

THE NATURE AND ART OF
FINANCIAL SUPERVISION
VOLUME II

VIRTUAL FINANCIAL ASSETS
VFA AGENTS, VFASPS AND IVFAOS

Contents

| | |
|---------------------------------------------------------|----|
| Contents..... | 1 |
| Table of Abbreviations..... | 2 |
| Introduction..... | 3 |
| VFA Agents..... | 5 |
| Overview..... | 5 |
| Authorisation..... | 5 |
| Supervisory Engagements, Risks and Recommendations..... | 5 |
| VFA Service Providers | 8 |
| Overview..... | 8 |
| Authorisation..... | 10 |
| Supervisory Engagements, Risks and Recommendations..... | 12 |
| Initial VFA Offerings | 14 |
| Collaboration with other Authorities | 16 |
| Financial Intelligence Analysis Unit (FIAU) | 16 |
| Malta Digital Innovation Authority (MDIA)..... | 16 |
| Ongoing Work | 17 |
| Further development of the VFA Framework..... | 17 |
| Comparative Analysis with MiCA..... | 17 |
| The MFSA’s 2021 VFA Supervisory Focus | 20 |
| Concluding Remarks..... | 21 |

Table of Abbreviations

| | |
|--------|---------------------------------------------------------------------------|
| AML | Anti-Money Laundering |
| AMLD | Anti-Money Laundering Directive |
| ARTs | Asset-Referenced Tokens |
| CASPs | Crypto-Asset Services Providers |
| CASPAR | Compliance and Supervision Platform for Assessing Risk |
| CFT | Combatting the Financing of Terrorism |
| DLT | Distributed Ledger Technology |
| EMTs | E-Money Tokens |
| EU | European Union |
| FATF | Financial Action Task Force |
| FCC | Financial Crime Compliance |
| FIAU | Financial Intelligence Analysis Unit |
| ICO | Initial Coin Offering |
| ITA | Innovative Technology Arrangement |
| IVFAO | Initial VFA Offering |
| KRI | Key Risk Indicator |
| LoI | Letter of Intent |
| MDIA | Malta Digital Innovation Authority |
| MFSA | Malta Financial Services Authority |
| MiCA | Markets in Crypto Assets |
| ML | Money Laundering |
| MLRO | Money Laundering Reporting Officer |
| PMLFTR | Prevention of Money Laundering and the Financing of Terrorism Regulations |
| PQ | Personal Questionnaire |
| REQ | Risk Evaluation Questionnaire |
| RMS | Risk Monitoring System |
| TF | Financing of Terrorism |
| VFA | Virtual Financial Asset |
| VFAA | Virtual Financial Assets Act |
| VFASPs | VFA Service Providers |

Introduction

The Malta Financial Services Authority (“MFSA” or “the Authority”), the single regulator for financial services in Malta, identified potential risks and a number of disadvantages in having the crypto-asset sector operating in a regulatory vacuum. It was in this context that it was decided to develop a specific framework for the regulation of crypto-assets in Malta, designed to protect investors, ensure market integrity (including the prevention of money laundering and the financing of terrorism) and safeguard financial soundness.

The approach taken by the Maltese legislator was not to regulate crypto-assets *per se*, but rather the persons issuing such assets and/or providing services in relation thereto, in or from within Malta. The Virtual Financial Assets Act (Cap 590 of the Laws of Malta) (‘VFAA’ or ‘the Act’) regulates persons providing intermediary services, *inter alia*, custodians of crypto-assets, operation of crypto exchanges, brokerage and discretionary portfolio management, when such services are provided in relation to Virtual Financial Assets (‘VFAs’). The Act also regulates VFA Agents which may be described as the first line of defence against market malpractice in this area, as they have the role of filtering applicants for authorisation under the VFAA before the request for authorisation is submitted for MFSA’s review. While not considered as service providers *per se*, the VFAA also regulates issuers of VFAs during their initial offering by mirroring the European Union’s (‘EU’) Prospectus regime.

The VFA Framework also consists of the Virtual Financial Assets Regulation (Subsidiary Legislation 590.01) (‘VFAR’) and the Virtual Financial Assets Rulebook (‘the Rulebook’) which provides further detail with respect to the overarching requirements found in the Act. The Rulebook consists of three chapters. Chapter 1 is applicable to VFA Agents, Chapter 2 sets out the requirements for issuers of VFAs and Chapter 3 sets out rules for VFA Service Providers. The Rulebook is also supplemented by various guidance documents and FAQs which are periodically updated on the MFSA’s website.

