Council of the European Union
General Secretariat

Interinstitutional files:
2021/0239 (COD)

Brussels, 09 June 2023

WK 7682/2023 INIT

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WORKING DOCUMENT

From:	Commission services
To:	Financial Services Attachés Working Party on Financial Services and the Banking Union (AML)
Subject:	AMLR: Commission services non-paper on implications of covering NFTs under the AML Regulation but not under the MiCA Regulation

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Implications of making NFT service providers obliged entities in the absence of their coverage under MiCA

As part of its negotiating position on the future Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) Regulation (AMLR), the European Parliament proposed that persons providing services for the sale and purchase of unique and not fungible crypto-assets (NFTs) be subject to AML/CFT requirements.

As a reminder, the Commission's initial proposal for a Regulation of the Markets in Crypto-Assets (MiCA) included these operators among crypto-assets service providers (CASPs). The Commission proposal for the AMLR of July 2021 is based on the same premise that NFTs should be CASPs and as such subject to AML/CFT requirements. Thus, no specific reference to NFTs was included in the Commission proposal beyond listing CASPs in the list of obliged entities. The final political agreement reached by co-legislators on the MiCA Regulation departs from the Commission proposal and excludes crypto-assets that are unique and not fungible with other crypto-assets from the scope of MiCA, and requires the Commission to issue, by 18 months after the date of entry into force of MiCA, a report on latest developments in crypto-assets. This report is to include an assessment of the development of markets in unique and non-fungible crypto assets and of the appropriate regulatory treatment of such crypto-assets, including an assessment of the necessity and feasibility of regulating offerors of unique and non-fungible crypto-assets as well as providers of services related to such crypto-assets (Article 142(2), point (d)).

Why were NFTs originally included in the MiCA scope?

The Commission considered that the prudential, consumer protection and ML/TF risks posed by NFTs and services provided to NFTs are practically the same as for crypto assets in the scope of MiCA. Leaving entities that provide MiCA services (custody, exchange, execution etc.) to NFTs outside the scope of MiCA means there is no common EU approach to the regulation of these services. There are no safeguards to ensure the effective segregation of client assets from own account assets of the service providers – resulting in considerable complexities in the event major service providers for NFTs were to enter insolvency – and the inherent challenges of attempting to allocate co-mingled assets. There are also arbitrage risks, as firms may seek to proactively structure crypto-assets in the form of unique and non-fungible financial-like products to circumvent the perimeter of MiCA. In addition, left unregulated, NFT markets remain prone to severe market manipulation risks such as wash trading and insider trading. While wash trading and scams has long been noticed in NFT markets, the first case of insider trading has just been brought in front of a US court in a case involving one of the biggest NFT trading platforms (OpenSea). Finally, as they are currently unregulated, NFTs may also become even more prone to ML/TF risks.

Following the co-legislators' choice to exclude NFTs and services provided to NFTs from the scope of MiCA, and in the absence of any specific reference to NFT service providers in AMLR, these operators are now outside the scope of AMLR as well. Had NFTs remained in the scope of MiCA, their service providers would have qualified as CASPs and as such been included in the list of obliged entities under AMLR.

During the third technical meeting on the AMLR, held on 24 May, the interaction of the Parliament's proposal with MiCA requirements was debated. As outlined above, in principle we agree that NFT service providers should be obliged entities (for all types of crypto asset services, not just the sale and purchase), consistent with the Commission's proposal. However, the Parliament proposal to cover NFT service providers under AMLR but not under MiCA creates a number of consequences, which the Commission was requested to lay out. This paper aims to respond to such a request.

Market entry requirements under AML/CFT rules

In line with FATF standards, obliged entities should be licensed or registered, and adequately regulated, and subject to supervision or monitoring for AML/CFT purposes, having regard to the risk of money laundering or terrorist financing in their sector. Under FATF recommendation 26, market entry requirements for operators providing a service of money or value transfer (as would NFT service providers typically do) include, at a minimum, licensing or registration.

This licensing/registration process allows Member States to;

- conduct market entry checks to ensure that the entity's senior management and beneficial owners are not convicted in relevant crimes and, where applicable, that they are fit and proper.
- define the supervisory population and identify the market participants for supervisory purposes.

Article 47 of Directive (EU) 2015/849 as amended by Directive (EU) 2018/843 enumerates the operators that should in any case be subject to licensing or registration, which includes the categories of crypto-asset service providers currently covered by EU rules[1]. This is because at the time of Directive (EU) 2018/843 there was no EU regulatory framework for virtual currencies and virtual asset service providers, thus the AML/CFT framework was the only available framework to incorporate this obligation. The regime resulting from that sees today most Member States having introduced a registration requirement for these entities, while others opted for a license regime. Registration offers no passport to these entities (hence multiple registrations are made in different Member States) and although they cover the basic obligations of FATF Recommendations, they fall short of a comprehensive framework for market entry and for regulating the conduct of these services.

