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Regulatory crossroads in digital finance

The EU needs vibrant and sustainable capital markets. Achieving this goal depends crucially on the ability of its financial sector to continuously adapt to faster innovation cycles and evolving business models, to new technological infrastructures and instruments and to fair and responsible use of digital data.

This challenge is recognised both by the new CMU action plan and the Digital Finance Strategy and will only be met if the regulatory and supervisory frameworks strike a balance between ensuring a level playing field that promotes innovation and safeguarding other objectives such as protection of consumers or competition. This, in practice, means we will need pragmatic approaches to the “same activity, same risk, same rules” principle.

In fact, mixing “activity-based” and “entity-based” rules will be necessary both to promote and control innovation in the digital era. Take BigTechs for instance - although their footprint is still limited in EU’s asset management and non-banking financial intermediation (but already relevant in the payments sector), it is wise to consider “entity-based” rules that might deal with possible impacts of their huge market power on financial stability, operational resilience, data protection or competition, together with “activity-based” rules.

On the other hand, and although “activity-based” rules are essential for a proper level playing field between incumbents and newcomers, we should simultaneously ensure that we clearly understand the true nature and implications of new proposals before we classify them and tie them to specific activity rules. This is especially relevant when we deal with completely new realities emerging from the confluence of Artificial Intelligence, Big Data, Cloud Services and DLT.

To face these challenges, regulatory sandboxes and innovation hubs might prove to be useful tools both for regulators and innovators, by helping to reduce information asymmetries and regulatory costs, as several studies have shown. EU-wide initiatives, such as the DLT pilot regime for market infrastructures are, therefore, welcome. This said, possible risks and the relevant differences between these two types of innovation facilitators should be considered.

From the experience and information gathered in Portugal FinLab, the innovation hub of the three Portuguese financial regulators (CMVM, Bank of

Portugal and ASF), innovations hubs seem to be particularly adequate for projects in seed or pre-seed phases that tend to have few resources allocated to the regulatory framework; while regulatory sandboxes might be better suited for more mature firms with innovation proposals.

As regards risks, at least three should be highlighted: given the level of regulators’ resources required by innovation facilitators, regulators’ focus might be diverted (and even biased) towards the selected projects, hindering a more comprehensive approach and strategy for innovation. Additionally, regulators might also end up prioritising innovation over other objectives such as consumer protection. Finally, there is a “race to the bottom” risk in what regards this regulatory framework. A clearer single regulatory rulebook and stronger supervisory convergence within the EU for innovation facilitators might help.