acuiti management intelligence

The Impact of MiCA on Crypto Market Surveillance: Insights and Challenges

IN ASSOCIATION WITH

EVENTUS

Table of Contents

Introduction

The European Union's Markets in Crypto Assets Regulation (MiCA) is the first comprehensive framework governing digital assets to be introduced by a major regulatory jurisdiction. The framework has been approved by the European Parliament and was endorsed by the European Council in spring last year. ESMA is currently consulting on technical standards that it intends to submit to the European Commission for endorsement by the end of this year at the latest.

Despite that timeline, most market participants now have a good view of many of the requirements being imposed on them. While the framework tracks much of the EU's MiFID II rules, there are still points of ambiguity and operational challenges that firms are working through. This process has added complications as national regulatory authorities transpose MiCA into local law.

Regulations of this size always create complexities. What makes MiCA different is that, for many native crypto firms — companies that were specifically created to provide crypto services — this will be the first time they have come into scope of a major regulation.

While MiCA represents an operational lift for TradFi firms, the challenge for native crypto firms is significantly harder.

Despite being welcomed by many in the industry, MiCA will introduce a higher cost structure for native firms that are in scope. It will also fundamentally change the nature of day-to-day operations for many.

As firms prepare for MiCA, they are looking to build and support infrastructure that can control the costs of compliance and ease the operational burden as much as possible.

In partnership with Eventus, Acuiti has undertaken a survey and conducted interviews with 68 firms active in crypto trading covering exchanges, proprietary trading firms, hedge funds and the sell-side in the native crypto and TradFi markets — exploring their views of MiCA and the impact that it will have on market surveillance.

This report investigates where they foresee the greatest compliance challenges in implementing the market surveillance requirements in MiCA. With the final technical standards still being written, there remains some uncertainty over which firms are in scope for MiCA. Central to this is the definition of "financial instruments", which are exempt from MiCA and subject to MiFID II. It is expected, but not yet confirmed, that derivatives will fall into this exemption.

Therefore, there remains relatively high levels of uncertainty in the market as to which firms will be in scope. In addition to this, there is, in some areas of the market, a lack of awareness over the regulation and its implications, particularly in the UK.

Within the crypto industry, many firms, both TradFi and native, have already established systems that monitor for market abuse. In fact, a major finding of this report is that the move to more sophisticated market surveillance in the crypto industry is already well underway, regardless of regulatory directives.

Overall, institutional crypto market participants are supportive of MiCA, and welcome regulation in general. This has long been seen as an essential step in creating credibility for the market and attracting new sources of flow, particularly from institutional investors.

However, jurisdictions are moving at different paces and adopting very different approaches. The EU boasts the most developed framework with MiCA, aiming to cover each stage of the digital asset lifecycle — taking in elements such as issuance, market abuse and ongoing market compliance.

In a number of jurisdictions, such as Singapore, Hong Kong, and the United Arab Emirates, authorities have also taken proactive approaches to regulating crypto markets, with robust licensing requirements and AML frameworks. The strengths of such frameworks are already attracting crypto service providers to set up shop in these jurisdictions.

The US has, until now, differed — favouring an enforcement-led approach. However, within the confines of market surveillance, malpractice is still covered by multiple rules governing securities, commodities, and derivatives trading.

Against that backdrop, many firms are deciding to get ahead of authorities and implement credible market surveillance systems that give investors and their clients the confidence and security to trade digital assets.

For most firms, this represents best practice and a means of growing the market rather than a response to regulatory mandates. Building out market surveillance systems is an essential step towards the creation of a vibrant, mature market no matter the jurisdiction and its respective regulatory framework.

