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Malta Financial Services Authority

By online submission

06 January 2023

Dear Sir/Madam

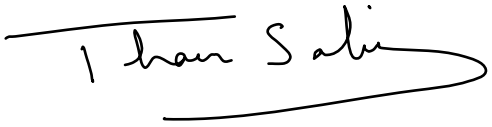
Re: Consultation on the Virtual Financial Assets (VFA) Framework - Non-Fungible Tokens (NFTs)

We welcome the opportunity to provide input on the MFSA's consultation on NFTs in the context of the VFA Framework. The EMA represents payments, crypto asset and FinTech firms, engaging in the provision of innovative payment services, including the issuance of e-money, e-money tokens, open banking payment services, and cryptoasset related services including stable coins. A full list of our members is provided in the appendix to this document.

The EMA was established some 20 years ago and has a wealth of experience in regulatory policy relating to payments, electronic money, and more recently crypto assets.

We would be grateful for your consideration of our comments, which are set out below.

Yours faithfully,



Dr Thaer Sabri
Chief Executive Officer
Electronic Money Association

1 Current Regulatory Treatment of NFTs under the VFA Framework

Distributed Ledger Technology ('DLT') Assets are defined within the Virtual Financial Assets Act (Chapter 590 of the Laws of Malta) ('the Act') as "(a) a virtual token; (b) a virtual financial asset; (c) electronic money; or (d) a financial instrument, that is intrinsically dependent on, or utilises, Distributed Ledger Technology". Given that NFTs are intrinsically built on DLT and the definition of DLT Asset is open-ended, it is the Authority's opinion that such assets would qualify as DLT Assets within the meaning of the Act and should therefore be subject to a Financial Instrument Test on a case-by-case in order to determine the applicable regulatory framework.

The Authority further notes that due to the residual definition of 'Virtual Financial Asset,' NFTs failing to qualify as either (a) a virtual token, (b) a financial instrument or (c) electronic money, would qualify as VFAs and entities engaging in activities relating to these assets would be subject to authorisation in terms of the VFA framework.

Q1. Do you agree with this analysis presented by MFSA?

Response:
We agree with the MFSA's interpretation of current legislation, based on the definition of DLT assets in the VFA (*a financial instrument, that is intrinsically dependent on, or utilises, Distributed Ledger Technology*); NFTSs are likely to qualify as DLT assets within the meaning of the Act.

2 Proposed Regulatory Treatment of NFTs

The Authority notes that the typical features borne by NFTs, namely their uniqueness and lack of interchangeability, limit the extent to which such assets may be used for investment or payment purposes. Furthermore, the inclusion of such assets within the scope of the VFA framework may run counter to the spirit of the Act, which sought to regulate investment-type services offered in relation to VFAs falling outside scope of existing traditional financial service asset categories.

The Authority further notes that the EU's upcoming Markets in Crypto-assets Regulation ('MiCA'), which is expected to enter into force in Spring 2023, will exclude crypto-assets which are unique and not fungible with other crypto-assets from its scope, eliminating the need for any form of authorisation when engaging in issuance or provision of services in relation to NFTs.

On the basis of the above, the Authority considers that it would be prudent to exclude certain VFAs, which display clear characteristics of uniqueness and non-fungibility, also be excluded from the VFA Framework.

Q2. Do you agree with the exclusion of NFTs from the scope of the VFA Framework?

Response:
We concur with the Authority's regulatory approach to target only DLT-based products that "may be used for investment or payment purposes." This approach should also apply with regard to NFTs. However, when considering NFTs, a particular challenge is that the term comprises a broad variety of products. NFTs are not a homogeneous product category with clearly defined (or definable) features capable of informing a coherent regulatory approach. As with crypto-assets more generally, the underlying blockchain technology allows for a "digital packaging" of many assets ranging from the physical to the digital, having different purposes, and a spectrum of values.

For example, some refer to digital files generated as an integral part of an artistic or some other creative activity (e.g., photos, videos, musical recordings, etc.) while others represent rights to participate in events or enter venues, and some capture rights to and records of interest in real estate. Any regulatory approach should consider in the first place how it would respond to the specific features of the underlying asset or value and the related professional occupation. Only if the digital packaging as NFTs gives rise to an investment or payment utility, would regulation for trading or for trading platforms drawing on the regulation of financial instruments and their markets warrant consideration.

