Pilot regime for DLT Market infrastructures

Shortcomings & Improvement Proposals

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Adan and EU Crypto Initiative

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Overview

On September 24, 2020, the European Commission unveiled its proposed "**pilot regime**" for market infrastructures based on distributed ledger technology[1].

The Commission's regulatory proposal is part of its *Digital Finance Package* and, more broadly, of its 2018 FinTech Action Plan. In particular, the Commission has organised public consultations with stakeholders to prepare these drafts. Adan had the opportunity to respond to two consultations: one on the framework applicable to the crypto-assets markets, the other on the FinTech action plan.

During its webinar held on October 7, Adan presented and analyzed the European Commission's proposal. The Association also expressed its concerns about the potential threats this pilot regime poses to innovation.

Adan is thankful to the European Commission for allowing the expression of industry players in this open feedback period. The Association's objectives are to help create the more favourable environment in the EU for the development of a crypto-asset industry competitive with other regions of the world.

This document aims to present solutions with the goal of improving the proposed pilot regime and, thus, promote the competitiveness of the European crypto industry. It was written in conjunction with industry actors in France, but also key players of the crypto-asset industry across Europe, as well as other national associations promoting the use and development of crypto-asset and blockchain technologies on the Old Continent. In particular, positions expressed in this document have been developed in the context of the European Crypto Initiative (EUCI).

Adan is available for any question and further discussions related to this paper.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0594

Introduction

Crypto-assets are improving the existing economic infrastructure worldwide, creating new businesses, helping financial inclusion and providing novel exchange opportunities for both public and private actors. Markets in crypto-assets reflect the growing awareness around such opportunities and the significant traction gained over the last years: the size of tokenized assets markets is estimated to reach 1.4T€ by 2024[2].

The European Commission decided to make financial innovation one of its key priority regarding the importance of making Europe fit for the digital age[3]. As part of the European Union's "Digital Finance" strategy released on 24 September 2020, the European Commission is proposing the creation of a pilot regime for financial instruments issued and traded on blockchain networks ("DLT transferable securities" or security tokens): this transitional regulatory mechanism would (i) allow, along a predetermined period and under conditions, infrastructures to benefit from targeted exemptions of certain requirements imposed by European regulations that are identified as incompatible with technological features of security token activities or not proportionate regarding some obliged entities and (ii) help adjust and build the definitive framework for security token markets based on such experimentation.

This is a significant step in the way of achieving the EU's goal of promoting financial innovation and stopping lagging on the development of the crypto-assets industry behind Asian countries and the USA[4]. Indeed, to be attractive and competitive, the EU must implement harmonized rules for these new markets, but also make the regulatory frameworks and supervisory practices more agile. For years many European actors - **both crypto newcomers[5] and significant financial institutions like Société Générale - are on the sideline, waiting for regulatory clarity to contribute to the growth of security token markets.** The launch of the pilot regime would release the energy and the creativity of the next European unicorns.

However, the current design of the pilot regime raises **significant concerns** likely to prevent the European Commission from achieving their two-fold objective: **building an innovation- and competition-friendly EU regime for security token markets.** The **main shortcomings** identified are:

1. Unequal opportunities between incumbents and newcomers
2. Insufficient proportionality and flexibility
3. Risks to public blockchains
4. Lack of cooperation with the private sector to build in regulation and supervision efforts

[2] Source: Plutoneo Consulting
[3] Ursula Von der Leyen Proposed Program *A Union that strives for more* - political guidelines for the next European Commission, 9 October 2019
[4] The 10 unicorns in the sector are incorporated there, and large-scale operations are happening in those jurisdictions. As an example, the HSBC-Singapore Exchange-Temasek (owned by the Singaporian State) partnership recently successfully executed a $294 million bond issuance on blockchain.
[5] In a recent survey conducted notably by the French professional association ADAN, 42 companies reported that they were implementing security token projects, among them: Equisafe, Société Générale – Forge, GT Equity, Kaiko, OFI, Tokeny and WeFundia. More details on their activities can be found in the synthesis report: https://pages.adan.eu/rapport_security_tokens_cadre_europe_en

Below are provided more details on each of these shortcomings and provide recommendations for addressing such.