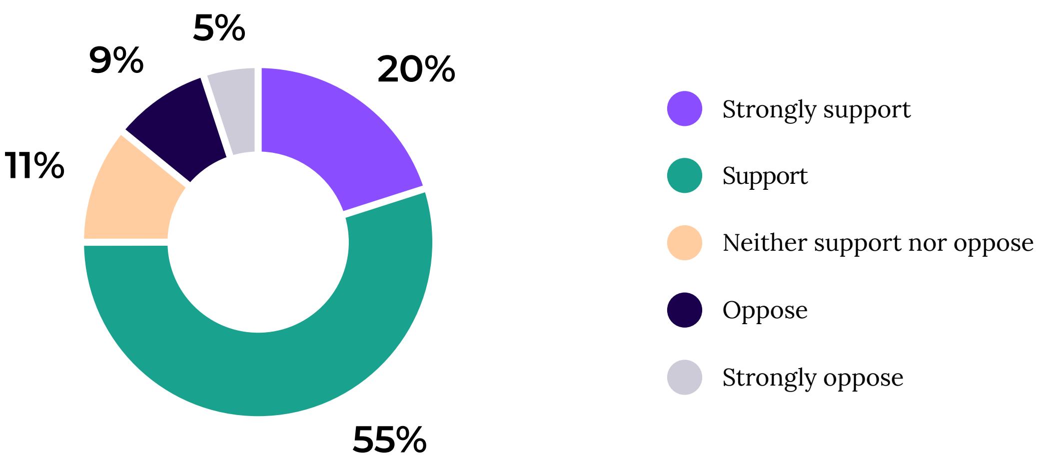
Key Findings:

- A move to establish market surveillance systems is taking place across the industry, including among 57% of the firms that don't expect to be covered under MiCA
- 25% of firms that expect to be covered by MiCA have not begun preparations, while only 9% say they are fully ready to go
- 39% of firms covered by MiCA are either planning to put trade surveillance systems in place or investing further in current systems
- 64% of firms coming under MiCA are planning to use third-party software for their market abuse and transaction monitoring processes
- 37% of firms coming under scope for MiCA are looking at upgrading their market surveillance systems in the next 12-18 months
- Insider trading has been identified as the most challenging form of market abuse to detect in crypto markets by 64% of survey respondents
- Finding skilled surveillance staff has emerged as a major challenge of establishing MiCA-compliant surveillance systems, as reported by 73% of survey respondents
- This challenge has been augmented by the differences between crypto and TradFi market structure— 71% of respondents cited adapting to these nuances as a major challenge

Getting ready for regulation

Digital asset market participants are enthusiastic about MiCA, which promises to create a clear regulatory framework for the asset class that could unlock institutional investors' participation. Three quarters of survey respondents supported the framework, with 78% of those who strongly supported it coming from the native crypto markets.

Overall, what is your view of MiCA?



While EU authorities are enjoying goodwill in their efforts to establish a framework, they still face significant challenges from crypto markets that move faster than the passage of legislation.

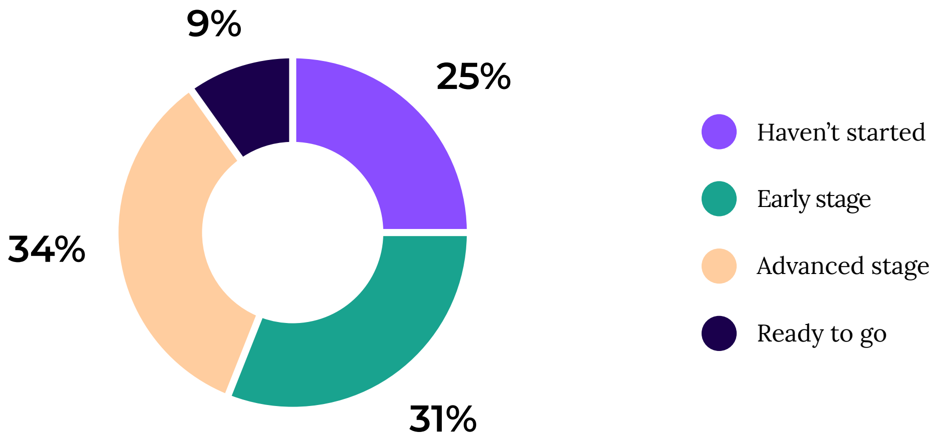
Steps towards MiCA began in 2019, in reaction to Facebook's attempt to launch its own currency, Libra. The market has evolved significantly since then, rendering some aspects of MiCA, such as ICOs, which once generated considerable excitement, largely obsolete. That should be caveated with the possibility that MiCA could reinvigorate activity in these assets through the establishment of a regulatory framework in which new issuances can be developed with greater market confidence.

In line with other financial frameworks, such as MiFID II and MAR — both of which MiCA draws heavily on — preparation has been a long and steady process, involving supranational and local bureaucracy, and extensive consultation with regulators.

With consultations still ongoing on the final technical standards, one quarter of those coming into scope had not yet started preparation. Just under a third were at an early stage of preparation, while just over a third were at an advanced stage. Only 9% said that they were ready to go.

