AFG POSITION PAPER ON THE EU REGULATION PROPOSAL CONCERNING THE PILOT REGIME FOR MARKET INFRASTRUCTURES BASED ON DISTRIBUTED LEDGER TECHNOLOGY

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AFG welcomes the objective of the European pilot regime to create a transitional regulatory framework which covers crypto assets that qualify as financial instruments (within the meaning of the MiFID 2 directive), and to allow in fine the EU institutions to determine whether a more substantial regulatory reform of EU laws (i.e., CSDR, SFD, MiFID 2) is required to accurately regulate DLT financial instruments-based projects. The European pilot regime as proposed by the European Commission is of such a nature as to provide legal certainty which would allow experiments to issue, custody and trade security tokens admitted to trading or traded in a trading venue.

AFG also strongly welcomes the innovative approach of providing targeted exemptions to EU regulations, even under conditions, to promote the development of a new economical ecosystem. It demonstrates the clear political commitment of the European Union to be positioned in the edge of the ongoing digitalization process of financial markets.

Specifically, the EU regulation proposal sets out rules applicable to two kinds of market infrastructures for crypto-assets that qualify as financial instruments issued, recorded, transferred and stored on a blockchain (the so-called "security tokens", or "DLT transferable securities" according to the term introduced by the European Commission), namely the multilateral trading facility (MTF) and the securities settlement system (SSS), and is designed to provide targeted regulatory exemptions to EU regulations to enhance the development of this emerging European ecosystem.

AFG supports the efforts being carried out by the EU institutions. Through this position paper we want to highlight key points for improvement concerning the pilot regime proposal.

Indeed, the analysis of the pilot regime as described hereafter shows that the **current wording of the proposal may be insufficient to achieve its intended purpose to support innovation within the EU**. Besides, the pilot regime will need to be accompanied by discussions at the EU level about the harmonization of EU Member States' securities laws to reduce the existing regulatory discrepancies and to allow the emergence of a competitive European digital market of security tokens.

The EU regulation proposal draft, as published by the European Commission in September 2020, provides that only a "**DLT market infrastructure**" (a market infrastructure based on distributed ledger technology) can benefit from the targeted exemptions provided in the European pilot regime. According to the first draft published, only two kinds of financial actors can be characterized as "DLT market infrastructure": the DLT MTF and the DLT SSS. These two terms do not exist to this day in European law and have been created in the context of the EU regulation proposal on the pilot regime.

To operate a multilateral trading facility that admits to trading transferable securities issued on a distributed ledger ("**DLT MTF**"), it is required to be approved at first as an operator of a multilateral trading facility ("**MTF**") within the meaning of the MiFID 2 directive. Similarly, to operate a securities settlement system using DLT technology ("**DLT SSS**"), it must first be approved as a central securities depository (v. art. 2(3) and 2(4) of the draft proposal). As **currently drafted, for any potential new market participant which aims to operate a DLT MTF or a DLT SSS, it would be mandatory for such entity to apply for an approval as a MTF operator or as a CSD from its national competent authority ("NCA"), in theory on the ground of a traditional business model of a MTF or CSD.** It is only once the approval as MTF or CSD is obtained that the entity could request to be authorized as a DLT MTF or DLT SSS and to benefit from targeted exemptions to some EU regulatory provisions (notably from the EU "CSDR" regulation), in accordance with its real targeted business model. This **double regulatory authorization would represent an important burden for a new market participant or a regulated entity (investment firm or credit institution)** without a previous approval to operate a MTF or a CSD to comply with more regulatory provisions than really necessary and to potentially delay for months its authorization and activity as a DLT MTF or DLT SSS while waiting for the effective entry into force of the EU pilot regime.

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The potential limitation of the scope of application of the EU pilot regime to the DLT MTF and DLT SSS as proposed in the current draft could constitute a bias in favor of existing market participants already approved as MTF and CSD, **to the disadvantage of new market participants or other key participants of the financial markets** (investment firms, credit institutions, "custodians", issuers, investors and service providers in the broad sense such as fintechs).

