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Pilot regime for security tokens: why stakeholders should absolutely get involved

On 24 September 2020, the European Commission published, as part of its digital finance package, a proposal for a so-called "pilot regime" for certain financial activities based on the blockchain technology (or distributed ledger technology). This proposal specifically targets activities related to security tokens and is designed to provide targeted regulatory exemptions to support their development.

In the light of the pilot regime's content (see description here), it is essential to highlight the innovative nature of the approach proposed by the European Commission with regard to the European regulatory framework. To our knowledge, the European institutions have never agreed to provide for targeted exemption systems, even conditionally, to support the development of an innovative ecosystem. The approach should therefore be welcomed with open arms, as it demonstrates a clear political will to position the European Union as a reference in the move to digitise finance.

However, it is debatable whether the proposal, as it stands, will be able to achieve this objective. Four issues in particular seem worth highlighting, so that they can be the subject of particular attention by the stakeholders in the negotiations that will continue until the final adoption of this regime.

These issues relate to the quality of the eligible actors (**1.**), the size of the projects that would be allowed under this pilot regime (**2.**), the nature of the technology they may use (**3.**), the compensatory measures that would have to be implemented in case of targeted exemption (**4.**) as well as the identification of the obligations that could be waived (**5.**).

1. QUALITY OF ELIGIBLE ACTORS: ACCESSIBILITY FOR NEW ENTRANTS

At this stage, the regime would provide for possible targeted exemptions for investment firms operating a multilateral trading platform, regulated market operator and central securities depositories (see description here). This exemption regime would thus only benefit authorised participants as such.

However, the cost of obtaining these authorisations can be significant. For the European Commission, eligibility to the pilot regime would be restricted to existing players of sufficient size and resources. Main existing financial players could thus be given priority.

It is interesting to note that the European Commission's approach in this respect differs from that of the French Financial Markets Authority (AMF). In its proposal for a European digital laboratory, the AMF expressly provided that the benefit of the European exemption regime should be extended not only to "entities that are already regulated and authorised to provide investment and payment services [but, beyond that, also to authorised entities] under schemes covered by specific national authorisations, such as digital asset service providers (DASPs) in France [and] non-regulated entities that offer guarantees of good repute and organisation equivalent to those required for regulated entities"[1].

The AMF therefore considered a much more open system that would allow existing financial market players, as well as new entrants, to take advantage of the pioneering regime to support blockchain trading activities.

Such an approach would certainly foster the emergence of new participants in the financial sector and their diversity. Should the European institutions decide to adopt it, it would be imperative to define the precise requirements that these new, as yet unregulated, participants would have to meet in order to ensure (i) fair

[1] AMF, Review and analysis of the application of financial regulations to security tokens, February 2020.

and proportionate treatment as compared with existing participants and (ii) sufficient safeguards in terms of market integrity and investor protection.

2. SIZE OF ELIGIBLE PROJECTS: THRESHOLDS TO SET FOR FINANCIAL ASSET VOLUMES COVERED BY THE PILOT REGIME

The pilot regime proposed by the European Commission would introduce thresholds in terms of volumes of assets for eligible projects : (i) for shares, a capitalisation threshold of EUR 200 million, (ii) for bonds, an issue volume threshold of EUR 500 million, and (iii) for infrastructures ensuring the blockchain-registration of securities, a threshold of EUR 2.5 billion of overall market value of the securities concerned (see description here).

The level of the thresholds thus defined is debatable.

- One understands the importance of limiting the asset volumes of projects eligible for the pilot regime, mainly for financial stability reasons.

- However, it is also essential not to limit these amounts too much, otherwise there is a risk of undermining the viability of the operations covered by this regime and the competitiveness of the players bearing them. Overly restrictive limits could thus call into question the sustainability of certain projects, whereas the obstacles encountered would not be due to the relevance of the technology but to their inability to reach the volumes necessary for their development over time.

Thus, the definition of these thresholds will undoubtedly be at the heart of future discussions on the pilot regime.

3. NATURE OF TECHNOLOGY: SHOULD PROPRIETARY TECHNOLOGIES BE MANDATORY?

At this stage, we understand that, in the European Commission's proposal, the blockchain on which securities would be registered by the central securities depository, or even the multilateral trading platform, should be a "proprietary" blockchain. The pilot regime would indeed require that such a blockchain be operated by the infrastructures themselves (see description here).

Such a requirement seems to us to excessively limit the scope of the reform proposed by the European Commission. It should be discussed in the forthcoming negotiations, in particular for the reasons set out below:

- Such a requirement is not in line with the reality of many projects borne by financial actors these past few years, where the technology used was mostly public or semi-public. It would call into question the choice of these players, even though it is sometimes justified by the cost of developing private protocols and the interoperability issues they may represent.

