COUNTRY UPDATE-Germany: Crypto-asset regulation

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The crypto-assets sector — which includes unbacked and asset-stabilised digital currencies, securities tokens, utility tokens, non-fungible tokens and services related to them — has potential benefits, but is turbulent. Over 2022, it experienced valuation plunges, a stablecoin's collapse, the exchange FTX's bankruptcy and concerns about decentralised finance (DeFi) arrangements.

This heightened calls for regulation to maximise crypto's advantages while minimising financial crime and risks to investors and market integrity. The International Organisation of Securities Commissions (IOSCO) opened a consultation on proposed recommendations for the regulation of crypto-assets in May 2023. Meanwhile, several countries have or plan rules affecting crypto-finance, but their approaches vary. Various EU Directives concern crypto, so differences also arise when member states transpose them into national law.

The Markets in Crypto-Assets Regulation (MiCA), which introduces an EU regime for crypto-assets and related services, is expected to come into force in 2024. How national regulators use their powers under MiCA may produce differences between member states.

This article provides an outline of EU legislation followed by an overview of crypto-asset regulation in Germany by Hans Stamm and Matthias Meinert of Dechert LLP.

Principal existing EU legislation:

Money Laundering Directives EU 2015/849 and EU 2018/843

The Fifth Money Laundering Directive (5MLD) extended the Fourth Money Laundering Directive (4MLD) regime to "providers engaged in exchange services between virtual and fiat currencies" and to "custodian wallet providers".

In July 2021, the European Commission proposed replacing 4MLD with a package of new anti-money laundering (AML) and counter financing of terrorism (CFT) rules. The package includes an AML/CFT regulation and a Sixth Money Laundering Directive (6MLD). It was still awaiting EU Parliamentary first reading on May 1, 2023.

Second Electronic Money Directive EU 2009/110 (EMD2)

Article 2(2) of EMD2 defines electronic money as "electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions … and which is accepted by a natural or legal person other than the electronic money issuer".

Some stablecoins can be "electronic money tokens" under this definition.

Revised Markets in Financial Instruments Directive EU 2014/65 (MiFID 2)

Some crypto-assets qualify as "financial instruments" under MiFID 2, art 4(1) point 15 and the associated list in section C of annex 1.

The MiCA regulation (COM 2020/593)

MiCA was approved by the European Parliament on April 20, 2023, and is expected to be published in the Official Journal in June with some provisions on stablecoins taking effect in mid-2024 and others in early 2025. It will apply to persons engaged in the issuance or provision of services related to crypto-assets not within scope of existing EU regulation.

MiCA distinguishes between stablecoins and other crypto-assets. Stablecoins are divided into "asset-referenced tokens" and "electronic money tokens". Any that pass threshold conditions would be classified as "significant" by the European Banking Authority (EBA).

The proposed revised Transfer of Funds Regulation (TFR) COM (2021) 422

The European Parliament also voted in favour of the TFR on April 20, 2023 and it may take effect from 2024, like MiCA. It will recast current rules in regulation EU 2015/847.

TFR will harmonise rules in the EU by extending the 'travel rule' applicable in traditional finance to crypto-assets. This means information on the source of an asset and its beneficial ownership will have to 'travel' with a transaction and be stored on both sides of a transfer.

Crypto-asset regulation in Germany

1. Which body or bodies regulate crypto-assets and related services in Germany?

In Germany, the financial services supervision is carried out by the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht — BaFin) and the Deutsche Bundesbank. As part of the Federal administration, BaFin is subject to the legal and technical oversight of the Federal Ministry of Finance. BaFin as well as Bundesbank can engage and make use of external auditors for forensic audits.

2. Has any regulator or finance ministry stated its attitude towards crypto-assets: for example, said it wants to encourage crypto ventures or warned the public against investing in them?

BaFin has repeatedly warned retail investors publicly about the highly speculative nature of crypto-assets. In this context, BaFin has consistently emphasized that the potential for high returns is inextricably linked to high risks. When investing in coins or tokens, investors face significant risks and may potentially lose their entire investment. Additionally, BaFin has informed the public that if a service provider, such as a trading platform or a wallet provider, loses money or must cease operations, there is no protection available to cover customer losses, like those offered by deposit insurance systems or investor compensation schemes. Crypto assets do not have access to such protective systems.