MiCA creates this comprehensive framework at EU level and provides for the authorisation of crypto-asset service providers, strict rules on their ownership, conduct of business and organisational requirements. Indeed, Article 4(1) of the proposal for a 6th AML/CFT Directive (AMLD6), which corresponds to Article 47 of the current Directive, does not mention CASPs because they were regarded as already comprehensively covered by MiCA and its licensing regime, therefore a registration for AML purposes would not be necessary. If NFT service providers were to be included under AMLR only, Article 4(1) AMLD6 should be amended to provide for a licensing or registration obligation for them.

While MiCA is the obvious place to provide for rules regarding NFT service providers, the inclusion of NFT service providers under AMLR only would require Member States to put in

[1] "Member States shall ensure that providers of exchange services between virtual currencies and fiat currencies, and custodian wallet providers, are registered, that currency exchange and cheque cashing offices, and trust or company service providers are licensed or registered, and that providers of gambling services are regulated." Note that the amendments introduced by the recast of the Transfer of Funds Regulation extend the scope of obliged entities to cover all CASPs under MiCA and remove the categories of CASPs from Article 47 of the Directive.

place a licensing or registration regime, which also includes checks on senior management and beneficial owners. Member States would be presented with two options: either to expand the MiCA requirements at national level to cover NFT service providers, or to set up a dedicated national licensing/registration framework. Under either scenario, the market fragmentation that exists today for CASPs and that MiCA will overcome would be replicated for NFT service providers, distorting competition in the internal market and giving rise to regulatory arbitrage. This would also give rise again to the risk that has been observed that market operators wrongly promote in public communications a mere AML/CFT registration as "stamp of approval" by financial supervisors.

AML/CFT Supervision

The inclusion of NFT service providers under AMLR would also imply the introduction of supervision for AML/CFT purposes. As NFT service providers would not qualify as CASPs, they would fall outside the scope of financial institutions. This differentiation would be important to mark a difference between regulated services and unregulated ones such as provision of services to NFTs as opposed to the MiCA framework. Identifying NFT service provision as financial activity qualifying those operators as financial institution would otherwise require Member States, consistent with FATF standards, to regulate this sector. The same approach was followed when introducing certain categories of virtual asset services under the current Directive. Should the report under Article 142 of MiCA conclude that NFTs should fall under its scope, then NFT service providers would need to become CASPs too, and thus financial institutions. This has significant consequences in terms of how supervision is carried out at national and Union level.

Indeed, while FATF standards are neutral as regards whether jurisdictions qualify CASPs as financial institutions or designated businesses and professions, they require CASPs to be subject to the same level of supervision as financial institutions. For this reason, in the amendments to the current Directive introduced by the recast of the Transfer of Funds Regulation the co-legislators agreed to qualify CASPs as financial institutions.

At national level, this may imply that CASPs fall under the scope of the financial supervisor (generally a single supervisor in charge of the entire financial sector, as opposed to the complex landscape of supervisors in the non-financial sector), and thus that NFTs would see their relevant supervisor change after a short period of time, with implications for the resources of the authorities concerned, as well as for the continuity of supervisory engagement with a nascent sector that as such would need significant accompanying by the supervisor. Financial supervisors also have wider powers vis-à-vis their supervised entities, and stricter requirements, than supervisors in the non-financial sector do[2].

At EU level, were the report under MiCA to conclude that NFTs have to be included among CASPs, they would also become part of AMLA's potential pool of directly supervised entities, whereas under the simple inclusion of NFT service providers as non-financial operators AMLA would have only had an oversight and regulatory role.

Conclusion

While including NFT service providers in the scope of AMLR without including them also in the scope of MiCA is technically possible, it would create costs for Member States that may

[2] See for reference the paper submitted by the Commission services under TFR regarding the inclusion of CASPs as obliged entities

not be justified were the upcoming report under Article 142 of MiCA to conclude that NFTs should be included within the scope of that Regulation, and would carry with it internal market impacts that would not arise were a Union-level solution (inclusion under MiCA) be chosen instead.

In particular, it should be noted that AMLR will become applicable 3 years after its entry into force (or 2 years under the Parliament's proposal), whereas the MiCA report would be adopted in early 2025, possibly already accompanied by a legislative proposal. Thus, were NFTs to be included under AMLR not as CASPs, the time between when Member States would need to have in place a dedicated licensing/registration framework under AMLD6 and when these operators would transition to MiCA would be extremely short, i.e. potentially less than 2 years.