I. Unequal opportunities between incumbents and newcomers

To avoid any misuse, authorized participants to the pilot regime must be **limited to actors developing, deploying or using security tokens**. However, this **should include the widest scope possible**: incumbent players from the traditional financial markets wishing to launch security token-related businesses of course, but also start-ups.

Under the current draft, the pilot regime regulation is only accessible to entities already regulated in the EU over current crypto players and newcomers, **which conflicts with the professed aim of being innovation- and competition-friendly**. Only entities authorised under MiFID2/MiFIR or CSDR are allowed to access the security token markets then ask for exemptions to financial regulations.

This monopoly to both develop security token activities and benefit from the pilot regime will force crypto newcomers to become incumbents themselves, even though this regime is supposed to promote innovation. In addition, as the pilot regime is based on a binary logic (i.e. regulated or unregulated activity), this leaves little room for experiments and heavily delays any newcomers' initiatives as the company must necessarily wait to get a regulatory status.

We understand - and share - the rationale of the European Commission but we propose a different method:

- **Participants must provide appropriate guarantees**, notably with regards to investor protection and financial stability, to benefit from the pilot regime. However it seems that an easy shortcut was found in limiting the pilot regime to already regulated entities. If the rationale behind the pilot regime is (i) to grant exemptions based on the advantages brought by blockchain technologies and (ii) to help innovative newcomers to build security token markets, **such appropriate guarantees should not only rely on regulatory statuses but also on new opportunities that blockchain technologies unlock to comply with the key principles of financial regulations.**

- **The pilot regime must be structured to avoid regulatory arbitrage, unfair competition and systemic risks for the financial system**. However such goals should not be achieved at the expense of newcomers. **Limiting authorised participants to regulated incumbent actors is a simplistic solution that will hamper any innovative efforts from crypto entrepreneurs.** This even gives rise to **legitimate doubts that traditional actors will develop security token markets** as they can rely on their existing infrastructures today and won't be encouraged to innovate if they do not fear any competition from some novel entrants.

Proposed adjustments: Open security token markets and exemptions proposed in the pilot regime to all actors - irrespective of their regulatory status - that would comply with requirements set in the pilot regime regulation. Indeed regulated entities under MiFID2/MiFIR or CSDR should

also provide guarantees regarding some elements that were not covered in their registration process, such as their level of expertise and experience in the crypto-asset sector (security tokens or other categories), their past activities, the history of technical developments on crypto-assets, etc.

- The following definitions in PRR, article 2 §3 and §4 should be adapted:

'DLT multilateral trading facility' or 'DLT MTF' means a 'multilateral trading facility', operated by an investment firm or a market operator **or any person authorised by the national competent authority**, that only admits to trading DLT transferable securities and that may be permitted, on the basis of transparent, non-discretionary, uniform rules and procedures, to: [...]

'DLT securities settlement system' means a securities settlement system, operated by a 'central securities depository' **or any person authorised by the national competent authority**, that settles transactions in DLT transferable securities against payment;

- An article 3bis should be added that states the conditions under which an actor that is not regulated under the existing financial regulations can be authorised by the national competent authority to operate a DLT MTF or a DLT CSD, such as:
  - Obligation to act honestly, fairly and professionally in the best interest of clients and information to clients
  - Prudential requirements (to be designed in a proportionate way)
  - Organisational requirements
  - Safekeeping of clients' DLT transferable securities and funds
  - Complaint handling procedure
  - Prevention, identification, management and disclosure of conflicts of interest
  - Outsourcing: policy, written agreement with the third party, prevention of operational risks
  - Minimum knowledge and know-how regarding blockchain and crypto-assets: level of expertise and experience in the crypto-asset sector (security tokens or other categories), their past activities, the history of technical developments on crypto-assets, etc.

- Iterations of "An investment firm or market operator operating a DLT MTF" should be replaced by "**The operator of a DLT MTF**".

- Iterations of "A CSD operating a DLT securities settlement system" should be replaced by "**The operator of a DLT securities settlement system**".

II. Insufficient proportionality and flexibility

The pilot regime lacks proportionality and flexibility.

First, *regarding possible waivers*. It is obvious that exemptions must be limited and directed towards rules that are deemed to be (i) incompatible with the functioning of security tokens markets or (ii) not sufficiently proportionate regarding the size and the stage of development of actors.