There is also a significant level of uncertainty among many firms that trade crypto as to whether or not they come under MiCA. Notable proportions of the hedge funds, proprietary trading firms and asset managers surveyed for this report either didn't think or didn't know if they had to comply with MiCA.

At what stage are you at in terms of your preparation for MiCA?



In part this likely reflects the use of derivatives in many of these firms' European-based crypto strategies, which are covered by MiFID II and MAR and expected to be exempted under the "financial instruments" exemption in MiCA.

However, it also speaks to the global structure of crypto trading, with the majority of transactions taking place on venues outside of the EU. Firms in scope for MiCA will either be based in the EU and trading or offering trading in instruments that are in scope, or will be marketing and offering such services to EU-based clients.

While 44% of the firms that were surveyed for this study said that they were not in scope for MiCA currently, almost 40% of those firms said that they expected to come into scope at some point in the future.

Challenges of preparation

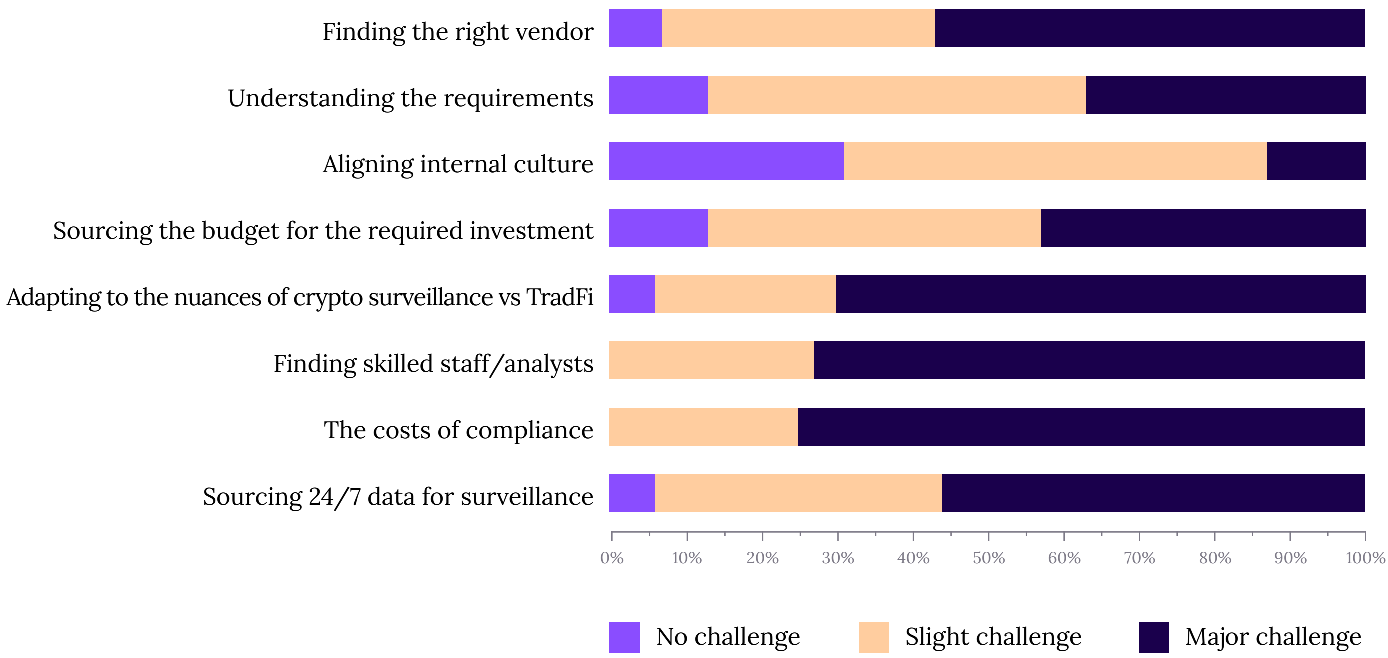
Preparation for MiCA constitutes a different set of challenges for firms depending on where they sit in the ecosystem that MiCA covers. For TradFi exchanges offering cryptocurrency services, readiness is mostly a question of licensing at this stage. For many native crypto firms, it represents the first time they have had to deal with a major piece of financial legislation.

From a market surveillance perspective, some will be more prepared than others. In recognition of both the inevitability of regulation across major jurisdictions and the need to attract institutional flow, many firms have already built systems to monitor for market abuse.