On the other hand, BaFin recognizes that, in addition to the risks, fintech business models, including crypto-asset services, offer numerous opportunities. These range from reduced transaction costs for cross-border payments to the emergence of entirely new business models and services that cater to the needs of a digitalized financial market, potentially injecting new dynamism into the entire financial industry. As such, BaFin underscores the importance of consistently maintaining a balance between fostering innovation and ensuring financial stability.

3. Does any non-EU derived law regulate crypto-assets or service providers such as exchanges or digital wallets?

Germany has introduced in its national financial services regulation (e.g., the German Banking Act (Kreditwesengesetz — KWG)) specific regulation to cover business activities in crypto-assets. The applicable regulatory rules depend on the definition of crypto-assets and related services. Starting point for a regulatory classification of crypto-assets in Germany should be a conceptual differentiation within the inconsistent terminology of digital assets.

Defining crypto-assets as "tokens" is too undifferentiated and not expedient, because the term "token" is only to be understood as a generic term of virtual assets or crypto-assets. A more precise and legalistic distinction between the digital assets, such as virtual currencies, security tokens and utility tokens is crucial for answering any subsequent regulatory questions. In particular, the functionality ("use case") must be taken into account. Crypto-assets in general are based on a blockchain technology (DLT).

Crypto-assets within the meaning of German Banking Act

Crypto-assets (in German "Kryptowerte") qualify as financial instruments within the meaning of the KWG. According to section 1 para. 11 sentence 4 KWG "Crypto-assets" are defined as "digital representations of a value that has not been issued or guaranteed by any central bank or public body and does not have the legal status of a currency or money, but is accepted by natural or legal persons as a means of exchange or payment or serves investment purposes on the basis of an agreement or actual exercise and which is transmitted electronically, can be stored and traded."

This definition goes beyond the EU definition in the 5th EU Anti-Money Laundering Directive. It includes digital units of value such as currency or payment tokens, which are often also referred to as "virtual currencies". Government-issued currencies are by definition not crypto-assets, as well as e-money, interconnection payment systems and payment transactions of providers of electronic communications networks or services.

Pursuant to section 1 para. 11 sentence 1 no. 10 KWG, crypto-assets also qualify as financial instruments. Since crypto-assets can already fall under one of the other categories of financial instruments due to their diverse characteristics, section 1 sec. 11 sentence 1 no. 10 KWG was designed as a catch-all to avoid regulatory gaps for virtual currencies.

Tokenized assets (security tokens)

The holder of security tokens is entitled to membership rights or claims to a certain asset under the law of contracts. These claims or rights are "embodied" in the token created on a blockchain and comparable to the rights of a security holder. Examples are claims for dividend-like payments, co-determination, repayment claims or interest payments.

Security tokens designed under German law constitute a digital representation of other forms of securities (e.g., tokenized bonds), or qualify as original digital securities after the introduction of the Act on Electronic Securities (eWPG), which came into force on June 10, 2021. As a consequence, German securities law applies to security tokens, i.e., the Prospectus Regulation, the German Securities Prospectus Act (WpPG) and the German Securities Trading Act (WpHG) or, if designed accordingly, also as an investment fund unit within the meaning of the German Capital Investment Code (KAGB).

At the same time, security tokens are considered financial instruments under the KWG, due to the technology-neutral definition of the "financial instrument" in MiFID II as "transferable securities" according to Article 4 para. 1 no. 44 MiFID II.

Utility tokens

Utility tokens provide the holder with access or usage rights to certain services or products. A repayment of the purchase price or granting of property rights is usually excluded. From this point of view, pure utility tokens can be compared with tickets or vouchers and are therefore not financial instruments. However, distinguishing them from tokenized assets or, if a payment function is integrated, from virtual currencies can sometimes be difficult and depends on the main function of the token's use case.

Financial services related to crypto-assets

For commercial services in connection with tokens that can qualify as crypto-assets within the meaning of KWG, financial instruments (Finanzinstrumente), securities (Wertpapiere), investments or investment units (Investmentanteile), corresponding regulatory authorisations are required in Germany.