However, **possible exemptions to other financial regulations should not be strictly listed and limited in a level 1 text as we cannot anticipate all regulatory deadlocks that constant and fast innovations could encounter in the (even near) future.** Moreover, no exemptions are currently based on proportionality criteria. On the contrary, as said previously, proportionality is totally eradicated as only regulated entities can access the pilot regime. **Exemptions should take into account the size and maturity of actors**.

Second, *regarding the cap for activities of participants in the pilot regime.* The current levels defined for authorised DLT transferable securities on the one hand, and their market capitalisation / issuance size on the other hand, are very weak. **This is likely to leave many actors on the wayside of the pilot regime and to discourage others as they will fear to activate their transition strategy quickly after launching their activity**.

Proposed adjustments:

- Open the pilot regime to any new exemption that would appear necessary for a project to overcome regulatory deadlocks.
- Include proportionality into conditions to benefit from exemptions.
- Increase limits allowing to apply for exemptions to financial regulations through the pilot regime, regarding both limits on the scope of DLT transferable securities (article 3§1), their total market value (article 3§3) and before the activation of the transition strategy (article 3§5).
- Authorize the settlement of payments in DLT transferable securities through e-money tokens even after central bank money becomes "practicable and available" by adjusting article 5§5 sub-paragraph 2: "The settlement of payments may be carried out through central bank money, where practicable and available, or ~~**where not practicable and available,**~~ through commercial bank money, including commercial bank money in a token-based form, or in e-money tokens". This would enhance flexibility, but also legal certainty.
- Remove PRR, article 4§3.e applying to the DLT MTF: "settles transactions in DLT transferable securities close to real time or intraday, and in any case, no later than on the second business day after the conclusion of the trade" to allow for more flexibility in processes

III. Risks to public blockchains

The current drafting of the pilot regime regulation suggests that "DLT" can only be a private/proprietary technology. To illustrate this fear:

- Recital 28 mentions "the rules on the functioning of the proprietary DLT they operate"
- Recital 37 explains that actors can lose their permissions and exemptions "where a flaw has been discovered in the underlying technology or the services or activities provided by the DLT market infrastructure", which suggests that such flaws are always attributable to the actor, which is not the case under a public blockchain scenario.
- Conditions to benefit from the pilot regime require operators of DLT market infrastructures to "establish rules on the functioning of the DLT that they operate" (article 6.2)
- Article 6.2 also requires operators of DLT market infrastructures requesting an exemption from article 3.2 of CSDR to establish for "the participation of the validating nodes" which could be only possible for closed blockchain networks..

  It should be noted that the concept of "facilitating nodes" is used instead of "validating nodes" in recital 28 to refer to the same obligation. That is why there should be one unique notion. Moreover, none of these two concepts are defined in the proposal. However "nodes" is a technical concept defining technical infrastructures (not persons) so it is unsuitable to use it in a regulatory context in order to make them apply legal obligations. To this end, as references to "nodes" in the Pilot regime text are improper and not used for a definition purpose, they should be removed.

This would be very dangerous as **innovative use cases of blockchain technology heavily rely on public/open blockchain infrastructures** and **use cases that are in line with EU financial regulations can be deployed in public environments**. The pilot regime should not exclude public networks.

Open networks are perfectly compatible with the underlying requirements set by financial regulations and have key features that can help improve financial markets:

- **Transparency and trustworthiness**. Smart contracts enable the automatic and trusted execution of operations when (and only when) all conditions are met. Open networks allow independent parties access to the ledger, who may verify the execution of operations. They may also verify and audit the smart contract code, which is key to ensuring correctness and robustness of the code. More eyes on the underlying application (smart contact) code is a substantial confidence enhancer for all, including end-users.
- **Open-source**. Public blockchain networks are open source projects, developed by a large and expert community which continually strives to improve protocols and their functionalities, develop innovative use cases and resolve issues. Code repositories and their version histories are freely available and usable on dedicated developer platforms such as GitHub. This provides excellent efficiency in permanently addressing the needs of end-users and project holders –

prompting the creation of standards and ensuring a steady stream of ideas and innovation.