Chapter 3 of the Rulebook sets out *inter alia* the licensing requirements, procedures and ongoing obligations applicable to VFA Service providers (‘VFASPs’), which reflect the high-level principles enshrined in the existing EU financial services legislation in relation to the provision of investment services, financial markets and prevention of market abuse. These include *inter alia*, governance, prudential and AML/CFT provisions. With regard to AML/CFT, the VFA framework has adopted a more stringent approach than the fifth Anti-Money Laundering Directive (‘AMLD’), whereby Issuers, VFA Agents and VFA Service Providers all fall under the definitional scope of a ‘subject person’ in terms of Regulation 2 of the Prevention of Money Laundering and the Financing of Terrorism Regulations (‘PMLFTR’) (SL 373.01 Laws of Malta). Moreover, VFA provisions have been extended in scope to include also crypto-to-crypto transactions. The approach taken by Malta and the MFSA in relation to AML/CFT with regard to crypto-assets clearly demonstrates the will to safeguard financial market integrity and to ensure

that gaps in the current European framework applicable in this regard are properly addressed at national level.

Since the field of crypto-assets is considered as high risk from an anti-money laundering perspective, the MFSA is applying high standards of due diligence with regard to the review of applications for a VFA licence, including the verification that applicants have the necessary policies, procedures and systems in place to comply with anti-money laundering standards set by the Financial Action Task Force ('FATF') and have the required levels of governance to ensure proper conduct of business. In this regard the MFSA works very closely with the Financial Intelligence Analysis Unit ('FIAU'), and the latter conducts mandatory interviews of the persons nominated as Money Laundering Reporting Officers ('MLROs') both for VFA Agents, as well as for VFASPs, to establish their competency.

The MFSA's strategy, with regard to crypto-assets, is that of contributing to the establishment of a sector made up of serious operators that are properly regulated and supervised at the highest level. This is important for the integrity of Malta's financial system and in line with the expectations of international institutions such as the International Monetary Fund and MONEYVAL.

The VFA function, within the MFSA's Supervisory Directorate, is tasked with the authorisation and supervision of VFA Agents and VFA Service Providers ('VFASPs'), as well as the registration of whitepapers. The VFA regulatory framework came into force on 1 November 2018, and the MFSA has adopted a stepped approach to its implementation.

This publication provides an overview of the VFAA and the manner in which it is being implemented in Malta.

VFA Agents

Overview

The first step in the implementation of the VFAA was the authorisation of VFA Agents, which are in effect regulated introducers of VFA business in Malta. VFA Agents play a pivotal role under the VFAA as their main role is the undertaking of compliance checks, both prior to approval of an issuer's whitepaper and an applicant for a licence, and with regard to the former, on an ongoing basis thereafter. In view of the nature of such role, VFA Agents, who are also subject persons for the purposes of AML/CFT legislation, are expected to have robust due diligence procedures, systems and controls in place in order to screen prospective issuers and persons providing, or wishing to provide, a VFA service. They are also expected to ensure that such persons are fit and proper for such purpose and have the necessary competences. Since VFA Agents act as the first line of defence for ML/TF risks, they are required to meet high fitness and properness standards, thereby strengthening overall investor protection, market integrity, financial soundness and AML/CFT.

Authorisation

The registration of a VFA Agent is subject to satisfactory due diligence on its beneficial owners, qualifying shareholders, senior management, and designated persons, all of whom are required to submit a PQ to the Authority. Senior management and designated persons are also subject to a competence assessment. As of 2018, VFA Agents are considered subject persons under the PMLFTR, meaning that they are subject to the same requirements identified in those regulations. These include the requirements to engage an MLRO, to perform customer due diligence to the standard envisaged, to perform client and business risk assessments, to perform sanctions screening, etc. VFA Agents are also required to submit yearly Risk Evaluation Questionnaires ('REQs') to the FIAU, which defines their risk scoring for AML/CFT risk purposes and are therefore placed on the FIAU's supervisory agenda.

The authorisation process for VFA Agents has a specific focus on AML/CFT, including the competence of the nominated MLRO, which is assessed by the FIAU during the mandatory interview. Currently there are 20 registered VFA Agents in Malta, four of which were successfully registered during 2020, with the remaining having been registered during the first half of 2019.

Supervisory Engagements, Risks and Recommendations

The VFA function supervises VFA Agents to ensure their effectiveness, particularly as a first line of defence. The VFA function has developed a Risk Monitoring System (RMS) which is in line with the MFSA's Risk Appetite Statement and the VFA Sectoral ML/FT Risk assessment, to establish its supervisory strategy. The ranking of VFA Agents in terms of the risks posed, serves to direct and focus the VFA function's supervisory attention towards authorised persons which

present a higher risk. With respect to AML/CFT, VFA Agents are risk ranked by the FIAU via the Compliance and Supervision Platform for Assessing Risk ('CASPAR'). Key Risk Indicators are derived from the yearly REQs submitted, from prudential data and information passed on to the FIAU by the MFSA, from STRs submitted, and from additional intelligence that may arise. Depending on the risk emerging from the same risk model, the FIAU draws up a Supervisory Plan, indicating which Subject Persons will be subject to an onsite inspection by the FIAU itself, or by the MFSA's Financial Crime Compliance ('FCC') function, acting as agents on behalf of the FIAU.

