term “index” is in and of itself widely defined under another EU legislation.

Finally, as will be explored in Part 2 of this article, there is growing consensus that cryptocurrencies constitute property. This means that they can potentially constitute yet another underlying in s (10) – assets.

OTC or exchange traded

Certain Relevant Sections differentiate between OTC and exchange-traded instruments. Overall, the Relevant Sections consider exchange-traded derivatives to be more financial instruments than OTC instruments.

Settlement method

Certain Relevant Sections also differentiate between cash and physically-settled derivatives. They catch any applicable contract type that is cash settled. On the other hand, there are a number of exclusions for physically settled instruments. As specified in the Delegation Regulation, a notable exclusion is physically settled spot contracts.

Application of the Relevant Sections to different crypto-derivatives

We now turn to certain crypto-derivative contract types – forwards, swaps and options – to see whether they would be caught by the Relevant Sections.

Crypto-derivative swap

Swaps are invariably cash settled. Examples of plain-vanilla crypto-currency swaps include CFDs and perpetual swaps. In the case of CFDs, parties make profits or losses by reference to the difference between the opening price and the current price of the underlying cryptocurrency. In the case of perpetual swaps, one party pays a funding fee to the other party depending on whether the perpetual price is higher or lower than the cryptocurrency's spot price. An

example of a structured swap is a dealer and a customer swapping, say, a LIBOR-based cash flow for a cash flow based on Bitcoin spot prices.

Crypto-derivative swaps potentially fall under s (4), (9) and (10).

- (i) Swaps whose reference underlying is financial indices or financial measures can be caught by s (4). As discussed above, it is possible for the underlying cryptocurrency's price (or an amalgamation of its prices) to be viewed as an index or measure. (The word “financial” is most likely irrelevant for our purposes given that swaps are monetary – and so financial – in nature in any event.)
- (ii) Section (9) applies to “financial contracts for differences”. This section can be interpreted widely as applying to all crypto-derivative swaps on the basis they involve the exchange of different financial flows. Alternately, it is possible that this section's scope is limited to CFD instruments only.
- (iii) The second limb of s (10) is designed to be a catch-all for cash-settled instruments only. (Incidentally, the first limb of s (10) does not apply to crypto-derivatives since cryptocurrencies do not constitute any of the reference underlyings specified therein). The second limb applies to “any other derivative contracts relating to assets ... indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, an OTF, or an MTF”. As already discussed, it is possible for the cryptocurrency to be treated as an asset. Furthermore, applying the same argument as for s (4), the underlying cryptocurrency can be treated as an index or measure.

The swap is an archetypical derivative and so would satisfy the “characteristics of other derivative financial instruments”. Finally, the reference to the instrument being exchange-traded is indicative and not mandatory and so its non-satisfaction by an OTC swap is not fatal to the analysis.

Options

An example of a crypto-derivative option is an investor having the right to sell (that is to

“put”) his Bitcoin to the counterparty for a pre-established price (the “put price”) if the spot price falls below such put price. Conversely, in a call option the investor has a right to buy (that is “call”) Bitcoin from the counterparty if the spot price rises higher than a pre-established price (the “call price”). Options can be cash- or physically-settled.

A cash-settled crypto-derivative option is potentially captured by s (4) and (10) for the reasons discussed above regarding indices and measures.

The same analysis would apply to a physically-settled crypto-derivative option, albeit it would only be potentially captured by s (4) since s (10) is restricted to cash-settled instruments.

Forwards

An example of a crypto-derivative forward is an investor entering into a contract to sell his Bitcoin to the counterparty for a pre-established price on a future date. Forwards can be cash- or physically-settled.

A cash-settled crypto-derivative forward is potentially captured by s (10), once again due to the reasons discussed above regarding indices and measures.

However, the position of a physically-settled crypto-derivative forward is significantly less clear. On a strict reading, s (4) does not apply to forwards given that they are not specified as a contract type. As a result, it is possible that physically-settled crypto-derivative forwards fall outside MiFID II.

CONCLUSION

Crypto-derivatives were clearly not contemplated as financial instruments when MiFID I entered into force in 2014 and this also appears to be the case when MiFID II was recast in 2018. It is, therefore, a matter of construction whether they are caught by the legislation. Given the potential for them to fall under multiple Relevant Sections as well as the position adopted by the FCA, it appears prudent to adopt the viewpoint that at least cash-settled crypto-derivatives fall – if not squarely, then just about – within the regulatory perimeter. ■