



BUILDING A EUROPEAN DIGITAL STRATEGY IN FINANCIAL SERVICES

Summary of the proposals

We encourage the European Commission to develop a European digital strategy for financial services that would allow European players to embrace innovation in a secure environment. Such a strategy could build upon the following axes:

- Enable the digitisation of financial instruments through the use of blockchain technology by removing existing legal obstacles and by establishing an interbank stable settlement coin;
- Develop a European framework for digital assets that do not qualify as financial instruments;
- Encourage testing of new projects to foster innovation;
- Address the risks identified in the area of the relationships between cloud providers and financial institutions in order to take full advantage of the use of artificial intelligence in the financial sector.

Background

This paper aims to contribute to the European Commission's overarching objective to foster financial innovation while ensuring investor protection. As a preamble, we share the priority proposed by the President of the European Commission, Ursula von der Leyen, regarding the importance of making Europe fit for digital age¹.

From our regulatory window, we note that the vast majority of financial players actively reflect on their positioning, what constitutes the core of their added value, and how to adapt to a digital environment. Ongoing projects and new business models tend to indicate profound changes that are affecting all business lines, whether in corporate finance, asset management or trading and post-trade infrastructures². These elements reflect a number of inefficiencies in our financial system: too costly for the clients despite being insufficiently profitable for the financial institutions, too slow, too national in unachieved banking and capital markets union and, in some cases, too cautious in the way in which the projects to be financed are selected.

While several of these observations hold true at the global level, the situation is even less satisfactory at the European level. On the one hand, our traditional European players see their competitiveness deteriorated under the double effect of the pressure on their margins exerted by the prolonged environment of low interest rates and the increase in costs notably related to post-crisis regulation. On the other hand, the regulatory framework constitutes a barrier to entry for new competitors, which partly explains the low number of start-ups developing in the financial services sector in Europe.

Europe is also lagging behind in innovation financing, with European start-ups raising only 10% of global funding in 2018, far behind the United States (53%) and China (27% compared to 10% in 2013)³. One can also regret that of the 372 unicorns counted worldwide in mid-July 2019, 182 are American, 94 are Chinese and only 12 are European⁴.

¹ Ursula Von der Leyen Proposed Program « A Union that strives for more » -- political guidelines for the next European Commission

² See speech of Robert Ophèle, AMF Chairman, « AI, Blockchain & Cryptoassets - Disruptive technology shaping the future of regulation & compliance », AFME Conference, 3 October 2019 – available [here](#)

³ Philippe Tibi, « Finance the fourth industrial revolution – Unlocking the financing of technology companies », July 2019, Report to the French Minister of Economy and Finance – based on KPMG, “Venture Pulse Q4’18”, based on Pitchbook.

⁴ Tibi Report, *ibid* – based on CB Insights Report « The Global Unicorn Club »

Against this backdrop, European public authorities should consider their role as catalysts or inhibitors. While a complete overhaul of our regulatory frameworks is by no means desirable, we believe that a regulatory status quo would be prejudicial. Instead, we should reflect on our tools and frameworks, in order to make them more agile and able to support these developments while not sacrificing the protection of our investors and the security of our financial system.

In its March 2018 Action Plan⁵, the European Commission had identified a number of topics deserving regulatory attention. While we agree that competent authorities at both EU and national levels should carefully monitor all of these topics, the AMF considers that the opportunities and issues related to the use of blockchains and data deserve particular attention in that they require regulatory responses and are likely to increase significantly the efficiency of financial markets. Although we welcomed ESMA's report on the adequacy of European regulation in the face of technological change⁶, which was a necessary first step, we believe that we must continue this work and together develop concrete measures to make European texts more agile in the face of innovation.

Therefore, the AMF proposes solutions hereafter to: **(1) remove regulatory obstacles to the development of security tokens (securities registered and transferred on blockchains); (2) manage the lack of regulation at EU level and the resulting legal uncertainty for digital assets that are not considered as transferable securities; (3) increase the agility of our frameworks by encouraging testing of new projects and innovative ideas and; (4) address the risks identified in the area of the relationships between cloud providers and financial institutions in order to take full advantage of the use of artificial intelligence in the financial sector.**

□ Proposals to remove regulatory obstacles to the development of security tokens

The use of Blockchain technology in the field of financial services may potentially bring many benefits such as:

- Reduction of the costs of certain financial operations (transfers, public offerings, etc.),
- Automation of post-trade processes (delivery vs payment, payment of expected cash flows for securities and repurchase agreements, derivatives margin calls, option exercise, etc.) thanks to the use of smart contracts⁷,
- Acceleration of the execution times of these operations,
- Possibility of reaching a global target,
- Possibility to strengthen transaction security by combining a secure history and advanced cryptographic techniques, that are inherent to distributed ledger technologies (DLTs),
- Possibility of increasing the liquidity of certain asset classes and fostering the emergence of new ones.