For those who have taken this route, the process has not been without challenges. Principal among these has been recruiting the right teams to build and run market surveillance systems. Finding staff that boast the right combination of both crypto knowledge and market surveillance experience has traditionally been hard to come by. Although some interviews indicate that this pressure is easing, talent shortages in surveillance have been a long-standing challenge in both crypto and TradFi.

MiCA is set to create even more strain on this front, as firms will need market surveillance teams that have knowledge of MiFID II and MAR or that can get up to speed on them quickly.

How challenging do you think the following will be in terms of putting in place the surveillance processes required to comply with MiCA?



This long-standing problem of finding skilled staff and analysts was one of the major surveillance challenges identified by survey respondents, second to the general costs of compliance. Both reflect the extensive and complicated nature of modern regulation in traditional finance — especially for firms confronting this for the first time.

A high proportion of survey respondents also foresaw challenges in adapting to the specific nuances of crypto surveillance as compared to the requirements and processes in TradFi.

Factors such as the absence of 24/7 trading have already raised complications for native firms considering trading on TradFi venues that offer crypto derivatives contracts. Closer to the topic of market surveillance, insider trading has been shown to contain some very different characteristics in TradFi compared to cryptocurrency markets.

Market surveillance systems

A crucial part of MiCA is ensuring the integrity of crypto markets by detecting and preventing market abuse. So far in the life of cryptocurrencies, market abuse patterns have broadly developed on similar lines to traditional asset classes. Techniques used to manipulate pricing and execution include order manipulation, wash trading and pump-and-dump schemes.

As such, MiCA's rules on market abuse and manipulation closely resemble those of MAR, with the former constituting a lighter version of the latter. This accounts for the higher proportion of smaller firms in the crypto market, which may not be able to support the administrative burden of a full MAR equivalent. The similarity between the two is also good news for firms that are already MAR compliant, who face a lighter lift complying with the new regulation.

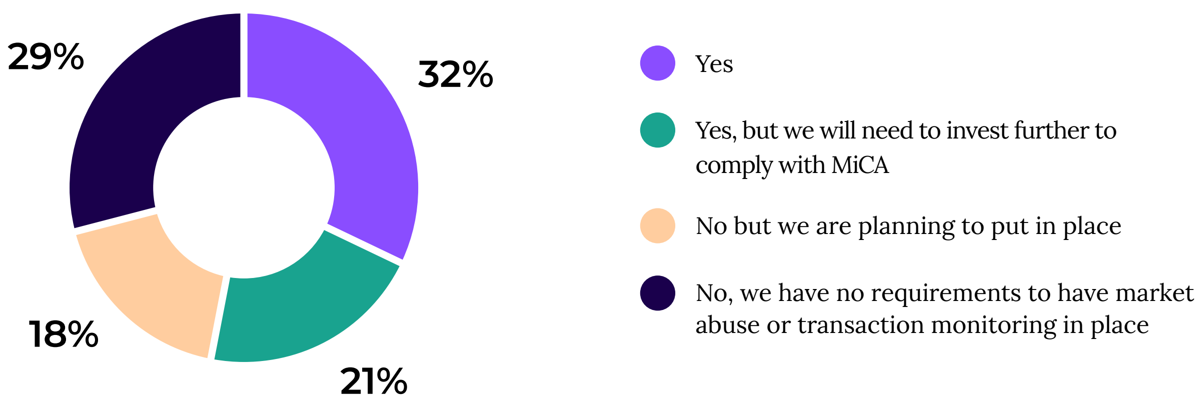
For firms coming under MiCA, readiness for market surveillance varies. While 53% of survey respondents reported already having systems in place to detect and prevent market abuse and monitor transactions in their crypto trading operations, about 21% needed to invest further to comply with MiCA. 18% of firms coming into scope for MiCA were planning to put market surveillance systems in place.

Overall, it is clear that MiCA will require an upgrade to many systems. Survey respondents indicated that they anticipated needing to invest in their surveillance infrastructure, particularly in capabilities for monitoring and detecting insider trading and broader market abuse, due to MiCA requirements. Some also reported needing to adapt their code and algorithm criteria, in order to identify new methods of market abuse.

However, it is also notable that even in advance or absence of a finalised regulatory framework, crypto firms have recognised the need for market surveillance systems and their necessity to the market's evolution — independently of regulation. While the proportion of firms with no requirements for market abuse systems was higher among firms that said that they were not in scope for MiCA, 57% did have such infrastructure already in place.