Accordingly, the term NFT does not provide the requisite granularity for a focus of regulatory action. This is analogous to focusing regulation on blockchain technology itself, which can be used to solve diverse problems, most of which do not warrant regulation.

Given the spectrum of products and services that may fall under the term NFT, a simple exclusion by the Authority on the basis of whether an asset displays characteristics of uniqueness and non-fungibility may fall short of the MFSA's objectives. This is primarily because there are still certain types of DLT-based products commonly referred to as NFT's which, despite not being unique or non-fungible, should still not be regulated. The Authority's aim of capturing DLT-based assets which may be used for investment or payment purposes is not mutually exclusive with the uniqueness or fungibility of these assets - rather, there are NFT's and NFT-related activities which can be fungible and not unique and should still not be subject to regulation.

A number of examples of how NFTs could be used are set out below to provide further context.

a) In the first example, 300 cinema tickets for a newly released film could be sold as NFTs, with all of the seats individually numbered. As each seat has an identifying number, it could be said that

these tickets are not fungible and unique. As such, these are excluded under the exemption, which makes sense as this type of activity should not be regulated.

b) The second example is the same as that above, but here the cinema seats are not individually numbered. As they do not have a unique identifying number, they could now be considered as fungible and not unique. As such, this instance would no longer be covered by the proposed exemption, and this type of NFT activity would be regulated when it more likely should not be, and it does not align with the Authority's intent to regulate only those DLT-based products which are used for investment or payment purposes which is clearly not the case here.

c) In this scenario, there are 30,000 tickets issued as NFTs for the last ever Rolling Stones concert. The concert is open air, and as such, it is impossible to have individually numbered seats. This could give rise to consider the NFTs as fungible and not unique in nature, and as such they would not be covered by the proposed exemption - when in fact, this is not something the Authority would actually want to regulate, given their intended use to be other than for investment or payment purposes.

Within this same scenario, however, the tickets themselves may have a pre- and potentially even post-event resale value on secondary markets given it is the last ever Rolling Stones concert. The prices of these tickets could skyrocket. Under these circumstances the authority may consider appropriate to regulate the digital marketplace itself on which the tickets are listed, as opposed to the issuance of the NFT-tickets themselves.

d) The final example scenario relates to established digital platforms for the streaming, acquisition and downloading of digital audio files (such as Bandcamp and Soundcloud), which are key distribution channels securing a revenue stream for a large number of musicians who have limited or no access to distribution by commercial music publishing companies. These audio files could be packaged in and released as NFTs, and issued as part of a series or collection, which as a consequence could potentially be captured under the proposed scope. However, these artistic activities and their output do not merit regulation and it would also go against the principle of technology-neutrality to introduce regulation as audio files traded on existing online platforms were captured only because these same audio files are being packaged as NFTs. Regulation would most likely have a significant negative impact on many creative artists and musicians. Beyond this example scenario much of the same applies to a range of other creative professions increasingly using NFTs as an additional distribution channel for their creative work.

The above examples demonstrate that there is a growing number of DLT-based creative products (commonly referred to as NFTs) which are on the brink of being fungible, or are actually fungible,

but yet still do not merit regulation. A more prudent approach would be to assess the nature and use case of these DLT-based products and how they are being utilised, as opposed to simply whether they are fungible and unique. This approach can help ensure that regulation is applied proportionately and only if warranted with a view to the investment or payment purpose of the given DLT-based product. Without a specific assessment of the given use case and the financial or non-financial purpose of the given DLT-based product regulation may become a barrier to innovation and growth of DLT-based products and markets putting at risk potentially significant benefits effectively prohibiting use-cases that should be welcomed and protected.

In line with the Authority's approach there may still remain the need for some regulation and oversight, where such DLT-based products are effectively aimed at or subsequently de facto used for investment or payment purposes. In these instances, as described in scenario C above, regulation should focus on the platforms and marketplaces themselves where these DLT-based products can be listed and traded. Where these platforms allow the products to be traded like financial instruments, or offer investment-type services, then they should be subject to regulation drawing on the regulation of financial instruments and related markets and services.