During 2020, the VFA function has carried out supervisory interactions, in the form of onsite inspections, to a number of VFA Agents – those covered are responsible for 50% of the VFASP applications being assessed, and were selected in accordance with the risk rating arrived at through the RMS.

Cognisant of the fact that VFA Agents serve as the first line of defence in terms of AML/CFT, the onsite inspections sought to assess VFA Agents' compliance with the VFA rules and regulations, particularly in areas of client onboarding, due diligence, governance and the carrying out of fitness and properness assessments.

The most common finding emanating from the onsite inspections carried out in 2020 related to the procedures on the fitness and properness assessments carried out by VFA Agents. In this regard, the Authority noted that whilst fitness and properness assessments were being carried out in line with the Authority's guidance, the procedures relating thereto were at times weak, particularly with reference to the assessment of competence and the verification of Source of Wealth and Source of Funds of potential clients. The Authority therefore makes reference to the circular issued on 18 September 2020 on the Guidance Note on the submission of the Source of Wealth and Source of Funds¹, and reminds VFA Agents of the importance of having written procedures that reflect how the different aspects of the fitness and properness assessments are to be carried out and documented, as well as how determinations are finally made by the VFA Agent in this regard.

Another common finding of the onsite inspections related to governance, and the undertaking of different activities by employees of the VFA Agent, enhancing the risk of potential conflicts of interest. In this regard, the MFSA notes that VFA Agents may lack the resources to build a strong governance structure, and this can result in the undertaking of multiple roles by individuals within the VFA Agent. In this regard, it is recommended that VFA Agents formally document the various roles, responsibilities and tasks undertaken by individuals within the VFA Agent. This enhances transparency and enables VFA Agents to monitor and address any potential conflicts relating to the above as these may arise.

Apart from the onsite inspections, the VFA function has also assessed several supervisory matters, requests and notifications in accordance with Chapter 1 of the VFA Rulebook. The

¹<https://www.mfsa.mt/wp-content/uploads/2020/09/Circular-on-the-Guidance-Note-on-the-submission-of-the-Source-of-Wealth-and-Source-of-Funds.pdf>

function has also maintained ongoing communication with VFA Agents with respect to their obligations in relation to the effective implementation of Chapters 2 and 3 of the VFA Rulebook. Despite the fact that the number of new VFA Agent registrations assessed during 2020 was small when compared to that in 2019, the VFA function has processed over 13 resignations and new appointments of approved individuals, as well as two voluntary surrenders of registration.

As part of its offsite supervisory work, Chapter 1 of the Rulebook was also amended to introduce reporting requirements for VFA Agents, which were notified to the market in the MFSA's circular of 13 August 2020². These requirements consist of the submission of an Annual Return, which captures information on the operations of the VFA Agent throughout the year, and the submission of Audited Financial Statements. The review of applications submitted by VFA Agents on behalf of applicants also serves as an assessment of the quality of work carried out by VFA Agents, and therefore also forms a vital part of the Authority's supervision of VFA Agents.

² <https://www.mfsa.mt/wp-content/uploads/2020/08/Circular-to-VFA-Agents-in-relation-to-Reporting-Obligations.pdf>

VFA Service Providers

Overview

The second step of the VFA regulatory framework implementation dealt with the licensing of VFA Service Providers. The VFA Framework introduced a transitory period of one year from its coming into force. To avail themselves of the transitory period³, VFASPs had to notify the Authority. Originally, 180 companies had notified the MFSA of their intention to operate in or from within Malta under the transitory framework. A circular⁴ issued on 6 September 2019 notified that any VFASP wishing to continue providing VFA Services in or from within Malta following the expiry of the transitory period was required to commence the VFA Services Licence application process by not later than 31 October 2019, through a submission of a Letter of Intent (“LoI”). Those VFASPs not intending to apply for a VFA Services Licence were required to cease their operations and submit a notification to the Authority in this regard, also by not later than 31 October 2019.

Only 34 companies submitted an LoI, which was required for them to keep on operating legally in or from within Malta after the 31 October 2019. Through feedback received from the market, the key reasons why many companies did not proceed towards licensing related mainly to the fact that the VFA Framework was perceived to be very stringent and too onerous.