This situation could discourage potential new market participants and thus limit the current interest in the EU pilot regime, given that the actors which could benefit the most from the potential efficiencies of the use of distributed ledgers (issuers, investors, investment firms and other kinds of service providers such as fintechs) are precisely the ones who could not benefit from the pilot regime and its target regulatory exemptions and who could not provide their inputs about the experiments to EU regulators. Given that the proposal for an EU regulation on the pilot regime aims to create an experimental area on a new technology, **it seems more logical to open the pilot regime to other regulated entities as well as potentially to start-ups which would comply with the relevant criteria established by EU institutions.**

In order to expand the applicability of the pilot regime to entities not approved previously as MTF or as CSD, **AFG recommends to allow regulated entities within the EU and fintechs to request to be directly approved as DLT MTF or DLT SSS with a previous approval as MTF or CSD. We also recommend to adapt the conformity costs in proportion to the type of projects envisioned and to the regulatory provisions applicable to the specificities of DLT technology for operating a DLT MTF or a DLT SSS.**

For a DLT MTF or a DLT SSS, it seems necessary to precisely identify the relevant provisions of the existing EU laws (MiFID 2, CSDR, SFD) that the authorized entity would have to comply with during its authorization process assessed by the NCA as DLT MTF or DLT SSS to benefit from targeted regulatory exemptions provided in the pilot regime.

To ensure the level playing field and to minimize the risk of regulatory arbitrage between the Member States of the EU, **it is important to state that the level of requirements applicable to DLT MTF or DLT SSS should not be less important than for traditional operators of MTF and SSS regarding investor protection, market integrity and financial stability**. To be authorized to operate a DLT MTF or a DLT SSS, it is therefore essential to establish clear and detailed criteria, notably requirements related to compliance, cybersecurity and regulatory capital, and that these criteria are defined and reviewed by guidelines in the form of non-binding agreements provided by the ESMA in order to strengthen the legal certainty of the envisioned experiments.

Furthermore, we request clarification on the conditions and requirements related to the possibility given to DLT MTF and DLT SSS to ensure the safekeeping of the crypto-assets qualify as financial instruments issued on a distributed ledger. Clarification is also required on the possibility that should be given to DLT MTF and DLT SSS to conclude contractual agreements with entities which would ensure the record keeping (on behalf of the issuer) and/or the position keeping (on behalf of the investors) of the security tokens issued on a DLT, and finally on the possibility for non-professional clients ("retail") to be a direct participant of a DLT MTF and/or of a DLT SSS.

To maximize lessons learned from the DLT-based experiments and from the potential efficiencies due to the use of a DLT, it would be important to allow new lines of accountability and responsibility for services related to the secondary market and to the delivery-versus-payment of the security tokens, as envisioned by other non-EU regulators, e.g., the US federal financial regulator SEC. The SEC has provided in a recent no-action letter related to a security tokenization project that potential alternative scenarios to enhance the delivery-versus-payment of financial instruments can be based on the use of a DLT, including a distribution of responsibility between a trading venue and a custodian to ensure the delivery-versus-payment of securities issued on a DLT[1].

[1] U.S. Securities and Exchange Commission (SEC), "*ATS Role in the Settlement of Digital Asset Security Trades*", "*no-action letter*" sent by the SEC to the FINRA, 25 September 2020.

1. THE NEED TO ENLARGE THE SCOPE OF EXEMPTIONS UNDER THE PILOT REGIME

The list of exemptions that could be requested under the pilot regime refers mainly to the CSDR regulation. Having in mind the objectives of attractivity and of the support of innovation, AFG recommends to considered to enlarge the **scope of possible regulatory exemptions**.

In particular, recognizing the importance of structuring a global ecosystem within the EU on security tokens projects, it could be also allowed to derogate from the provisions related to the traditional settlement and payment processes. In this perspective, it could be interesting for the pilot regime to allow potential exemptions to targeted provisions of the Settlement Finality directive[2].

In addition, given the nascent nature of the DLT ecosystem in the European Union, the gradual development of projects and of the legal issues met by private stakeholders, it seems essential that the pilot regime allows the gradual structuration of a global ecosystem. To this end, some key regulatory uncertainties should be covered, notably regarding the role and responsibilities of the custody and administration of financial instruments issued on a distributed ledger, with its technical specificities and its relevant regulatory regime. To ensure the success and effectivity of the pilot regime, it would be important to bring legal certainty and security on this kind of legal issues which are hampering the projects envisioned by some market participants related to security tokens.