Thus, any exclusions of DLT-based products from the VFA should focus on their nature, use-cases, and the related purpose, as opposed to purely on the basis of fungibility or uniqueness. This will help to ensure that the Authority does not regulate DLT-based products and related activities that do not pose any of the risks associated with financial instruments and related markets or any other assets that are being used for investment or payment purposes.

Q3. Do you foresee any further considerations and/or implications?

Response:
The Authority makes reference to the EU's upcoming Markets in Crypto-assets Regulation ('MiCA'), which is expected to enter into force in Spring 2023 and will exclude crypto-assets which are unique and not fungible with other crypto-assets from its scope.

The issues highlighted in response to Question 2 are also relevant here and we strongly encourage the Authority to apply MiCA, in particular the exemption in Article 2 (2a) of MiCA, in line with its current approach of limiting regulation to DLT-based Assets used for investment or payment purposes. We believe this approach is well aligned with the MiCA objective of introducing financial sector regulation for cryptoassets that are aimed at or effectively subject to financial use, as referred to in a number of MiCA recitals including recital 6b ("Such features limit the extent to which these crypto-assets can have a *financial use*, thus limiting risks to users and

the system, and justifying the exemption") and recital 13 ("To ensure that all offers of crypto-assets, other than asset-referenced tokens or e-money tokens, which can potentially have a *financial use* in the Union, or all admissions of crypto-assets to trading on a platform for crypto-assets are properly monitored and supervised by competent authorities…").

Accordingly, the exclusion of unique and non-fungible crypto-assets in Article 2 (2a) MiCA (and, accordingly, an inclusion of NFTs and other DLT-based products which may be fungible and not unique) should be applied based upon the principle of "substance over form" as referred to in recital 6c. In line with its ultimate objective, MiCA should only apply to NFTs (including those issued as part of a series or collection) and, as the case may be, other DLT-based products (that are fungible and not unique) if used for financial purposes i.e., for investment or payment purposes.

If the principle of "substance over form" is not used to qualify the scope of MiCA, MiCA may extend to use cases and their supporting ecosystems (issuers/offerors and providers of related services), which do not carry any of risks that would warrant ongoing prudential, conduct of business, and market abuse supervision as introduced by MiCA.

More specifically and in line with our comments above regarding creative and artistic NFT use cases we strongly believe that creators of digital art and collectibles should be able to issue their creative output as series and collections of NFTs (including in the form of Digital Collectibles). The referenced digital media file can be as in scenario d) above an audio file (e.g. in .mp3, .wav, .flac or some other digital audio format), but it can just as well be an image file (e.g., in .jpeg, .png, or some other digital image format) or a video file (e.g., in .mp4, .mov, .avi or some other digital video format).

Similar to audio files of musical recordings the underlying creative activity is directly analogous to the activities of artists creating signed and numbered prints, or a numbered edition of a piece of video art, or the video recording of a performance or some other artistic event. In these cases, the primary function of the issuance as an NFT is to replace the traditional paper-based certificate of ownership or authenticity used in more traditional art markets. These creative outputs of artists drawing on some form of media-specific reproduction technique have always been considered unique works of art, albeit potentially subject to different forms of distribution.

Using NFTs as a new technology for reproduction, distribution and certification of ownership and authenticity should not change the status of the creative output. Application of MiCA and ongoing supervision by financial sector regulators in these NFT use cases is not warranted and would, moreover, as highlighted already in the discussion of scenario d), run against the principle

of technology-neutrality when compared to unregulated traditional formats (prints, video art, performance art) using established reproduction techniques and subject to traditional forms of distribution.

We encourage the Authority to also pursue its approach to the scope of regulation for MiCA, and the interpretation and application of the exemption in Article 2 (2a) in particular, in line with the principle of "substance over form" referred to in recital 6c of MiCA (see above) and continue to focus on the use being made of NFTs or other DLT-based products. MiCA as any other financial sector regulation should only apply where crypto-assets are being used for financial i.e., investment or payment purposes.

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