Leveraging DLT in the securities market

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How can the EU take full benefit from the development of blockchains and smart contracts?

With distributed ledger technologies and smart contracts, we are moving to the next level of Internet: the “Internet of Value”. What the Internet has made possible for information transfers now seems possible for value transfers, i.e.: virtually free, almost instantaneous, anytime, cross-border, secure exchanges of any type of value: virtual currencies, loyalty points, coupons for future services, representation of physical goods. In recent months, we noticed a growing interest in the representation and transfer of securities.

DLT present a number of benefits for the competitiveness and integration of EU securities markets. On the issuance side, digitalisation or “tokenisation” could reduce the total cost of the transaction and facilitate the exchange of illiquid assets. It could also allow the emergence of new asset classes and facilitates cross-border trading. On the secondary market side, the use of DLTs and self-executing contracts (smart contracts) eliminates the need for reconciliation, which can reduce back office costs by a factor of up to 3. Finally, the direct publication of financial information on the blockchain network makes it possible to carry out almost instantaneous transactions between two counterparties compared to the two business days required for traditional settlement. Automation of back-office processes (settlement, cash flow payments, etc.) would also be possible for repurchase agreements, margin calls on derivatives and the exercise of options, thanks to the use of smart contracts.

As a regulator, it is our duty to be aware of these changes and possibilities and to ensure that our regulatory frameworks remain appropriate. These frameworks must allow us to manage risks and protect users effectively, without losing the benefits of innovation. Against that background, the AMF examined the legal obstacles to the development of security tokens that mainly stem from EU regulation and presented its analysis in a recent paper.

To overcome these obstacles, we recommend the creation of an « EU digital lab » allowing national competent authorities (NCAs) to remove, in return for appropriate safeguards, certain requirements imposed by European regulations and identified as incompatible with the blockchain environment, provided that the entity benefiting from this exemption respects the key principles of the regulations and that it is subject to increased oversight by its NCA. The AMF also published a position to clarify the notion of trading platforms and bulletin boards.

Where tokens do not qualify as financial instruments, pending the creation of an EU framework, the French “PACTE law” adopted in 2019 introduced in France an optional visa regime for fundraising in crypto-assets (ICOs) and an optional license regime for digital assets service providers (DASPs) supplemented by a mandatory regime that imposes to DASPs due diligence in the fight against money laundering and the financing of terrorism. Only crypto-assets that are not considered as financial instruments are eligible to these regimes. The creation of these new regimes and interaction with numerous professionals for two years before the law was passed has helped us improve greatly our understanding and develop specific and more tailored requirements. As for the implementation, the AMF gave its first optional visa for an ICO in December 2019, and some players have expressed interest in the DASP optional framework. The two first DASP registrations were granted mid-March. It is too soon to learn all the lessons, but we are convinced that only a bespoke, flexible and attractive framework can work at this stage for the European Union.


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Embracing the DLT (r?)evolution

Over the past years, DLT has emerged as an important piece of technology that promises to transform capital markets by delivering a real-time, transparent, Peer-to-Peer(P2P) and inclusive experience. It enables a real-time view of activity and positions across a business network. Making it possible to detect, assess and react faster to threats and opportunities. Participants can share and trust in a single source of truth, increasing transparency and reducing reconciliation. Because of its distributed nature, participants can directly hold and transfer value in a P2P manner, but still retain the possibility to be serviced by a third party without mediation of information or network. This allows for greater direct inclusion to capital markets.

Inspired by this promise, a number of the DLT based PoCs have now moved to a project phase and aim to go live soon. Post Trade FMI & intermediaries also fully acknowledge this transformative potential. Hence, they have not been a passive observer and have already launched dozens of projects with DLT or invested in FinTechs for use cases related to issuance, settlement, asset servicing, funds distribution, collateral management etc. The journey for most industry initiatives, however has been a very long and arduous one and the path to mass adoption
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The path to industry-wide adoption of DLT isn’t yet obvious. How can regulators and market actors help the industry embrace in its future evolution?

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Slow down to speed up:
DLT reaches potential through collaboration and standardisation

The technology adoption life cycle – often referred to as an S-curve – has four stages – innovation, syndication, diffusion and substitution – and there is also usually a period of hype early on, when a new technology is introduced.

Distributed ledger technology (DLT) is sitting firmly in the syndication phase, during which technology is demonstrated and a small portion is commercialised, with the potential for immediate utilisation. True to a typical technology life cycle, DLT did experience the intense hype phase, however recently, the industry has taken a more considered position as to how it may benefit financial services. That said, for DLT to be accepted more widely in financial markets, certain areas need to be addressed.

A key issue is security. As addressed in our recent whitepaper, Security of DLT Networks, the industry must develop a comprehensive and standardised approach to security to ensure the confidentiality, integrity and availability of an organisation’s DLT operations. There is no ‘one size fits all’ approach but there is an optimal model: the development of a reliable and comprehensive industry-approved framework. A critical component of this framework is the development of industry standards, which enables interoperability between multiple DLT implementations and therefore reduces risk and cost for market participants by preventing a fragmented industry eco-system.

DLT standards would also facilitate the sharing of information between market participants and vendors, which would improve understanding of the benefits and risks of the technology, knowledge
Although cryptoassets and stablecoins (DLT) could have useful applications, the underlying distributed ledger technology is not free from consequential lack of safety. Yet the cryptoassets’ severe price volatility and inherent lack of safety serve the public, as well as the clients and the industry.

Regulators and policymakers must consult and collaborate on new technologies, such as DLT, at the global level to better understand how the technology can improve the functioning of financial markets without putting safety at risk. Standard setting bodies (SSBs), such as the Financial Stability Board and IOSCO, have an important role to play in that process.

Now that the initial excitement about DLT has died down, it remains clear that the technology holds potential value for the industry. Benefits include, processing efficiencies, operational capacity and scalability, as well as maintenance of data integrity. In order to realise this value, there must be a standardised approach to DLT security via a comprehensive framework most effectively achieved through collaboration between the industry, market infrastructures, policymakers and vendors.

Effective and efficient collaboration between relevant stakeholders - clients, regulators and vendors - is another benefit of developing standards that is critical to the successful implementation of DLT. For example, it is important that the industry collaborates with policymakers to ensure that the case is well-made around how new technology implementation can safely serve the public, as well as the clients and the industry.

The more open and interoperable a tokenised securities system can be, the better.

And the future is likely to see a transition, not a big bang.

Tokens and DLT offer a number of benefits for securities, but they come with costs. It is therefore very unlikely that a large-scale coordinated move will take place any time soon, or simultaneously. Therefore, as new assets and securities become tokenised, they will need to interoperate with existing account-based cash and securities systems. The more open and interoperable a tokenised securities system can be, the better.