This leads us to believe that **the "tokenisation" of finance is a major trend, which should not be fought but supported by a framework that allows it to develop in a secure environment.**

The use of Blockchain technology in the field of financial services raises several regulatory issues that we should address in order to enable the development of primary and secondary markets for digital assets at European level. The fact that Europe manages to be one of the first geographical areas to offer this type of services could represent a competitive advantage and attract foreign capital, potentially interested in increased liquidity, the possibility of exchanging a wide range of instruments (securities or not), and offer instant and less costly settlement than current financial markets. Acknowledging at European level the registration of a security in a blockchain as proof of ownership could also be a way of developing a common European securities law.

Regulatory changes would be needed on the European level to allow the development of digital securities platforms (see summary table in annex). The existing EU regulatory framework requires the presence of regulated

⁵ European Commission, "Fintech Action Plan: For a more competitive and innovative European financial sectors", March 2018. In this Action Plan, the EU Commission recommended to examine in particular the impact of Blockchain technology, the increased use of data and the development of AI or machine learning techniques, cyber-risks. In addition, the Commission tasked the ESAs to map current authorising and licensing approaches for innovative FinTech business models, and explore in particular how proportionality is applied.

⁶ ESMA Report, « Report on the licensing of fintech business models », July 2019

⁷ Smart contracts are self-executing contracts with the terms of the agreement between the parties being directly written into lines of IT code.

intermediaries, in particular it requires using the conventional banking system for securities settlement and various post-trade intermediaries for their delivery. However, by automating reconciliation processes, blockchain technologies reduce the steps required to conclude a transaction, which mechanically reduces the associated risks. Therefore, the approach of regulatory authorities should consist in questioning to what extent there are still risks that justify the presence of a regulated intermediary and adjusting the regulatory status of these actors accordingly (risk based approach). By way of example, it is questionable whether the status of CSD is relevant or appropriate in a blockchain environment when settlement and delivery is instantaneous. When reflecting on potential regulatory changes, we consider essential to make sure the regulatory framework remains technologically neutral and in particular does not lead to preventing experiments involving public blockchains, since they currently offer many advantages compared to other types of blockchains (costs, security, scalability, potential for automation). It cannot be excluded at this stage that the development of blockchain technologies will follow in the footsteps of the Internet, i.e. the emergence of a decentralized technology on a global scale (Internet) and the development of many applications for more private use (e.g. intranets).

Following a comprehensive legal analysis, **the AMF has identified several legal obstacles to the development of digital securities:** (i) **the need to identify a blockchain manager acting as a securities settlement system**, which de facto excludes decentralised platforms of digital securities and, more generally, the use of public blockchains which are based on a decentralised consensus not allowing to identify any operations manager; (ii) **the obligation of intermediation by a credit institution or an investment firm** so that individuals may obtain access to the settlement and delivery system, which does not seem compatible with the current functioning of digital assets platforms by direct access; and (iii) **the obligation to settle securities transactions in cash, in central bank or commercial currency**. As long as financial transactions remain secure, regulation should be technology-neutral and therefore should not lead to the prohibition of the blockchain.

Three avenues should be contemplated: (i) amendment of the European texts for which obstacles to the development of digital securities have been identified; (ii) creation of bespoke regulations for digital securities in order to allow for the specific features of the blockchain and its decentralised nature, such regulations being hard to conceive at this stage given the market's lack of maturity; (iii) establishment of **experimental spaces at the European level** allowing the national competent authorities (NCAs) to resolve certain requirements laid down by the European regulations and identified as incompatible with the blockchain environment, provided that the entity benefiting from this exemption complies with the key principles of the regulations and that it is the subject of heightened supervision by the NCA. This system would require the establishment of a governance mechanism at the European level so that the NCAs could exchange and harmonise their practices. Such a system would have the advantage of clearing the regulatory obstacles to the emergence of digital securities market infrastructure projects which could take shape in a secure environment, without immediately modifying the European regulations, which could take place at a later stage, once the ecosystem is more mature, in a secured way and backed up by the expertise that the NCAs would have derived from the support of companies.

Beyond the purely regulatory aspect, the AMF considers that the emergence of efficient blockchain settlement infrastructures presupposes the existence at European level of an interbank settlement instrument compatible with this technology, i.e. an **interbank stable settlement coin** to allow DvP on chain. Removing regulatory obstacles to the development of security tokens is a key priority as projects cannot be developed as regulations currently stand.

Proposal to manage the lack of regulation and legal certainty at EU level for digital assets that are not considered as transferable securities

A second initiative could be to propose a European framework for digital assets that do not fall within the definition of transferable securities as defined by MiFID 2, which are largely in a legal vacuum at the European and international level.