Following the submission of the LoI, the VFA function organised preliminary meetings with the prospective applicants - this was a mandatory step in the application process. The first application documents started being received towards the end of December 2019, as applicants had to submit their applications within 60 days from the date of the preliminary meeting. The Authority kept receiving applications during the first three months of 2020. A number of applications received were subsequently withdrawn by the applicants. In fact, only 23 out of the original 34 entities which had submitted their LoI actually submitted an application. The Authority also received a further 4 applications, 2 of which in December 2020, bringing the total number of applications to 27. A summary of the LoI and VFASP applications received is provided in Table 1 hereunder.

| VFASP Applications | Number |
|------------------------------------------------------|--------|
| VFASPs submitted Letter of Intent by 31 October 2019 | 34 |
| VFASPs subsequently submitting an Application | 23 |
| New VFASPs submitting an Application | 4 |
| Total VFASPs applications received | 27 |

Table 1

³ Article 62 (2) of the VFA Act

⁴ <https://www.mfsa.mt/wp-content/uploads/2019/09/20190906-Circular-to-Virtual-Financial-Asset-Service-Providers.pdf>

It was immediately clear that most of the VFASPs applications submitted lacked significant information, this notwithstanding the Authority's Circular⁵ of the 14 January 2020 which provided guidance to applicants in this respect. Application packs lacked various supporting documentation and, as a consequence, the VFA function could not initiate its review as applications were not deemed to be complete in terms of Chapter 3 of the Rulebook. In the meantime, while the VFA function was in constant communication with the respective VFA Agents delineating the missing documentation and lacking information, the function focused on the necessary due diligence checks to speed up the process.

By the beginning of May, the Authority had only received 4 complete applications, 6 by the beginning of June, and 13 by the beginning of August. This prompted the Authority to issue another Circular,⁶ on 6 August 2020, which set a cut-off date of 15 September 2020 for completion of applications. By this date, any application from an entity operating under the transitory period that was still deemed to be incomplete would be shelved by the Authority and applicants will be required to cease all VFA operations being carried out in or from within Malta. In order to further expedite the VFASP application process, the Authority also imposed a deadline of three weeks for response to the Authority's comments. The Circular achieved the desired effect as applicants having pending applications submitted the relevant documentation by 15 September 2020.

The current status of the authorisation process is summarised in Table 2 below:

| VFASP Applications | Number |
|--------------------------------------------------|-----------|
| VFASP Licences issued | 1 |
| VFASP in-principle approvals issued | 12 |
| VFASP Applications withdrawn | 3 |
| VFASP Applications withdrawn voluntarily | 3 |
| VFASP Applications rejected | 1 |
| VFASP Applicant using exemption under VFAA | 1 |
| VFASP Applications being processed | 3 |
| VFASP Applications on hold | 1 |
| New VFASP applications received in December 2020 | 2 |
| TOTAL | 27 |

Table 2

Further to the above, the VFA function also processed another 9 requests for exemptions under the VFAA.

⁵https://www.mfsa.mt/wp-content/uploads/2020/01/20200114_Circular-to-VFA-Agents-in-relation-to-the-Application-Process-for-VFA-Service-Providers.pdf

⁶<https://www.mfsa.mt/wp-content/uploads/2020/08/Circular-to-VFA-Agents-in-relation-to-the-authorisation-process-of-VFA-Service-Providers.pdf>

Authorisation

As previously stated, the MFSA's strategy for the crypto-asset sphere is that of contributing towards the establishment of a sector constituted of serious operators. During the authorisation process, the VFA function paid particular attention to: [i] governance arrangements, assessing whether applicants had clear organisational structures with well-defined, transparent and consistent lines of responsibility and reporting; and [ii] effective processes to identify, manage, monitor and report the risks to which they are or might be exposed. The Authority also assessed whether that management bodies of these entities, as well as their shareholders are of good repute and have sufficient expertise, both in financial services and the VFA sector. Their fitness and properness was also assessed from an AML/CFT perspective.

The authorisation process also looked at the resources being employed and the level of local substance, whereby some core activities of the company were expected to be based in Malta. It is the Authority's expectation that VFASPs should have strong internal control and risk assessment mechanisms, as well as a system that guarantees the integrity and confidentiality of information received. Continuity and regularity in the performance of their activities is also expected, and therefore the VFA function also ensured that VFASPs have established business continuity plans aimed at ensuring the performance of their core activities in the case of an interruption to their systems and procedures, as well those services acquired from third party service providers.

VFASPs are also expected to have appropriate arrangements to keep records of all transactions, orders and services related to VFAs which they provide. They should also have systems in place to detect potential market abuse, as well as strong client on-boarding and transaction monitoring procedures.

Cognisant of the fact that reliance on Distributed Ledger Technology ('DLT') based systems increases certain technological risks, the MFSA, in collaboration with the Malta Digital Innovation Authority ('MDIA'), has included a Systems Audit as a requirement for licensing under the VFA framework, for those VFASPs which use an Innovative Technology Arrangement ('ITA'). A Circular⁷ to this effect was issued on 10 December 2019. As of today, every applicant for a VFASP licence that requires a systems audit has already identified and engaged a Systems Auditor.