Furthermore, the scope of the pilot regime should include **the asset management industry, which is not mentioned in the draft proposal.**

Due to the major role of this industry to channel savings to investment (in security tokens…), it seems critical to involve the investment funds and the asset managers in the ecosystem that the pilot regime is about to create. Like the equities and bonds, units and shares of funds are to be explicitly fully integrated among the types of financial instruments covered by the EU regulation on the pilot regime.

2. INCREASE THE THRESHOLDS

The thresholds related to « *DLT transferable securities* » under the pilot regime should be increased: the limitations related to the market capitalization of the issuers of listed equities and the size of issuance for bonds – and consequently the activation threshold of the transitional strategy towards the complete application of the financial regulations – are relatively small and insufficient in the current wording to justify substantial investments during several years by the main European financial institutions.

This threshold issue is even more accurate regarding the total market value of financial instruments which can be registered on a blockchain by a DLT MTF or a DLT SSS under the EU pilot regime, which shall not exceed 2,5 billion euros. This amount seems fundamentally insufficient to justify a significant investment from regulated market participants. Only 5 issuances of bonds at 500 million euros would block for years any other project envisioned by a DLT MTF or a DLT SSS for several years.

AFG considers key to provide a flexibility *a minima* until 10 billion euros, which would represent the amount of 20 bond issuances at 500 million euros, due to the fact that the pilot regime will be enforced for several years and therefore will strongly contribute to structure the European market of security tokens. Each DLT MTF or DLT SSS should be allowed under the EU pilot regime to register at least 4-5 bond issuances for major issuers per year. If the pilot regime lasts 3 or 5 years, it would represent potentially a total amount between 7,5 billion euros (for 3 years) and 12,5 billion euros (for 5 years).

An alternative to a higher threshold of 10 billion euros *ab initio* would be to provide that transactions above the 2,5 billion euros total market value threshold should be possible (up to 10 billion euros) if an

[2] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement system (SFD).

additional supervisory authorization is sought by the same authorized market participant (from the national competent authority and the ESMA).

Without flexibility or at least a potential increase of the total market value of financial instruments registered on a DLT, which would allow a gradual structuration of an emerging market, there is a significant risk concerning the viability and adoption of the pilot regime by regulated entities in the years following its entry into force.

Regarding listed equities, the threshold of market capitalization of the issuer set at 200 million euros could be seen as too restrictive, because it would allow the listing of equities of only a fraction of the existing SMEs.

We propose that every company with a market capitalization below 1 billion euros be considered as an SME[3], or we propose to provide a transaction threshold for equities based on the size of issuance of equities (500 million euros, as for the bonds) rather than on the market capitalization of the issuer. To strengthen the objective of the pilot regime, it seems reasonable to extend the transaction thresholds to this size of market capitalization or issuance, in order to maximize the number of European issuers which could benefit from the innovative framework set up by the pilot regime. It should be emphasized that the potential issuers and investors of the experiments under the pilot regime will be primarily listed companies with a financial capacity sufficient to finance such experiment projects which require a strong hybridization of their operational value chains, a substantial regulatory and compliant analysis and innovative technological start-ups to make such issuance possible.

3. THE NEED FOR MORE PROPORTIONALITY

The Swiss Confederation, in its federal law related to DLT-based developments of September 2020, to the establishment of a simplified authorization and exemption framework for small DLT MTF or DLT SSS[4], mentions that a "*trading venue based on DLT is considered as small when it poses low risks for the protection of financial market participants and for the good functioning and the stability of the financial system, notably because the number of participants, the trading volume, the volume of the value it holds or the value of clearing and settlement is limited*"[5].

We advocate for a similar set up for small DLT SSS and DLT MTF under the European pilot regime. It would be favorable to the emergence of new service providers, not regulated to date, provided that they comply with the requirements set up by EU institutions about the security and resilience of the underlying technology, with lessened requirements related to regulatory capital and organization, in exchange of a limitation of their scope of activity, with thresholds about the eligible financial instruments and the total amount of operations registered significantly below the thresholds proposed in September 2020 by the European Commission[6].

[3] In its report of June 2020, the CMU high-level forum has recommended a threshold of 1 billion euros of market capitalisation as a criterion for the category of SMEs (recommendations 6a and 6n).