- It would result in regulation not being neutral with regard to the technological choice made by the players. It thus differs, without any obvious justification, from several reforms carried out at national level, on the use of blockchain in the financial field, where the legislator has not imposed any specific characteristic on the technology chosen. On the contrary, these reforms have focused solely on the guarantees that this technology should present, whatever its nature. Thus, for example, French law recognising the possibility of registering certain securities on a blockchain merely imposes obligations, particularly in terms of reliability of registrations and continuity of activities, without imposing any particular type of protocol. It thus preserves the freedom of players in this area, without pre-empting

their technological choices, while at the same time addressing the fundamental issues of market security and stability.

- Such a requirement seems to disregard the fact that the development of blockchain projects, particularly in the financial field, implies not only the use of a technology but also an interface to roll out the project to clients. While the technology may be public and open source, the interface is generally managed and operated by the project owner. This interface, and its implementing system, usually makes it possible to offer various guarantees that ensure the overall security and sustainability of the project, despite the use of public technology.

It therefore seems essential to preserve technological neutrality in the European legislator's approach. The pilot regime considered should not impose any restrictions on the technology used that (i) would not be justified in view of the need for security and sustainability of the projects, and (ii) would risk undermining the European Commission's objectives of innovation and attractiveness.

4. COMPENSATORY MEASURES: SHOULD ACTORS PROVE THEIR EFFICIENCY AND RELEVANCE?

Under the pilot regime, each actor eligible for the scheme would be obliged to identify, among the provisions listed by the European Commission, those from which it requests exemption. It would then have to put in place compensatory measures and demonstrate how such measures would meet the purpose of the obligations from which it would be exempted. This demonstration should be convincing not only to the competent authority from which the exemption is requested, but also to ESMA (see description here). While ESMA's opinion would be non-binding, it can be expected that it would nonetheless be decisive, at least in the early stages of implementation of the regime, in the decision that the national authority would take.

Placing such a burden on the actors, prior to obtaining the necessary authorisation to benefit from the pilot regime, should not be underestimated. Here again, the objective is to ensure that such a regime is not in fact limited to too small a number of players. In addition, it will be necessary to ensure that the relevance of the demonstration will be assessed in the light of objective criteria by the authorities, whether national authorities or ESMA.

It should also be noted that this approach would require the authorities, both national and European, to equip themselves with the necessary legal and technological resources to be able to assess, on a case-by-case basis, the relevance of the compensatory measures put in place for each project. In this regard, it is debatable whether these needs might not have an inflationary impact on the estimated budget for setting up the pilot regime with the very authorities that the European Commission is assessing in its proposal[2].

Other approaches are possible to limit the costs to be borne by the actors. The system put in place could have directly provided actors for exemptions from certain obligations, provided that they satisfy requirements pre-defined in the regulations. Compliance with the latter could have been verified by the authorities when the exemption was granted and/or *a posteriori*, in particular considering the regular reporting that the players would have with the authorities during the time the exemption would last. Such

[2] "*The estimated supervisory costs for each Member State (including staff, training, IT infrastructure) can range from €150.000 to €250.000per year per DLT market infrastructure. However, this would be partially offset by the supervisory fees that NCAs would levy on DLT market infrastructures. For ESMA, the estimated cost in relation to review and coordination are estimated at €150.000-300.000 in total, not per DLT market infrastructure, as they will have no direct supervision*.", 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. 8.

an approach, which is certainly more prescriptive, could give stakeholders better visibility on the accessibility of the pilot regime and limit the costs necessary to request it.

Access conditions to the pilot regime should thus strike a fair balance between legibility and costs to be borne by the actors.

5. POSSIBLE EXEMPTIONS: SHOULD EXEMPTIBLE OBLIGATIONS BE PRECISELY DEFINED?

In its proposal, the European Commission has exhaustively listed the provisions for which exemption could be requested (see description here). This list could only be adjusted during the review of the pilot regime, scheduled to take place five years after its entry into force, on the basis of a report to be drawn up by ESMA.

To support innovation, and in a context where it remains difficult to anticipate an exhaustive list of regulatory provisions that hinder the development of the blockchain ecosystem for finance, a more agile mechanism could be considered.

- Thus, a more frequent review of the pilot regime could have been provided for, for example on an annual or semi-annual basis, to adjust the list of regulatory provisions for which temporary exemption would be possible. These provisions could be identified on the basis of feedback from stakeholders (market players, regulators, etc.) and the concrete projects in which they are involved.

- It could have been provided that, beyond the provisions listed in the pilot regime, players would be entitled to request an exemption from any other provision under EU financial law[3], provided that they demonstrate to the authorities that this provision prevents the development of the project and that measures have been put in place to address the potential risks associated with the requested exemption.

Approaches of this type could increase the flexibility of the regime, in support of innovation, in a constantly changing ecosystem.

[3] With the exception of fundamental rules concerning, for instance, combating money laundering and the financing of terrorism or market abuse.