The required authorisation differs depending on the actual service and regulatory classification of the crypto-assets. It should be noted (for providers as well as for users) that even if these services are offered from abroad to German users in a targeted manner, this may trigger a German authorisation requirement.

Depending on the factual design of the transaction, it may qualify, for example, as a banking transaction, i.e., as a financial commission transaction (Finanzkommissionsgeschäft) or underwriting business (Emissionsgeschäft). In addition, an authorisation as a financial service (Finanzdienstleistungsinstitut) may be required where the service involves investment brokerage, investment advice, operation of a multilateral or organized trading system, placement business, brokerage, financial portfolio management, proprietary trading or investment management.

In this respect, there is no difference to traditional financial instruments, with BaFin referring to the "technology neutrality" of the financial regulations.

Special financial service: crypto custody business

With the inclusion of crypto-assets in the definition of financial instruments in Germany, a new financial service for the "custody" of crypto-assets was introduced in section 1 para. 1a sentence 2 no. 6 KWG. This financial service is defined as the "custody, management, and securing of crypto-assets or private cryptographic keys used to hold, store, and transfer crypto-assets for others. "BaFin has described the relevant criteria and requirements in detail in its guidance notice on crypto custody business.

Whether the activity conducted by the service provider is a regulated activity often depends on if the service provider holds the private cryptographic key in its systems on behalf of the client and so has access to the decentrally stored crypto-assets. This is typically the case for crypto exchanges and digital wallet providers (commonly known as Hot Wallets), where the crypto assets, or more precisely, the private cryptographic keys, are digitally stored.

The result may be different if the service provider only offers a software that interacts with crypto exchanges, for example (via interfaces called "API" – Application Programming Interfaces), without ever having contact with the private cryptographic keys.

BaFin has expressly stated that the production or distribution of hardware or software to secure the crypto-assets or the private cryptographic keys, which are operated by the users on their own responsibility, are not covered by the crypto custody business definition if the service providers do not have access to the crypto-assets or private cryptographic keys held by the user. These "software as a service" business models usually do not constitute a regulated activity under German law.

4. What rules apply to the promotion of crypto-assets, and are others proposed?

The regulatory marketing rules applicable to crypto-assets depend on the characteristics of the crypto-assets whether they are considered as financial instruments, securities, investments or investment units. Consequently, there is no general answer in terms of applicable marketing rules.

Marketing activities in the course of or in preparation for an offering of crypto-assets can be considered as regulated activity. This would require a prior authorization by BaFin and / or can be subject to a prospectus obligation. The decisive question is often whether the construction of the token in the specific case constitutes a security within the meaning of the European Prospectus Regulation

(Regulation (EU) 2017/1129) and the German Securities Prospectus Act (Wertpapierprospektgesetz — WpPG). (Please see also answer to question 2 — financial services related to crypto-assets.)

In terms of services related to crypto assets, it must be noted that if the service itself is considered a regulated service, e.g., a crypto-custody business within the meaning of section 1 para. 1a sentence 2 no. 6 KWG — please see above), the respective marketing activities for this service would already trigger an authorization requirement of the service provider.

In this context it should be noted that the marketing activity does not necessarily have to take place in Germany. A connection to Germany is deemed if the offering or the marketing activity is aimed at entities or persons in Germany, while using means of distance communication and exclusively by way of cross-border provision of services, without maintaining a network of intermediaries or a physical presence in Germany.

It must generally be assumed that a permission pursuant to section 32 para. 1 KWG is required if a foreign company intends to target the market in Germany for the purpose of offering Crypto Custody Business on a commercial basis to companies and/or people based in Germany.

5. What anti-money laundering requirements apply to crypto-asset transactions or custody?

In Germany, the anti-money laundering obligations are regulated by the German Money Laundering Act (Geldwäschegesetz — GwG). The GwG, however, do not apply to everyone, it rather defines the scope of the people and entities by means of their services offered or their profession which are subject to those anti-money laundering obligations.

According to section 2 para. 1 no. 2 GwG, financial service providers fall within the scope of anti-money laundering obligations. As described above, providers offering services in relation to crypto-assets can be considered as financial service providers within the meaning of section 1 para. 1a KWG. This inclusion was driven by the 5th EU Anti-Money Laundering Directive.