The Systems Auditor, who is to be registered with MDIA, is charged with undertaking system audits and producing systems audit reports which are to be submitted to the MFSA and the MDIA. Technological resilience (including cyber resilience) will also be assessed by the Systems Auditor. Furthermore, the circular also included guidance on the requirement of an IT Audit for VFASPs which do not interact with an ITA, as to also ensure that such VFASPs have robust IT systems and cybersecurity framework. Finally, all VFASPs will be required to establish and have, at all times, a Live Audit Log in place which is to be located in Malta. The main purpose of the

⁷https://www.mfsa.mt/wp-content/uploads/2019/12/20191210_Circular-to-Virtual-Financial-Asset-Service-Providers-in-relation-to-Amendments-to-Chapter-3-of-the-Virtual-Financial-Assets-Rulebook.pdf

Live Audit Log is akin to that of a traditional audit trail and facilitates the supervision of the relevant VFASPs and may be used in cases where investigations are necessary.

In accordance with Rule R3-2.2.3.3.4, the VFA function in collaboration with the FIAU, held mandatory interviews with nominated MLROs to ensure adequate levels of competence. A number of candidates had to be recalled for a second interview due to their poor performance. Other proposed MLROs were found to lack the necessary competences to hold such role/s within the VFA sector and therefore the applicant was requested to propose another candidate.

To elaborate further on the aforementioned challenges the VFA function encountered at Authorisation stage, it became increasingly apparent that the adoption of new business models enabled through the latest technologies, evolving market infrastructures and operational concepts in a divergent global regulated environment, led to a myriad of terms borrowed from the traditional space with fluid and at times conflicting definitions and interpretations. This led to several exchanges of communication and meetings between the Authority and the applicants to obtain a clearer understanding of the applicants' operational models and the respective VFA services and VFA licences necessary.

Another layer of complexity when analysing business models was the fact that the majority of the applicants were benefitting from the transitory provisions and were therefore already operating. It became very apparent that operational models within this sector were evolving rapidly, and the VFA function had to handle ongoing developments and modifications to the business plans. In light of the above and the novelty of this industry and regulatory framework, the VFA function took a cautious and critical approach when reviewing business plans and models.

The MFSA also expects licensed entities operating in or from within Malta to have a degree of local substance. Particularly in this highly technological, disseminated, and remote working industry, attracting applicants from all over the globe, finding a suitable proportionate level of local substance proved to be rather challenging.

The VFA function has also encountered instances of changes to the shareholding structure as well as capital raising efforts leading to additional correspondence and revised assessments. The majority of the 27 applicants were backed by significant beneficial owners and composed of seasoned teams with substantial experience. Nonetheless, in view of the nascent industry, corporate structures generally reflected entrepreneurial ventures with close-knit teams and a high direct involvement of the beneficial owners. To this effect, the VFA function held additional discussions in order to seek ways to strengthen controls so as to enhance the level of independence from the applicants' beneficial owners, as well as to improve governance structures in line with the Authority's expectations.

Supervisory Engagements, Risks and Recommendations

Despite the fact that companies operating under the Transitory Period were not yet licensed by the MFSA, in terms of R3-3.6.2.1 of the VFA Rulebook, VFASPs benefitting from the transitory provision are still expected, in so far as is applicable, to comply with the Rulebook on a best efforts basis, and therefore subject to the MFSA's supervisory powers.

The MFSA's VFA function developed a VFASP Risk Model, which captures Key Risk Indicators based on Governance, Shareholding, VFA services offered and business model, degree of operations, Due diligence, and Client responsiveness.

A data collection exercise was carried out in August 2020 on these entities through a Compliance and Supervisory Questionnaire, to include another KRI specifically related to AML/CFT controls, as well as activity levels, to give better visibility on the operational extent. This Compliance and Supervisory Questionnaire has also been used as a form of offsite review on all VFASPs operating under the transitory period.

Following a risk-based approach, the VFA function also conducted an onsite visit focusing primarily on AML/CFT to all nine VFASPs whose risk rating was determined to be high. These inspections have been conducted with the support of the FIAU. Such inspections included scheduled meetings with the Board of Directors, the MLRO and the Compliance Officer, covering topics including, *inter alia*, the entity's risk appetite; target markets/jurisdictions of operation; Business Risk Assessment; Customer Risk Assessment; client on-boarding procedures, AML/CFT risk and internal controls; transaction monitoring; client categorisation; and implementation of the Travel Rule.

In view of the unprecedented transitory provisions, which enabled VFASPs to operate while still undergoing authorisation, the said onsite inspections also contributed to this process, with the inclusion of the mandatory Compliance Officer and MLRO competence interviews during such inspections.

The onsite inspections revealed a number of strengths and weaknesses of VFASPs. While several VFASPs appeared to have solid tools enabling them to undertake sufficient monitoring, some VFASPs were found to be lacking and were utilising a significant amount of manual operations with struggling resources.

The VFA function also encountered instances of weak governing structures, including insufficient participation from all board members, inadequate dual control and independence of thought, as well as lack of independence given and lack of ownership by the compliance officer and MLRO. Based on the outcomes of the inspections the VFA function has, *inter alia*, imposed deadlines for the setting up and implementation of additional controls, safeguards and systems.