Firms preparing for MiCA

Do you currently have systems in place to detect and prevent market abuse and monitor transactions relating to your crypto trading operations?



Market surveillance challenges

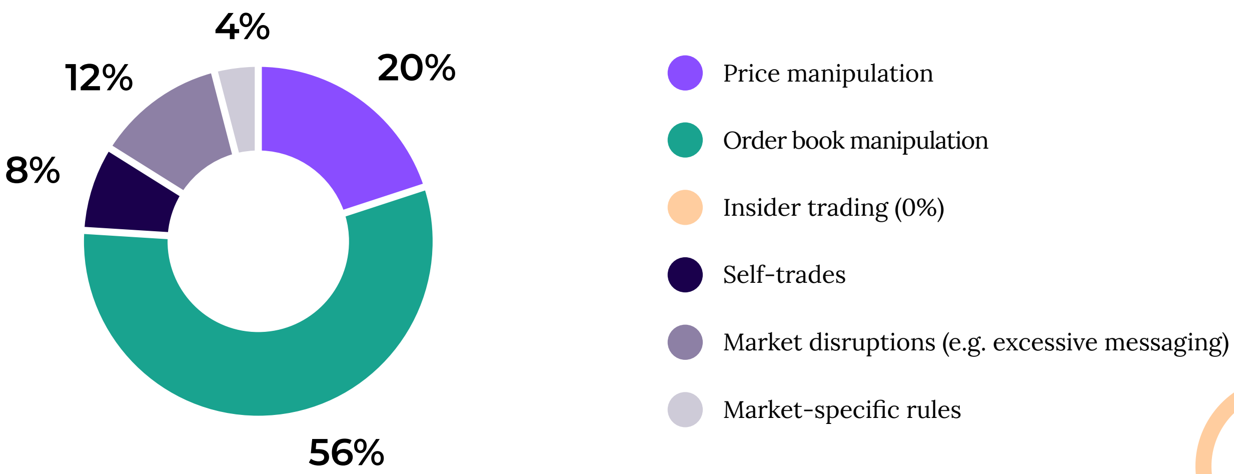
While patterns of market abuse in crypto largely reflect those in TradFi, the characteristics of the market present unique challenges.

Survey respondents identified order book manipulation as the easiest type of market abuse to detect. However, it should be noted that order book manipulation has been relatively rare in native crypto venues where retail has dominated the liquidity profile. These market participants generally lack the sophistication to deploy order book manipulation techniques.

That said, layering is a common pattern on these venues — a result of many crypto exchanges not allowing clients to change their orders. This means that traders often legitimately pull and replace orders. It is also a pattern most observed among market-makers, who need to rebalance their orders when they quote on both sides of the book. Price manipulation was also identified as relatively easy to detect in crypto markets.

By contrast, insider trading was identified as the hardest type of market abuse to detect, and by a high margin. Here, the decentralised

Which of the following types of market abuse do you think you can most effectively detect in crypto trading?

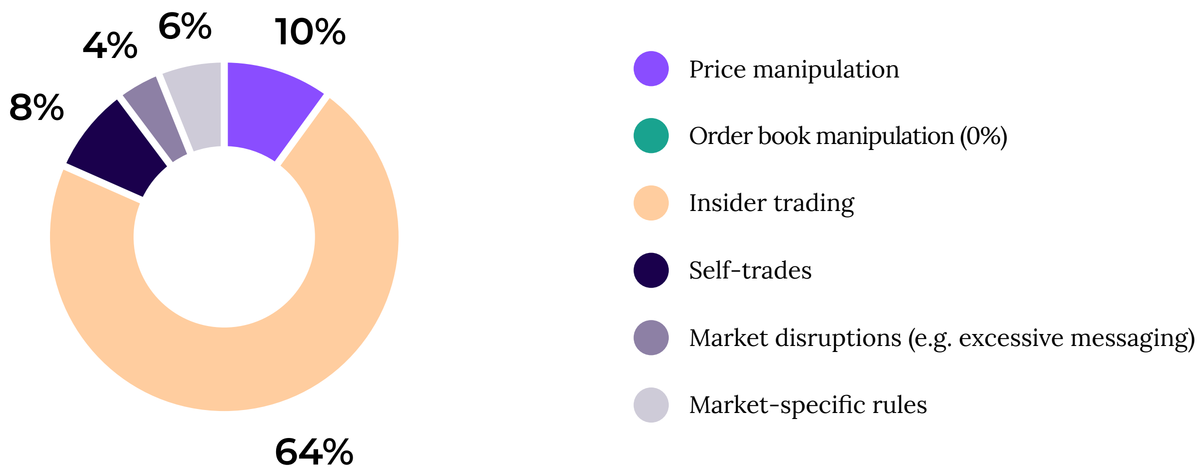


nature of digital assets can create challenges, in contrast to TradFi markets, where insider trading is typically confined to one product, such as cash equities, and revolves around a relatively limited pool of information sources, such as quarterly earnings reports or company press releases.