- **Available technological ecosystem and composability**. Public blockchain networks have become proven technologies. An entire ecosystem of tried and tested technological building blocks (e.g., standards, applications, infrastructure, developer tools) are readily available for anyone to use. Such components may also be combined to create advanced use cases. On the contrary, implementing closed networks requires deploying the supporting infrastructure from scratch (e.g., nodes, block producers) and recruiting validators. To this end, open blockchain networks would induce considerable time and cost savings and have a significant competitive advantage compared with less open technologies.
- **Resilience**. The resilience of a blockchain network correlates directly with the number of participants (nodes) in a said network. There is a positive relationship between the number and diversity of participants (decentralisation) on a blockchain network and its resilience to cyber-threats and breaches. With no single point of failure, incentive systems reward participants for the safety and value they bring to the network. And with a large number of observers auditing networks' performance and code, decentralised blockchain networks have proven to be highly resilient and nimble in the face of attacks. Moreover, they enable the creation of advanced permissions and rulesets necessary for large-scale applications.
- **Interoperability and synergies facilitator**. Crypto-assets in general should be built using the same technologies to allow full interoperability between the current financial and monetary systems and the nascent decentralised economy. Therefore, as private sector initiatives run primarily (and increasingly so) on public blockchain networks, interoperability, value creation and global mass adoption will be heavily enhanced if "DLT financial services" are deployed on such networks.
- **"Financial" inclusion**. Depending on their configuration, blockchain networks can be open for anyone to participate or limit their participants. In the context of financial services, which must be usable by billions of individuals, open networks appear much more convenient and user-friendly. They are likely to improve accessibility to markets for both current and prospective participants. Moreover substantial liquidity and market depth will be easily achievable on open networks while private ones will be limited by governance and rivalry considerations.
- **Privacy**. Blockchain networks offer an interesting mix of features that make them suitable for both institutionally-backed and community-supported applications. Accounts are pseudonymous, which allows each user to maintain a certain level of privacy, while at the same time, all the transactions are publicly recorded, allowing for reliable auditability (see Transparency). In addition, cryptographic primitives allow, when required and even for the most open systems, to support higher levels of privacy, and notably, making some transactions entirely private.

Proposed adjustments: Redraft articles in the pilot regime regulation that could exclude use cases that are deployed on public networks.

IV. Lack of cooperation with the private sector to build in regulation and supervision efforts

With the implementation of the pilot regime, security tokens markets will become a new area of supervision for both national and EU authorities. Not all of them with the EU are already familiar with these new assets. That is why **regulators and supervisors should work closely with the industry in order to build the definitive set of rules that actors in security tokens will need to comply with**. Such crucial efforts from national and EU competent authorities should therefore be combined with the expertise of the crypto ecosystem regarding the functioning and the practices of these new markets.

> *Proposed adjustments*: Supervision of DLT Market Infrastructures should go together with the creation of a regulatory working group at EU level dedicated to regulatory adaptations of the pilot regime and the financial regulations.

Under such adjustments, the pilot regime will truly allow for innovative security token use cases deployment without threatening the financial system nor individual investors.

About Adan

Adan is an industry body that brings together and represents digital asset and blockchain professionals in France and Europe. Our members cover a wide range of activities, including market makers, custody providers, payment service providers, investment management, analysis tools, events and marketing, and security. We are dedicated to all the companies that are interested in crypto-assets and are targeting the French market.

We believe that digital assets represent a transformational shift in finance and economics. Crypto-asset technologies challenge centuries-old foundations of economics and monetary theory and offer the potential to create a new social contract built on the principles of inclusion and openness.

Our mission is to be a pragmatic voice for the French and European digital asset industry, contributing to its growth and development through constructive dialogue and education.

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About EUCI

The EUCI is a European initiative focused on impacting future regulation in favor of decentralized use cases, open blockchains, and sustaining innovation in the blockchain space.

The Initiative brings together European industry-wide associations, individual industry players and individual supporters to create and disseminate information and proposals with respect to the EU regulation of crypot-assets.

EUCI main supporters include:

- Adan (French crypto-assets association, 60+ member)
- Bundesblock (German blockchain association, 100+ members)
- Blockchain Think Tank Slovenia
- Ledger
- Gnosis
- Individual supporters

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