Furthermore, following discussions and the outcomes of the inspection, a few VFASPs reconsidered their intention to obtain a licence and requested a withdrawal of their application, as indicated in the Table above. The VFA function has thus also been involved in the monitoring of the winding down of operations from or within Malta of such applicants since these were operating under the transitory provisions.

The MFSA is also using a blockchain analysis tool, both for the purposes of fitness and properness assessment of prospective licence holders, as well as to monitor the risk profile of entities in relation to their interaction with third party VFA wallets, by assessing inflows and outflows, as well as being able to trace the origin of the VFAs as necessary. This will feed into the risk model thereby affecting the risk profile of the VFASP.

It is envisaged that all applications currently undergoing authorisation will be processed by the end of Q1 2021, after which the VFA function will focus its efforts on the supervision of the licensed VFASPs, as well as registered VFA Agents.

The VFA function recognises that ML/FT remains one of the highest risks of this sector. That being stated, the function is also well aware of other risks emanating from the increasingly evolving sector, such as technology risk, cybercrime and the significant exposures and reliance on outsourced service providers. To this effect, while the MFSA understands the realities of these risks and the nature of this sector, VFASPs are expected to give due priority to the monitoring and mitigation of such risks, including the appropriate due diligence and ongoing monitoring of outsourcing service providers both from an operational and business continuity perspective.

In addition to this, VFASPs are also expected to tackle and mitigate unnecessary risks emanating from possible weak governance. The MFSA reiterates the importance of the second and third lines of defence, consisting of the control functions and the responsibilities of the board of directors in this respect. In this regard, the Authority expects VFASPs to enable and support compliance officers, MLROs and internal auditors to give due attention to the testing of the effective implementation of policies and procedures in place, and the assurance of the operational three lines of defence.

Initial VFA Offerings

The VFAA also regulates issuers of crypto-assets during their initial offering by reflecting the principles of the EU Prospectus regime. Initial Coin Offerings ('ICOs') are seen as high-risk speculative investments exposed to numerous risks including, *inter alia*, inadequate information, cybersecurity, and fraud.

The VFAA encompasses those ICOs where the crypto-asset is classified as a VFA, and terms these offerings as Initial VFA Offerings ('IVFAOs'). The VFAA addresses information inadequacy through the imposition of the high-level principles enshrined in the Prospectus Regulation⁸ on such issuers. In particular, the VFAA requires issuers to draw up a whitepaper⁹ and register it with the Authority, through their appointed VFA Agent, prior to proceeding with an IVFAO. Similar to a prospectus under traditional financial services law, the purpose of the whitepaper is to provide investors with sufficient information on the VFA, its issuer and the proposed project. Such a full disclosure regime is seen as a *sine qua non* towards the formulation of an informed opinion on the prospects of an IVFAO.

Whereas risks relating to cybersecurity and fraud are partially addressed through the aforementioned disclosure regime, investors do not possess the required technical expertise to assess certain parameters of IVFAOs, including, *inter alia*, the DLT protocol or platform developed or the smart contract deployed by the issuer, and therefore investors would not be in a position to make a truly informed investment decision. Therefore, the adoption of additional technological safeguards, mitigating loss-, theft- or misappropriation-related risks, is a prerequisite for effective investor protection in this field. For these reasons, the VFA framework requires that a systems audit is carried out to cover all the constituent parts of the utilised technology including *inter alia* any smart contracts being deployed. The Systems Auditor, after checking that the issuer's DLT infrastructure meets the required cybersecurity standards and that the functionality of any smart contracts are in line with the description included in the pertinent whitepaper, will submit an attestation in this regard to the Authority.

The Authority has to date received four whitepapers. It has registered three whitepapers (with one issuer deciding to pursue the project in another jurisdiction) and rejected another.

During the whitepaper registration process, the Authority predominantly aims to assess whether: [i] the contents of the whitepaper are in line with the requirements set out in the First Schedule of the Act; [ii] a Systems Audit has been carried out by an MDIA registered Systems Auditor; and [iii] the Issuer, its shareholders, Executive Directors and MLRO are fit and proper for the purpose of the Issue. The Authority also ensures that the proposed MLRO has the required competence to undertake its role, through the mandatory interview conducted by the FIAU.

⁸ Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC.

⁹ A Whitepaper typically contains information about the issuer and its business, the available tokens, the investments planned and other relevant information.

To date, submissions for the registration of whitepapers have generally been compliant with the requirements emanating from the Act. Despite this, the Authority often seeks further clarifications on a case-by-case basis, particularly in cases where the Issuance does not fall squarely within the parameters set by the Rulebook. In this regard, the MFSA intends to effect updates to the Rulebook in 2021, which will further distinguish between the issuance of a VFA and the admission of a VFA to trading on a DLT exchange.