[4] Swiss Confederation, Federal law about the adaptation of federal law to developments in distributed ledger technology (Loi fédérale sur l'adaptation du droit fédéral aux développements de la technologie des registres électroniques distribués), adopted by the Swiss Federal Assembly on 25 September 2020.

[5] *Ibid.*, article 73f of the Swiss federal law of 19 June 2015 on financial market infrastructure (Loi fédérale suisse du 19 juin 2015 sur l'infrastructure des marchés financiers): « *Un système de négociation fondé sur la TRD est considéré comme petit lorsqu'il présente de faibles risques pour la protection des participants aux marchés financiers et pour le bon fonctionnement et la stabilité du système financier, notamment parce que le nombre des participants, le volume de négociation, le volume des valeurs qu'il conserve ou le volume de compensation et de règlement est limité* ».

[6] For these market participants, the eligibility threshold could be substantially reduced in order to allow these new service providers to facilitate fundraisings of start-ups and scale-ups. The average amount of the equity tokens issuances was 8 million euros globally in 2019 (source: PwC) and the average amount of "classic" fundraising for start-ups and scale-ups at 7 million euros in France in 2019 (source: France Invest).

4. THE IMPORTANCE OF THE PRINCIPLE OF TECHNOLOGICAL NEUTRALITY

According to the pilot regime proposal, **our understanding is that the blockchain on which the financial instruments will be registered by the DLT SSS, or the DLT MTF, should be a "proprietary" blockchain of the DLT SSS or of the DLT MTF.**

Such requirement and its potential consequences seem to significantly exceed the scope of the reform proposed by the European Commission. Discussions should be considered during the negotiations about the EU regulation wording, notably for the following reasons:

- Such detrimental requirement does not reflect the reality of many projects developed by European financial actors in the recent years, where the underlying DLT technology chosen are predominantly public, semi-public or consortia DLT/blockchains.

- This requirement seems to impose the use of a specific technology and is therefore not neutral as for the technological choice by market participants. **This wording, if adopted, would contradict directly the objectives set out by the European Commission in its « explanatory memorandum » on the pilot regime**[7]. The imposition of a given technology in the draft proposal is also in contradiction, without apparent and clear justification, of the regulatory reforms adopted at the national level within the European Union and in its neighboring countries, such as France, Luxembourg, or Switzerland. In these various countries which have allowed the use of DLT to register some types of financial instruments, the legislator has not imposed any specific characteristic related to the technology chosen by market participants and has not imposed to the private sector any specific technology[8]. To the contrary, these reforms have focused the requirements on the features a technology should provide, whatever its nature (public, private, consortium…), and which shall be justified by the users of the technology.

It seems key to preserve and protect a technological neutrality approach for EU financial regulations, notably regarding experiments on new technologies.

The pilot regime should not impose constraints related to the nature of the technology chosen by private entities which would not be justified in terms of the security and sustainability of the projects envisioned and which would risk substantially to harm the objectives of innovation and attractivity of the European Commission.

5. THE NEED FOR A RAPID ENTRY INTO FORCE OF THE EUROPEAN PILOT REGIME

Timing is key for experimental projects on new technologies. If the European institutions wish to foster a strong adoption of the European pilot regime by market participants, **the effective entry into force of the EU regulation must be as rapid as possible, to position the EU in response to the SEC's "no-action letters" and to the various regulatory positions rapidly adopted in Asia (Singapore, Hong Kong, etc.).**

We also request to **reduce as much as possible the deadline for the entry into force of the European pilot regime, ideally on 1 September 2021 or at worst on 1 January 2022**. If the entry into force is postponed until mid or late 2022, one significant risk is that non-European countries adopt more substantial regulations in the meantime and pre-empt the incentive pilot regime created within the European Union. Until the entry into force of the European pilot regime, it could be considered that the ESMA could also issue "non-action letters" to put European actors in a similar position as their peers in other jurisdictions.

[7] « *The EU follows the principle of technological neutrality* », explanatory memorandum, Section 2, 24.9.2020.

[8] By way of example, the French law, which provides the possibility to register and trade some types of financial instruments on a distributed ledger, contains only requirements related to the reliability of the registrations on the distributed ledger and a continuity plan by the issuer or its agent, without imposing a particular type of DLT. This choice would preserve the freedom for market participants to choose the most adapted technology to their business models, without pre-empting their technological choices, while ensuring the fundamental requirements for investor protection, financial stability and market integrity.