Such a regulatory framework should make it possible, on the one hand, to harmonise AML-CFT control practices at European level and, on the other hand, to propose rules of conduct in order to guarantee an efficient price formation mechanism that ultimately offers greater security to investors. With regard to AML-CFT, the work

undertaken by the European Commission within the 5th AML/CFT Directive to regulate wallet providers and platforms offering conversion with fiat currencies is to be welcomed. Europe has been a pioneer in this respect. Nevertheless, since then, the market for digital assets has evolved considerably and the FATF has updated its recommendations on due diligence in this environment. Regulatory developments to take account of these recommendations only make sense, however, if the response of Member States is coordinated. Therefore, the European AML-CFT framework for digital assets should be reviewed in the light of these elements, taking into account the specificities of the Blockchain environment. A regulatory framework based solely on AML-CFT measures would not be sufficient to effectively protect investors and encourage a healthy development of this ecosystem. We believe that it would be necessary to accompany this framework with appropriate measures to regulate primary markets and intermediaries operating in this sector, drawing inspiration from the rules applicable to the regulation of financial services and adapting them to the specificities of digital assets.

A new regulation at EU level for these assets, provided that it is designed in a flexible, proportionate manner and takes duly into account the specificities of the blockchain environment, could serve the objectives of bringing investor protection, addressing the AML-CFT risks and reducing legal uncertainty for the serious projects being developed in this area.

□ Proposal to increase the agility of regulatory framework

Beyond the issues related to the development of the blockchain, we believe it is essential to make our regulatory frameworks and our supervisory practices more agile.

Many European regulatory texts already contain provisions on proportionality in order to adapt the level of regulatory requirements according to the nature, scale and complexity of the activity. Nevertheless, this approach is still based on a binary logic, i.e. regulated or unregulated activity, which ultimately leaves little room for experiments as the company must necessarily wait to obtain a license before starting its activity.

Other sectors have a more flexible approach to innovation, even though the risks to users may be considered greater than those associated with the provision of financial services. In this regard, the European Commission may wish to draw inspiration from the practices that prevail today in the pharmaceutical industry, where innovation is encouraged through a system of strictly precise phasing clinical tests. If applied to the field of financial services, this approach could in practice result in a phased-in licensing process where one could imagine that a company wishing to test a regulated service with a limited circle of investors and involving small amounts of money could do so without being licensed, subject to compliance with the main principles of regulation (typically those defined in level 1). One possible way to materialise it would be to allow the competent authorities to send no-action letters to the company that would benefit from this scheme, specifying the terms of the projects, the conditions under which the test phase would be authorised (duration, number of participants involved, etc.), similar to the no-action letters used by the SEC in the United States⁸. Unlike the experimental spaces that would be reserved for projects for which regulatory obstacles have clearly been identified (e.g. in the field of blockchain), these testing zones could be open to any company that falls within the existing regulatory frameworks. However, as in the case of experimental spaces, such a mechanism should necessarily be authorised at European level, and should leave it to the NCAs to select the projects that can be admitted, provided that an effective convergence and information exchange mechanism is in place.

□ Proposal to address the risks identified in the area of the relationships between cloud providers and financial institutions in order to take full advantage of the use of artificial intelligence in the financial sector

Finally, another strategic issue relates to the storage and the protection of data. The extensive use of data can bring significant benefits by streamlining procedures, making it possible to offer more personalised services to investors and, ultimately, by making the European financial players more competitive from an international point of view. At the same time, it is important that such data driven projects respect the European rules related to data privacy and are subject to robust anti money laundering requirements. In that context, pooling resources on certain

⁸ The US SEC used a no-action letter to authorize the Paxos project to test the development of a blockchain settlement and clearing service over a 23-month period as part of a feasibility study. Further information available on the US SEC website : <https://www.sec.gov/>

subjects such as KYC/AML may be fruitful since the fragmentation of practices hinders the effectiveness of the European financial institutions. The European Commission could have a role to play to encourage the emergence of such market initiatives.

Further, while from a strictly regulatory point of view, it seems premature to regulate strictly the use of Artificial Intelligence (AI) or Machine Learning (ML), which remain at early stages of development in the EU, developments in this area will need to be closely monitored in order to contain the risks they may generate in terms of market integrity and investor protection.

The associated risks are exacerbated by the growing reliance on cloud services provided by a limited number of third-party providers, that frequently use lock-in practices that prevent their customers from easily retrieving their data and from switching to another cloud provider based on contractual, practical or technical elements. Such a practice creates a dependence of companies on their cloud providers, which raises serious concerns in terms of business continuity and oversight. Against this background, we believe that dealing with the risks above described deserves to be high on the European agenda.

Annex

The main identified legal obstacles to the development of security tokens concern secondary markets and can be listed as follows:

Identified obstacles	European regulations
Identification of a trading platform manager, incompatible with decentralised or hybrid platforms	MiFID 2 Article 5 (conditions of authorisation) Article 4.1.1 (definition of investment firm)
Identification of a securities settlement system manager for the purpose of authorisation by the central securities depository, incompatible with decentralised platforms or platforms operating on a public blockchain	Settlement Finality Directive Article 2 1. 1) of the CSDR (definition of CSD)
Obligation of intermediation to take part in a securities settlement system	Settlement Finality Directive Article 2 f) (definition of participant in an SSS)
Cash settlement in a securities settlement system	CSDR Article 40