Collaboration with other Authorities

Financial Intelligence Analysis Unit (FIAU)

During 2020, the VFA function in collaboration with the FIAU, held over 30 mandatory MLRO competence interviews. This interview, which is mandatory, ensures that the competence of nominated MLROs is of a very high standard, both in terms of overall knowledge of the PMLFTR and also with regard to the risks inherent to the VFA sector. Moreover, the VFA function worked very closely with the FIAU on the drafting of the Consultation on the FATF Recommendation 16 to VFA Sector¹⁰ which was issued on 27 August 2020. This document set out a proposal for subsidiary legislation providing for the application of FATF Recommendation 16, more commonly referred to as the *'Travel Rule'*, to transfers of VFAs. It is expected that following the analysis of the feedback received from this consultative process, the subsidiary legislation will be issued, effectively bringing into scope the transfers of VFAs.

Malta Digital Innovation Authority (MDIA)

Cognisant of the fact that reliance on DLT-based systems increase certain technological risks, the VFA function has collaborated with the MDIA to explore how ITA certification with MDIA can be used within the VFA framework in order to maximise technological assurances, thus reducing the risks to investors by providing an additional level of regulatory certainty, user-trust and oversight by relying on MDIA as the Authority responsible for the certification of ITAs based on Systems Audits. The Authority intends to issue a consultation document in this regard to get feedback from Industry participants and interested parties on the way forward.

Also, as indicated in the next section below, the Authority has been working closely with MDIA on the Digital Finance Package, particularly with respect to the legislative proposal of Markets in Crypto Assets ('MiCA'), in order to be able to come forward with a strong and unified Malta position based on the collective experience of both Authorities in the field of crypto-assets and the underlying technologies.

¹⁰ <https://fiaumalta.org/consultations/>

Ongoing Work

Further development of the VFA Framework

Since its inception, the VFA Framework has undergone several amendments with the aim of improving the framework. Most notable is the set of amendments effected to Chapter 3 of the Rulebook as communicated through the Circular of the 10 December 2019, wherein the MFSA chose to revisit certain obligations in order to support innovation in the VFA Sector. In this regard, the MFSA sought to adopt a more principles-based approach whilst continuing to ensure effective investor protection, market integrity and financial stability.

Some of the areas of Chapter 3 which have been amended included *inter alia* requirements in relation to Systems Audits and IT Audits; requirements on the undertaking of services in other jurisdictions and the revision of supplementary conditions applicable to Class 4 VFA Service Providers. In this regard it was noted that some of these requirements were at times overly prescriptive, resulting in some of these requirements not being applicable at all times.

In August 2020, Chapter 1 of the Rulebook was also amended to introduce reporting obligations for VFA Agents. These consist of the submission of an Annual Return and Audited Financial Statements. These requirements will further enhance the supervisory work carried out by the MFSA.

Going forward the Authority intends to make further updates to the Rulebooks in order to further promote innovation while ensuring that the VFA Framework remains robust and continues to effectively achieve the principle objectives of financial services regulation. Moreover the Authority will also continue monitoring the developments within the Digital Finance Package and in particular the legislative proposal of MiCA, in order to ensure that the VFA framework can evolve in a seamless manner into the new Regulation once this comes into force. In this regard the Authority intends to consult industry participants and interested parties on the way forward.

Comparative Analysis with MiCA

On 24 September 2020, the European Union adopted the Digital Finance Package, including legislative proposals on the regulation of MiCA. This proposes three overarching frameworks namely (i) the regulation of issuances of crypto-assets in the EU, (ii) a framework for *so-called stablecoins* which classifies the latter as either Asset-Referenced Tokens ('ARTs') or E-Money Tokens ('EMTs'); and (iii) a framework for the regulation and supervision of crypto-asset services providers ('CASPs').

Upon publication of the proposed MiCA Regulation, the MFSA sought to conduct a gap analysis between MiCA and the VFA framework, a high-level summary of which is included below. It was

found that the VFA Framework is generally aligned with the proposed MiCA Regulation, with both being largely based on the MiFID II framework. The Authority also noted the following differences between the two frameworks:

Scope and Definitions

The MiCA Regulation proposes a wide definition for the term 'crypto-assets' with the scope of the regulation being reduced through a list of exemptions found in Article 2(3) of the proposed regulation. In this regard, while numerous definitions in MiCA differ from those found in the VFA Act, the scope of the VFA framework is largely aligned with that of MiCA.

Framework for the issuance of crypto-assets in the EU

The framework for the issuance of crypto-assets as proposed by MiCA will require the notification of crypto-asset whitepapers to competent authorities prior to commencing the issuance of a crypto-asset to the public. In other words, under MiCA, crypto-asset whitepapers will not be subject to *ex-ante* approval, however competent authorities have been granted *ex-post* powers. Crypto-asset whitepaper notifications are to be accompanied by an explanation as to why the crypto-asset in question falls within the scope of MiCA, and not other traditional financial services legislation such as MiFID II.