6. THE NEED FOR PERIODIC REVIEWS OF THE EUROPEAN PILOT REGIME AND FOR IN-DEPTH ANALYSIS BY THE EUROPEAN INSTITUTIONS OF REGULATORY DIVERGENCES BETWEEN EU MEMBER STATES

The Commission's proposal provides for an exhaustive list of provisions actors can be exempted from under the European pilot regime. This list could be adjusted only in the context of the review of the pilot regime planned five years after its entry into force, based on a report to be drafted by the ESMA. Additional provisions subject to potential exemptions could also be identified thanks to feedbacks from stakeholders (market participants, regulators, etc.) regarding the concrete projects in which they are involved.

We request that the **pilot regime be reviewed frequently, for example annually, through reports published by the ESMA and the European Commission from the end of the second year after the pilot regime has come into force**. The publication of periodic reports would enable a gradual and flexible adjustment of the list of targeted exemptions by EU institutions.

This could also help to assess the need for the European institutions to amend European regulations (CSDR, SFD, MiFID 2, etc.) without having to wait five years after the entry into force of the pilot regime.

This regular review of the pilot regime and the feedbacks of the industry needs (issuers, asset managers, investment service providers, market infrastructures, technology providers, etc.) to the ESMA could be carried out by a new working group, composed of experts from the private and public sectors, which would be dedicated to the regulatory developments of the pilot regime and would work in close cooperation with NCAs and the ESMA. This periodic review would help to ensure that the pilot regime would remain efficient and competitive for the European financial actors and the European market, compared to other regimes applicable in other jurisdictions especially in a post-Brexit environment.

In the context of these reviews by the ESMA and the European Commission of the pilot regime, the current major divergences between EU Member States' securities laws could raise serious concerns for the selected projects. Such discrepancies include notably:

- The interpretation of key concepts of EU financial regulations, such as the terms of "financial instruments", "transferable securities",
- The legal analysis and requirements for the investment services and activities and the ancillary services (within the meaning of the MiFID 2 directive), such as the custody and administration of financial instruments on behalf of clients, or the service of record keeping on behalf of security token issuers (a type of service that is very unequally regulated at the level of EU Member States)[9].

These differences in national regulatory interpretations of EU-level regulations (notably the MiFID 2 regulation), as pointed out by the ESMA in its report of January 2019 on crypto-asset regulation[10], is a source of market fragmentation within the EU. **The emergence of a European market for natively digital security tokens seems difficult without a global discussion on securities law at the European level.**

7. ISSUES RELATED TO THE SUPERVISION OF THE EU PILOT REGIME BETWEEN THE NCAs AND THE ESMA

Beyond the debate about the type of entities qualifying for the targeted exemptions under the pilot regime, and deadlines, one of the key aspects of the pilot regime is to provide an efficient gathering by the national (NCAs) and European (ESMA) regulators of the relevant information and feedbacks about the regulatory burdens and the benefits vs. drawbacks related to the use of DLT to issue, custody and trade transferable securities issued on a DLT.

[9] Regarding this latter service, there are many divergences within the EU Member States on whether or not a registrar should be a regulated entity, which raises the fundamental problem of creating an offer of services at the EU level. In France, for example, this service is not regulated, unlike in Germany, where this activity necessarily requires an authorization.

[10] ESMA, « *Advice on Initial Coin Offerings and Crypto-Assets* », ESMA 50-157-1391, and « *Annex 1: Legal qualification of crypto-assets – survey to NCAs* », ESMA 50-157-1384, published on 9 January 2019.

In this part we share our views on the role and powers of the NCAs and the coordination between NCAs and ESMA

7.1 ROLE AND POWERS OF THE NCAs

The pilot regime proposal creates targeted exemptions granted to private entities providing financial services based on the distributed ledger technology and which would request to benefit from such exemptions under a specific authorization by its relevant NCA. Thus, the national authorities would be requested under the pilot regime to assess the quality, the competence, and the compliance with the relevant criteria of the eligible actors, the size of the projects envisioned, as well as the nature of the technology they plan to use.

