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BLOCKCHAIN & FINANCIAL MARKETS: the European Commission takes a step in favour of innovation

On 24 September 2020, the European Commission published, as part of its digital finance package, a proposal for a pilot regime for certain financial activities based on the blockchain technology[1]. This project aims to position the European Union as a jurisdiction of reference in this field through an unprecedented regime of targeted exemptions in support of the development of the ecosystem created around financial securities recorded in blockchain (*security tokens*). An analysis of this proposal's content confirms its pioneering character.

Since the creation of Bitcoin in 2008, the use of blockchain and the related market for crypto-assets have evolved considerably. Initially reserved for specialist experts, this technology seems to have broadened the scope of interested players. An increasing number of companies, and in particular, several well-known banking and financial institutions, have already announced the launch of concrete projects to explore the opportunities it offers.

Indeed, blockchain's distinctive feature is that it can be used as a distributed ledger, in particular to record securities (*security tokens*) and their transfers. In the financial sector, the main advantages of blockchain include its ability to combine (i) easy transferability of securities registered on it, with (ii) increased transparency on the movements of such securities, for a potentially wide range of stakeholders.

The prospects offered by this technology thus constitute a strategic development avenue for certain types of securities, so far illiquid. Indeed, it enables transfers to be structured on the secondary market, without being held back by the challenges of register-keeping and the need for direct visibility of the issuer on the security holders. This is particularly true for securities issued by certain SMEs, or for the private equity industry.

These prospects are also of interest to the liquid securities market, particularly for listed securities. Here, one of the main challenges is to assess the contribution of blockchain technology (in particular of its distributed nature) in the light of the missions of various financial intermediaries whose role has been, to date, to ensure the security and transparency of securities transfers, which are by definition numerous and frequent in this sector.

Despite these prospects, many stakeholders still identify two hurdles to the development of the use of blockchain technology in the financial field: on the one hand, the lack of clarity on applicable rules, and on the other hand, the incompatibility of some of these rules with this technology.

With these arguments in mind, the European Commission decided to act. As part of its work on digital finance[2], it published various texts on 24 September 2020[3], including a proposal of a new "pilot regime" for security tokens, designed to provide for targeted regulatory exemptions to support the development of blockchain use in the financial sector.

What can the financial industry expect from this approach? To answer this question, it is useful to review the genesis of the European Commission's proposal (**1.**) before turning to its content (**2.**).

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[1] Distributed ledger technology.
[2] European Commission, Digital Finance Package, 24 September 2020.
[3] European Commission, Proposal for a Regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology, 24 September 2020.

1. GENESIS OF THE EUROPEAN COMMISSION'S PROPOSAL FOR A EUROPEAN PILOT REGIME FOR SECURITY TOKENS

The European Commission's proposal is part of its work programme defined at the beginning of 2020, after the reorganisation of its members in December 2019. The European Commission thus aims to ensure that "Europe [is] fit for the digital age"[4]. Its objective is in particular that "Europe can truly influence the way in which digital solutions are developed and used on a global scale" and that it is thus "a strong digital player, independent and constructive in its own right"[5]. To achieve this objective, the European Commission announced that it wished to set forth reforms on crypto-assets before the end of 2020.

This strategy has been defined at a time when many states are positioning themselves to make digital stakes and especially those linked to blockchain in the financial sector, a driver for attractiveness and strong international competitiveness. Non-European states such as the United States come to mind, where the authorities have agreed to remove certain regulatory constraints to allow the issuance of security tokens on their territory[6]. Some European states also come to mind, whose pioneering initiatives unfortunately remain isolated, and were held back by the limitations set by the European regulatory framework and the lack of a harmonised framework in a so-called "single" market.

France, in particular, very early set itself apart with an unprecedented approach to crypto-assets[7] and the use of blockchain in the financial field. As of 2016, France recognised the possibility to register and transfer certain blockchain-registered securities. Recently, France's Financial Markets Authority (Autorité des marchés financiers, or AMF) also called for the establishment of a European digital laboratory[8] to go further and enable the development of digital finance. This proposal was formulated precisely to nourish discussions underway at the European level on the reforms needed to support the development of the use of blockchain in the financial sector. This digital laboratory has been designed to allow, at European level, certain players, under certain conditions, to apply for exemptions from regulatory obligations currently in force if such obligations prevent the development of some of their innovative initiatives related to security tokens. The purpose of these exemptions is thus twofold: on the one hand, allow testing of the economic relevance of concrete projects, without being limited by the regulatory framework in force; and on the other hand, better identify the regulatory provisions preventing the development of these projects, in order to target precisely and on the basis of concrete examples, the reforms necessary for the development of blockchain-registered securities.

The approach proposed on 24 September 2020 by the European Commission with this pilot regime is very close. The similarity between the objectives of the European digital laboratory and the pilot regime makes it likely that the AMF's proposal played a decisive role in developing the European Commission's suggestion. Similarly to the AMF's proposal, the European Commission's pilot regime aims to define an EU framework that is favourable to innovation and compatible with the use of advanced technologies, including blockchain[9].

An analysis of the details of this proposal provides a better understanding of how this pilot regime could effectively serve this purpose.

2. CONTENT OF THE EUROPEAN COMMISSION'S PROPOSAL FOR A PILOT REGIME FOR SECURITY TOKENS

The European Commission is proposing the establishment of a regulatory framework that will conditionally allow financial players to be exempt from regulatory constraints. According to the European Commission, this proposal must overcome four main challenges: ensuring legal certainty, supporting innovation, ensuring investor protection and market integrity, and ensuring financial stability.