This differs from the methodology adopted under the VFA framework, where the issuance of VFAs to the public is subject to a registration regime which includes *inter alia* the appointment of a MLRO and undertaking of Systems Audits which assess any innovative technologies used by the Issuer during the course of the VFA offering. Furthermore, as part of the application for the registration of a whitepaper, issuers are also required to submit a 'Financial Instrument Test' determination confirming that the asset in question is a VFA and therefore falls within scope of the VFA Act.

The MiCA regulation has also opted to exempt the issuance of crypto-assets which '*are unique and not-fungible with other crypto-assets*'. This is reflected in the VFA Act through the introduction of the term 'virtual token' and its exclusion from the scope of the VFA framework. In terms of the information content of the whitepaper, these are similar under the two regimes, however MiCA contains more specific requirements in relation to the admission of a crypto-asset to trading. Furthermore, MiCA also requires further information on the technology used by the issuer to be included in the whitepaper, in lieu of any requirements in relation to technological assurance which the VFA framework demands through Systems Audits reports.

Framework for CASPs

The list of crypto-asset services identified within the MiCA Regulation are largely aligned with those found in the VFA framework. One major difference in this regard relates to the definition of '*the operation of a trading platform for crypto-assets*' which is defined within the VFA Framework as '*the operation of a VFA Exchange*'. The use of this terminology provides a clearer

distinction between the service of exchange and the matching of orders on a trading platform than that found within the VFA framework. Furthermore, the MiCA regulation has not identified 'dealing on own account' as a service in itself and has explicitly prohibited CASPs from dealing on own account on a trading platform which they operate. In this regard, the service of 'dealing on own account' is a listed service within the Second Schedule of the VFA Act. Another gap identified with respect to services relates to that of 'portfolio management', which has not been included within the scope of MiCA.

With reference to the ongoing obligations of CASPs, it is noted that MiCA generally imposes less prescriptive organisational and governance requirements than the VFA framework. Furthermore, while the MiCA Regulation is backed by the DORA Regulation, a robust framework relating to ICT risk and cybersecurity, the MiCA regulation does not explicitly address the use of innovative technologies and/or provide for their certification, as do the Systems Audit requirements found within the VFA framework.

Going forward, the Authority is closely following EU discussion centring around the MiCA proposal and working closely with both the MDIA and the Ministry for Finance and Employment to contribute to the EU discussion based on the experience gained in Malta with the development and implementation of the VFA framework. The Authority will also be taking the MiCA proposal into consideration when undertaking future regulatory developments to the VFA regime.

The MFSA's 2021 VFA Supervisory Focus

Given that the Authority will be issuing several licences to VFASPs during Q1 2021, the main supervisory focus will naturally be on such new licence holders thereby building on work conducted in 2020. In this respect, the Authority is in the process of finalising its VFASP supervisory framework.

The VFA function will also be issuing information and guidance to VFASPs on the regulatory quarterly returns that would be expected to be submitted, as well as guidance on the implementation of the live audit log to be in place within six months of licensing. The function will also be making full use of blockchain analysis tools to monitor on an on-going basis the activities of licensed VFASPs.

To ensure that the effective implementation of the VFA framework and that it successfully addresses the risks of this new industry, the MFSA has identified areas of focus for 2021. In this respect, the Authority will be placing particular emphasis on:

1. the effective implementation and robustness of the governance structures;
2. the implementation and quality of the compliance function and its compliance monitoring programme, with particular attention on the level and nature of testing undertaken by compliance officers to ensure compliance;
3. the operational aspects of the business models adopted, including outsourcing and resource sharing;
4. examination of asset safekeeping;
5. AML/CFT controls including the Travel Rule implementation;
6. cybersecurity and IT systems, including the reviews of the submitted IT and System Audit reports; and
7. the implementation of the live audit log.

With respect to VFA Agents and VFA Issuers, the MFSA has identified the following areas of focus for 2021 priorities;

1. examination of the systems to enable VFA Agents fulfil their ongoing obligations with respect to VFA Issuers;
2. continued focus on the inherent and residual risks within the governing structures of VFA Agents which may weaken their role as the first line of defence within the VFA framework; and
3. a review on the competence of the VFA Agents in fulfilling their obligations with respect to their registration.

The above will be conducted on the basis of a risk-based approach and using the results obtained through the RMS, which the function runs on a quarterly basis.

Concluding Remarks

Cognisant that the VFA is a new sector which is still in its embryonic stage, the MFSA has, through this publication, outlined the implementation of the VFA framework in Malta, highlighting several actions undertaken along with concerns that have come to light during this process.

The Authority expects VFA licence holders, as well as prospective applicants under the Act, to note the findings set out in this publication and to adopt recommendations or take corrective action where appropriate, in order to match the Authority's expectations. Going forward, the Authority will engage with, and assess licence holders as part of its supervisory assessments in 2021.

Malta Financial Services Authority

Triq L-Imdina, Zone 1

Central Business District, Birkirkara, CBD 1010, Malta

communications@mfsa.mt

www.mfsa.mt