The decentralized and often anonymised nature of crypto trading markets makes insider trading a lot harder to detect. The global reach of crypto trading also adds to the difficulty of tracing information leakage, with traders able to access different sources of information and so many different marketplaces around the world. This can make it easier to time trading activity with the launch of a new coin.

This is typified by the challenge of monitoring off-chain data (external to the blockchain) and on chain data (transaction data within the blockchain), which increase the number of factors to consider when investigating insider trading.

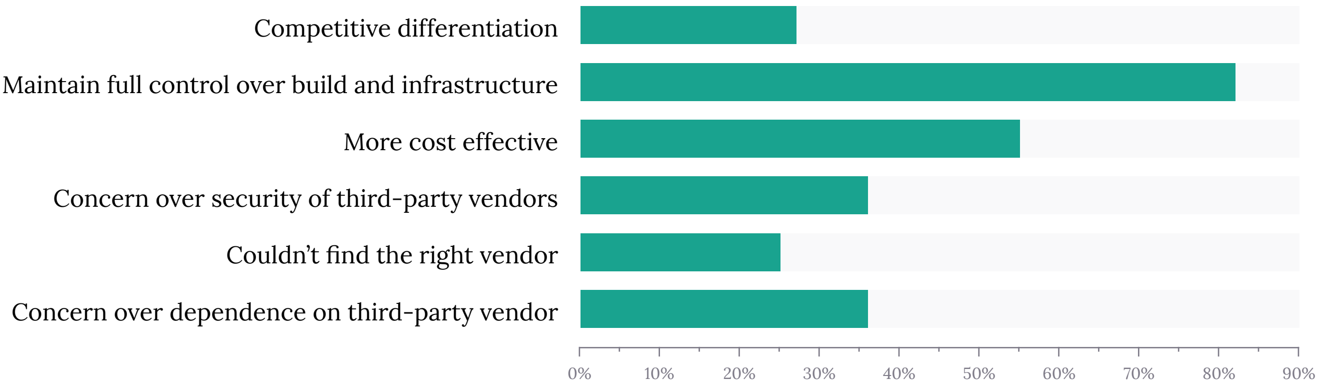
And which of the following types of market abuse do you think are most difficult to detect?



Structuring the right market surveillance operations for MiCA

Similar to TradFi, a key decision for firms integrating market surveillance systems is whether to build the infrastructure in-house or outsource it from a third party. Firms that take the in-house route most often do so to maintain full control over the build and infrastructure. Survey respondents also believed it to be more cost-effective and cited concern over the security of third-party vendors and dependence on them.

Why do firms choose to build surveillance systems inhouse?

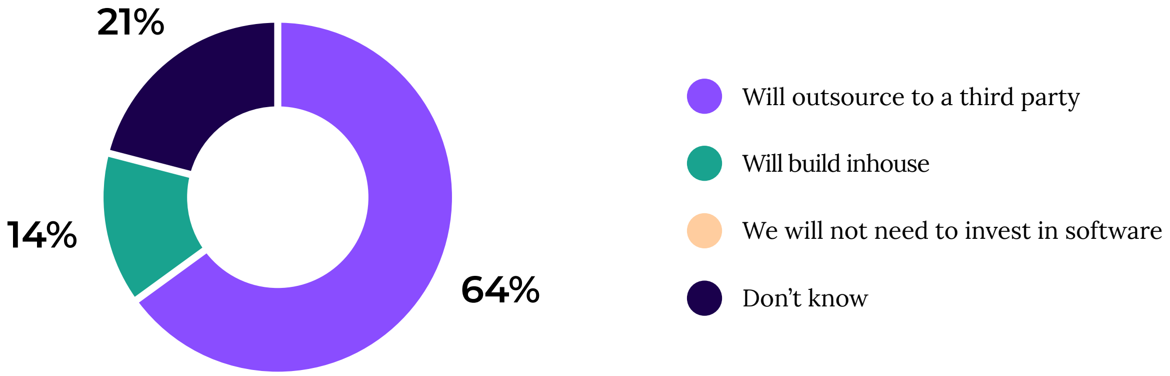


In a more MiCA specific context, some survey respondents perceived the market to be lacking software solutions that ensured full compliance with every MiCA requirement.