[4] European Commission, Work Programme, January 2020.
[5] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: "Shaping Europe's digital future", 19 February 2020.
[6] See, for example, the use of no-action letters by the Securities and Exchange Commission.
[7] In this respect, see in particular the regime introduced for providers of services on digital assets (PSAN) and the offers at the public of tokens (ICO) in the PACTE law (Law no. 2019-486 of 22 May 2019).
[8] AMF, review and analysis of the application of financial regulations to security tokens, March 2020.
[9] European Commission, Proposal for a regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology, 24 September 2020, p. 1.

In response to these challenges, the pilot regime set forth by the European Commission would introduce, for certain market infrastructures (**2.1.**), a system of targeted exemptions (**2.2.**), under the supervision of national and European authorities (**2.3.**).

2.1 Scope of application: blockchain market infrastructures and their operators

The pilot regime would target the market infrastructures likely to be involved in the issuance and the exchange of security tokens. These would include multilateral trading platforms as well as securities settlement systems, since these infrastructures are based on blockchain technology.

The exception regime described below (see section 2.2.) would thus apply to their operators, namely: (i) for multilateral trading platforms: an investment firm authorised under MiFID[10] or market company, and (ii) for securities settlement systems: a central securities depository within the meaning of CSDR[11].

Moreover, the framework of exception thus introduced would only benefit activities related to security tokens in the form of shares or bonds (excluding sovereign bonds), provided that (i) for the former, their capitalisation does not exceed EUR 200 million and (ii) for the latter, the issue volume does not exceed EUR 500 million. In addition, the activities of a same infrastructure ensuring the blockchain-registration of securities and benefiting from this regime should not exceed in aggregate EUR 2.5 billion. These volume restrictions would meet the challenges of financial stability of such a regime.

Lastly, it should be noted that the other categories of financial instruments, i.e. stocks or shares of collective investment entities and derivative contracts, are not covered. This is certainly a consequence of the non-inclusion of these instruments in the European concept of "transferable securities", enabling them to not come into conflict with the regulatory provisions identified by the European Commission as preventing the development of market infrastructure using blockchain.

2.2 Regulatory Innovation: targeted exemptions

In essence, market infrastructures using blockchain and eligible for the pilot regime may request to be exempted from certain obligations that should apply to them, and that are specifically targeted in the proposal. The obligations from which derogation would be permitted would arise mainly from CSDR[12].

Among the provisions for which exemption may be sought is the requirement for securities admitted on trading platforms to be registered in an account with a central securities depository or the cash payment obligation applicable to securities settlement systems operated by central securities depositories.

These obligations correspond to the provisions identified so far as hindering the development of the use of security tokens, in particular because they prevent admission on a trading platform. These provisions are considered as hampering the structuring of a secondary market for this new form of securities, thus hindering their liquidity and therefore their attractiveness for investors.

With these exemptions, multilateral trading platforms could admit blockchain-registered securities, whether this registration is made by the platform itself (and thus without requiring any central securities depository) or by a central securities depository operating a securities settlement system of securities based on blockchain. Note that the pilot regime seems to require that the underlying blockchain be the "owner", without this term being precisely defined but which seems opposed to fully or partially public blockchains.

To benefit from these exemptions, various conditions would have to be met. Thus, eligible operators of blockchain market infrastructures should apply for a specific authorisation. This authorisation would involve meeting specific requirements in addition to the authorisation procedure currently in effect. These specific requirements would include:

- the provision of a business model and a detailed description of the proposed activity, as well as the internal organisation set up;

[10] European Directive 2014/65/EU.
[11] European Regulation 909/2014.
[12] European Regulation 909/2014.

- a demonstration of all the compensatory measures put in place to achieve the objectives pursued by the various regulatory obligations, from which the operator is asking for exemption;
- for central securities depositories and, where applicable, for operators of multilateral trading platforms that ensure the blockchain-registration of securities, the description of the operation of the proprietary blockchain they are using; and
- a description of the transition strategy that would be put in place if/when the benefit of the regulatory exemptions were to be/would be terminated.

This authorisation would be granted for a maximum period of six years and would be valid throughout the entire European Union.

2.3 Supervision of the regime : a joint involvement of national and European authorities

The specific authorisation referred to above should be obtained from a national authority, on the basis of a demonstration that the conditions specified above have been met.

This national authority could only decide to grant such authorisation after having notified the European Securities and Markets Authority (ESMA), in particular by sending it all the information it requires on the requested exemptions and the compensatory measures considered.

On the basis of this notification, ESMA should provide a non-binding opinion within three months on the appropriateness of the exemptions granted, taking into account the need for a consistent approach between Member States and the proportionality of the granted exemptions.

In order to ensure the transparency of the overall scheme, ESMA would be required to publish a register of those blockchain market infrastructures having requested such authorisations, their validity dates and any exemptions granted.

Lastly, authorisations could be withdrawn by the competent authorities, in particular in the event of a malfunction of the underlying blockchain.

With the publication of its proposal for a pilot regime, the European Commission proposes for adoption by the European Union of a pioneering and innovative mechanism to support the development of blockchain in the financial field. Negotiations underway and up to the final adoption of the text must be an opportunity for all stakeholders to ensure that the EU's framework strikes the right balance between the issues of attractiveness, competitiveness, investor protection and financial stability. It is therefore essential that all players come together to actively contribute to the definition of a relevant framework, and to make the European Union and its financial actors using the blockchain a reference in the field of digital finance.

To find out more about the issues at stake in the upcoming pilot regime negotiations, please read our article available here.