The assessment of an authorization request under the pilot regime by a NCA should therefore consider a series of objective and qualitative criteria related to each of the projects which would apply for a specific authorization.

About the organization process to be handled by national competent authorities, the pilot regime proposal mentions that each eligible actor to the pilot regime is required to identify, among the provisions listed by the European Commission, the specific EU regulatory provision(s) for which an exemption is requested.

The applicant will be required to put in place adequate compensatory measures and justify that these measures are sufficient to achieve the objective pursued by the relevant requirement subject to a potential targeted exemption. The application for a specific permission would have to convince its relevant national competent authority as well as the European regulator (ESMA) to approve the granting of the requested targeted exemption.

The application for a specific permission will be notified by the relevant national authority to the ESMA and be accompanied by information on the requested exemptions, its justifications and the proposed compensatory measures, before being definitively granted.

On a more concrete level, the ESMA will have to send within three months to the relevant NCA a non-binding opinion on the application with potential recommendations about the accuracy of the exemptions requested by the applicant. Besides, the ESMA would have the possibility to consult with competent authorities to withdraw the permission or any of the exemptions granted, notably if a flaw in the functioning of the DLT or the services and activities has been discovered.

It seems that the articulation between the national competent authorities and the ESMA is only one-sided. The regulation proposal only provides the possibility for the ESMA to oppose the grant of a specific permission of targeted exemptions by a NCA to an applicant. In the opposite way, it seems that the ESMA cannot be seized of complaints in the event of a suspicion of regulatory arbitrage to the detriment of the industry.

The Board of appeal[11] of the ESMA could allow the NCAs to “appeal” a decision made by the ESMA and address potential issues related to the application process, but this process will not benefit to the applicants directly. Yet the role of the Board of Appeal of the ESMA could also be focused on the development of the financial activities addressed by the EU pilot regime, given the objectives set out by the European Commission to strengthen the development of digital finance within a harmonized single market.

7.2 COORDINATION BETWEEN THE NCAs AND THE ESMA

The potential refusal or withdrawal of the granting of exemptions from the ESMA is conditioned by its objectives to promote the consistency and proportionality of exemptions granted by NCAs under the pilot

[11] Articles 58 and 59 of the respective regulations related to the EBA, the EIOPA and the ESMA.

regime. The ESMA would therefore ensure the effective respect of a level playing field between the EU Member States and the consideration of proportionality of the exemptions granted.

It appears however that the ESMA would ensure the harmonization of the implementation of the regulation provisions only after the reception of a notification related to an application by a national competent authority. We recommend strengthening the coordination role attributed to the ESMA, by adding in article 9.5 of the European pilot regime the power to develop draft regulatory technical standards similar to the power granted in other EU regulations.

An applicant does not seem able to submit a complaint case directly to the ESMA in the event where the applicant would consider that its exemption request has been denied in an inappropriate way by its relevant national competent authority.

The creation of an *ad hoc* consultative committee by the ESMA, which would bring together representatives of both public and private stakeholders (in the form of a stakeholders' group), for a limited period (for example three years), to allow market participants to submit a case to the stakeholder group, appears to be necessary.

This committee would be able to transmit a written statement to the ESMA relevant departments setting out the reasons of a refusal of an exemption permission which would be considered by the committee as insufficiently reasoned or ill-suited to the requirements set out in the EU regulation.

To the extent that the ESMA is expected to publish and maintain on its website a list of DLT market infrastructures and information about the permissions and the list of exemptions granted, to guarantee the transparency of the framework, it seems useful for the ESMA to be able to be called on in the event of a refusal or withdrawal of permission – considered as inappropriate – by the relevant national competent authority.

However, to avoid abusive complaints submitted to the ESMA by applicants, a specific procedure could be adopted to analyze only the complete and documented complaints transmitted to the consultative committee. This procedure could provide notably a shortened delay of transmission of the request to the consultative committee after the response of the relevant NCA, a set of documentation to be transmitted to the consultative committee which would include notably a summary of the applicant's activities and the requested exemptions. A translation in English of the refusal by the NCA would also have to be inserted in the complaint transmitted.

After an examination of the case transmitted by the applicant, the consultative committee would draft a written statement which would be transmitted to the relevant ESMA departments if it considers that the refusal or withdrawal of permission is not consistent with the requirements set out in the EU regulation.