Working with a third-party vendor has its own advantages though, such as greater control over total cost of ownership and speed of installation. In TradFi markets, a strong reason for taking the outsourced route has been regulators' familiarity with these systems.

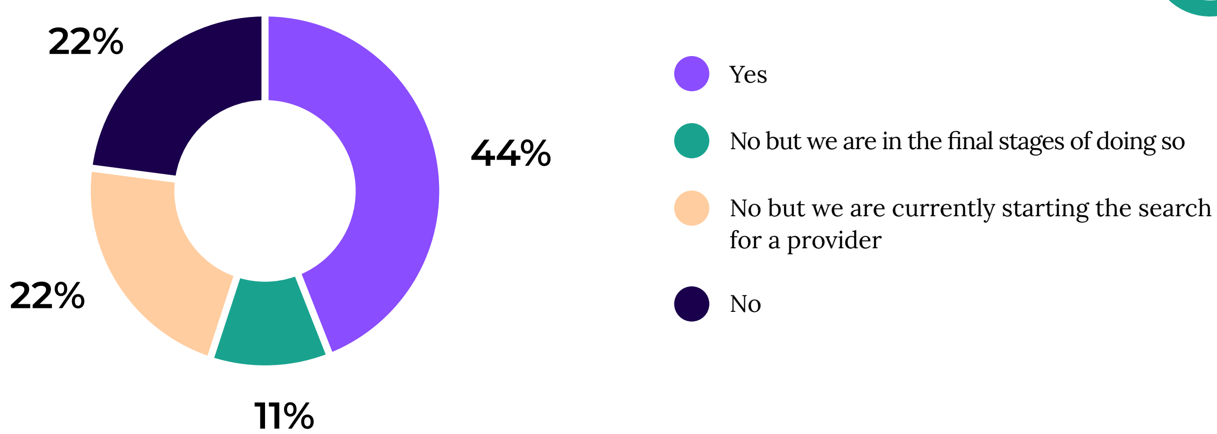
As TradFi and native intermediaries and markets begin to overlap, with TradFi exchanges offering crypto products, similar regulatory frameworks emerging and crypto firms looking to offer TradFi services (and vice versa), this trend is also likely to take hold in crypto markets. Many businesses that already feature MAR compliant platforms can pivot

How will you source the software required to develop market abuse and transaction monitoring processes under MiCA?

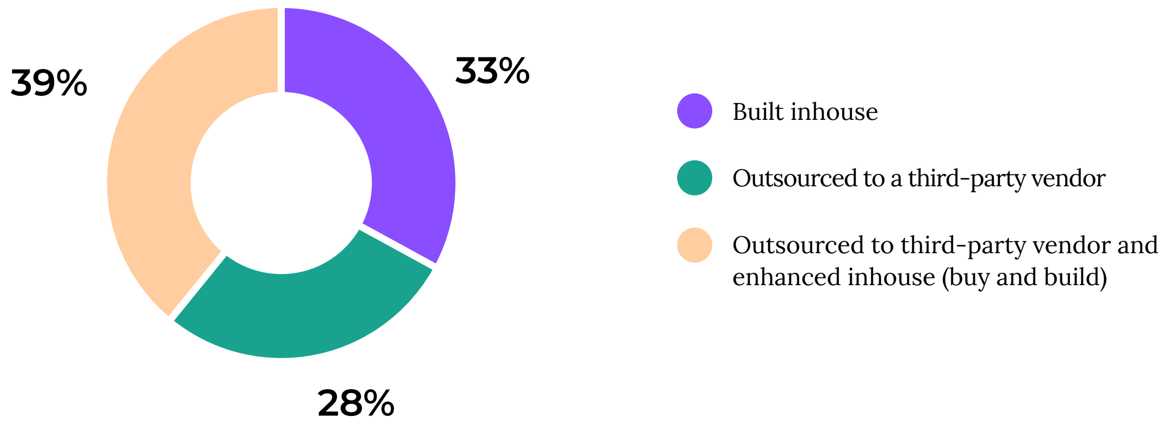


to a MiCA offering with relative ease. In fact, greater comfort with third-party systems is already emerging. Of those firms preparing for MiCA and planning to put a market surveillance system in place, most were opting for a third-party model with their crypto operations — suggesting that there is an emerging trend towards outsourcing market surveillance software for crypto to a third-party vendor. Given the operational burden of hiring skilled surveillance staff — both the engineers that build and maintain systems and analysts with the necessary expertise in regulatory developments and surveillance norms — third-party options have been the most efficient option for many respondents.