In particular, the anti-money laundering obligations apply to crypto trading platforms and crypto exchanges (section 1 para. 1a sentence 2 nos. 1 b, 1 d, 4 KWG) as well as to crypto custody service providers (e.g., wallet providers) (section 1 para. 1a sentence 2 no. 6 KWG). They are subject to the GwG even if the services providers only offer services in relation to one kind of crypto-assets. As a financial institution those service providers are obligated entities within the meaning of the GwG.

Furthermore, service providers arranging transfers of crypto-assets on behalf of customers are subject to the German Ordinance on Enhanced Due Diligence Requirements for the Transfer of Crypto Assets (Kryptowertetransferverordnung — KryptoWTransferV). Based on this ordinance, the service provider acting on behalf of the transferor must transmit the name, address and account number (e.g., the public key) of the customer and the name and account number (e.g., public key) of the beneficiary simultaneously and securely to the receiving service provider acting on the side of the beneficiary.

The service provider acting on behalf of the beneficiary must ensure that it receives and stores the details of both, the transferor and the beneficiary/transferee. The ordinance includes further data collection requirements applicable to obliged entities for transfers from or to digital wallets which are not managed by a financial service provider.

6. Does any existing or proposed national law impose requirements regarding stablecoin?

Stablecoins are typically considered as crypto-assets within the meaning of section 1 para. 11 sentence 4 of the German Banking Act (KWG).

7. Do any other rules apply to banks' holding or dealing in crypto, or to crypto derivatives?

Yes, the German MiFID rules as implemented by the German Securities Trading Act (Wertpapierhandelsgesetz — WpHG) which are relevant for financial services provided in Germany distinguish between services provided to retail and professional clients.

Financial service providers must apply stricter rules regarding the required suitability and appropriateness test to retail clients than to professional clients to ensure that the client only purchases such investments which are in line with the client's individual financial situation, experience, knowledge and investment objective. These principles are basically also applicable to investments in crypto-assets.

Further BaFin has imposed specific restrictions on the marketing, distribution and sale of contracts for differences (CFDs) to retail investors.

Due to significant investor protection concerns, BaFin adopted a product intervention measure with its general administrative act dated July 23, 2019 on CFDs. CFDs are typically used for short-term speculation and are only traded over the counter (OTC). They are leveraged contracts between two parties speculating on the price performance of a given underlying and characterised by an unlimited risk of loss for the investor.

Based on BaFin’s product intervention measure, the marketing, distribution and sale of CFDs to retail clients in Germany is restricted. The exact restriction rules depend on the underlying assets.

In terms of crypto-assets as underlying, BaFin declared that "CFDs with cryptocurrencies as their underlying produce other serious concerns. Cryptocurrencies are relatively new investment products that expose investors to immense risks." Therefore, and due to the

high volatility of crypto assets, CFDs with underlying crypto-assets for CFDs are subject to a stricter leverage limit than other classic assets such as fiat currencies, gold or major indices.

Retail clients in Germany are permitted to only trade CFDs with underlying crypto-assets with a leverage of up to 1:2. The leverage limit was achieved with the implementation of a compulsory initial margin of 50% of the notional amount as an initial margin protection.

8. Do any current or proposed rules apply to decentralised finance (DeFI) arrangements?

Germany has not established any regulations specifically targeting decentralized finance (DeFi) arrangements so far. However, DeFi platforms and DeFi services may be subject to existing financial regulations depending on their specific functions and activities.

For instance, if a DeFi platform facilitates trading or exchange of crypto-assets, it may be subject to the same regulatory requirements as traditional financial service providers under the KWG, WpIG, and/or WpHG. Additionally, DeFi platforms dealing with tokenized securities could be subject to the WpPG and other securities regulations.

As mentioned above in question 2, if a service provider holds the private cryptographic key in its systems on behalf of the client and thus has access to the decentrally stored crypto-assets, this is considered a regulated activity, specifically the crypto-custody business as defined in Section 1 para. 1a) sentence 2 no. 6 KWG. This may apply to DeFi platforms, which would then require a license pursuant to Section 32 para. 1 KWG.

Complaints Procedure