Have you already selected the vendor that you will use?



How do you currently source your software for trade surveillance for crypto markets?



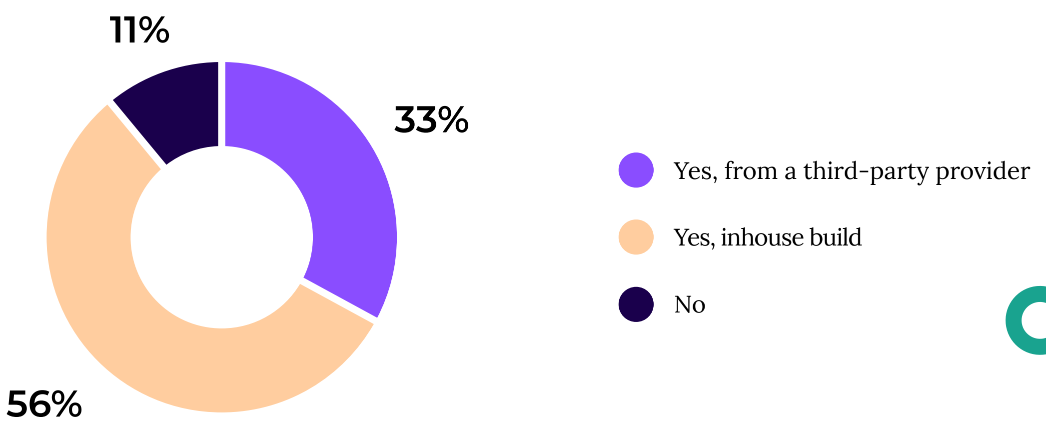
Third-party offerings are also often operationally quicker to get running. Over half of those preparing for MiCA had either selected a vendor to work with for their market surveillance responsibilities or were in the final stages of doing so.

For those survey respondents already operating surveillance systems, one third built in-house, with a lower proportion fully outsourcing to a third-party vendor. However, the highest proportion were choosing a buy and build option — marrying the cost and operational advantages of third-party software with customisability.

Clearly, the movement towards market surveillance systems is already in swing, regulation aside. A majority of firms preparing for MiCA — 73% — had invested in trade surveillance software over the past three years.

These recent investments are reflected in the 58% of respondents that said they were not planning on upgrading systems in the next 12-18 months. However, perhaps in a sign of the requirements that MiCA and future regulation in other jurisdictions will introduce, 37% were considering making further investments in market surveillance in the next 12-18 months.

Has your organisation invested in trade surveillance software over the past three years?



Conclusion

Crypto markets are rapidly maturing, as regulatory frameworks are developed across the globe. At the same time, many firms are taking measures of their own to increase the credibility of digital assets and their offerings to clients. One of the main routes to achieving this goal is establishing systems to identify and stamp out market malpractice.

Any credible regulation will contain measures to combat market abuse. In this respect, MiCA has signalled the direction of travel that other jurisdictions will take as they develop more comprehensive frameworks for regulating crypto.

However, as this report shows, many crypto firms are making moves of their own to develop market surveillance systems — independently of regulation. This is not to minimise the importance of regulation, which will impose significant new requirements on such systems. But it does show that the importance of defending against market abuse is increasingly recognised across the crypto industry.

These two trends — the increasing incursion of TradFi regulatory norms on crypto and a broad recognition within the industry of the need for market surveillance operations — are set to increase demand for solutions that marry expertise in both worlds.

Given longstanding problems of sourcing surveillance teams in crypto, an increasingly tight timeline for MiCA compliance and the growing sophistication of third-party systems on offer to the crypto market, investment in outsourced third-party market surveillance software is likely to be a growing trend for both crypto native and TradFi firms in the next phase of the market's evolution.

acuiti management intelligence

+44 (0) 203 998 9190
acuiti.io
info@acuiti.io