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Regulation and DLT: Working to Strike the Right Balance

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Ladies and gentlemen,

Today is a day of no small importance, as regulators and market players are brought together under one roof to discuss the challenges and opportunities that Distributed Ledger technology has the potential to introduce. I will begin my remarks by discussing the role of the securities market supervisor and how we go about approaching the topic of financial innovation and the attendant regulatory challenges. I will then discuss in greater detail the work we have on the DLT.

ESMA Mission

First, a few words about ESMA and our work on financial innovation. ESMA's focus is on European securities markets and it has as its primary objective to promote investor protection, orderly markets and financial stability. It achieves this by: assessing risks to investors, markets and financial stability, completing a single rule book for EU financial markets, promoting supervisory convergence and directly supervising credit rating agencies and trade repositories. And specifically in terms of innovation, ESMA is in charge of ensuring a coordinated approach to the regulatory and supervisory treatment of new or innovative financial activities in the securities markets.

Approach to Monitoring Financial Innovation

ESMA has put in place a framework to analyse financial innovation and its impact on markets and consumers. The framework provides a principles-based approach to the work both in terms of the range of financial innovation we track as well as the tools we employ. In designing the framework, we have been guided by the three core objectives of ESMA --- investor protection, financial stability and orderly markets. The ESMA objectives serve to ground the analysis of financial innovation. We bring to the subject a balanced approach, both protective and supportive.

Regulatory Challenges

The issue of DLT and the regulatory response is a critical topic for both regulators and market participants. The challenge is to identify when the regulator should step in. This is the regulatory 'tipping point' --- the point between 'too small to care' and 'too large to ignore'. I want to share how ESMA approaches the challenge.

When confronted with a financial innovation, a regulator can roughly take one of three approaches, each of which is in its own way 'pro-active' rather than 'reactive':

1) Ban or restrict products or processes, in the light of the potential risks (restrictive approach).

2) Take a "wait and see" approach (watchful approach).

3) Actively facilitate and regulate the product or process because of its potential economic and social benefits (facilitative or catalyst approach) and/or because of known threats to our objectives.

The first, banning, is a power that ESMA and the MSs will have once MiFID II/MiFIR becomes effective on 1 January 2018. Until then, if we believe a harmful 'tipping point' has been reached, we can take measures such as issuing warnings as we have done against 'contracts for differences' in 2013, and reinforced this past year, or the Statement we issued in 2014 on the risks to investing in Contingent Convertibles, in which we outlined that these instruments should only be purchased by sophisticated investors and are not appropriate for retail.

The second, the 'wait and see' approach as I will make clear later, is largely the approach that ESMA, like most regulators, have taken towards the DLT. There is a collective need to better understand DLT and its possible applications in the financial market. Now, do not interpret this as a passive approach, but rather one in which we actively try to learn more about the innovation, but do so while it remains sufficiently immature that we are not placing our objectives, stability, protection and integrity, at risk by not taking action. At the same time, by waiting to see how the innovation develops we do not risk stifling a potentially socially or economically useful product or process. The innovation has not reached a 'tipping point' where active regulatory participation is needed.

The third of the three approaches, actively facilitate and regulate the product or process, is an approach we will take when we believe an innovation has matured or become too large to ignore; that is, a tipping point has been reached. An example of this is the work we did in investment-based crowdfunding, where after extensive research we saw the potential for investor protection harm to arise, if the crowdfunding platform operated outside of MiFID rules. We also recognized that there existed both EU-wide regulation and local regulation that were potentially serving to inhibit the growth of crowdfunding. Our action was to draft an Opinion to the 28 National Competent Authorities on how they should consider supervising crowd funding; and Advice to the European Institutions (Parliament, Council and the Commission) on how they should consider regulating crowd funding.

Why have we taken the second of the three approaches to the DLT? We can rule out the first --- restrictive approach as we do not see the DLT presently posing risk to our three objectives --- stability, protection and integrity. While the third, 'facilitative' approach has merits, as it may reduce regulatory uncertainty around DLT and it may also potentially lead to more rapid development in ways that are responsible, perhaps even in accordance with guidelines established by regulator. However, if the technology fails to develop as anticipated, the approach could lead market participants to suggest that the Regulator acted impetuously or disrupt a socially and economically useful phenomenon from evolving.

DLT

ESMA began examining the topic in early 2013 as the virtual currency known as 'bitcoin' became a widely-known alternative payment service. ESMA then began analysing the degree to which there existed investment products that used virtual currencies as an underlying asset. We learned that such investment products were at best marginal at the time but should be monitored were they to grow and introduce risks to investors. As time passed, ESMA became aware that market participants' focus was largely shifting from virtual currencies as such to the underlying technology.

In April 2015, ESMA published a 'call for evidence' on investments using virtual currency as an underlying asset and on the anticipated uses of the core distributed ledger technology. The resulting responses from the call for evidence indicated that investments using virtual currencies as underlying assets remained marginal. However, there was a clear consensus that the core distributed ledger technology had many potential uses across the lifecycle of the investment chain and could have significant effects on the status quo. In particular, the responses emphasized that the DLT could be used as a more efficient lower cost alternative to the existing trading infrastructure.

By then ESMA had put in place a DLT Task Force made up of regulators from across the MSs as well as representatives of the EC and the ECB. Given ESMA's remit, the primary focus of the Task Force has been to better understand how the DLT would function in the area of post-trade activities. As well, the Task Force sought to establish an open dialogue with market players to better understand the potential use cases and begin to address how the technology and regulation would interact.

In June 2016, ESMA published a Discussion Paper to collect feedback from the market on the potential uses, benefits and risks of DLT applied to securities markets. The Discussion Paper also provided a stock-take, with a particular focus on post-trade activities, of the key EU regulations that would be applicable to DLT. ESMA stressed that firms willing to use DLT should be mindful of the existing regulatory framework. More than 60 stakeholders have responded to our consultation, which closed on 2 September 2016. We are using the feedback to develop a position on the use of the technology in securities markets and assess whether a regulatory response to the DLT may be needed.

Let me share with you some initial thoughts on our analysis. ESMA's view is that DLT could bring a number of benefits to securities markets, including but not exclusively to post-trade

processes. However, a number of challenges will need to be addressed before these benefits may materialise. Importantly, despite a number of interesting proofs of concept, DLT is still at an early stage and we remain unclear as to its capacity to overcome all of these challenges. Also, ESMA realises that while DLT may at once reduce or mitigate certain risks, it may also create or exacerbate others.

We anticipate that the early applications of DLT will focus on optimising existing processes under the current market structure. Respondents to our DP confirmed this belief arguing that they expect DLT to start small in low volumes, niche, relatively 'simple' and mostly unregulated markets, which is consistent with the early projects that we are seeing. Segments of the markets or activities that are the least efficient will likely be targeted first. Sophistication in terms of applications will increase, as the technology develops. Over time, however, DLT might help rethink some of the functions of financial intermediaries. ESMA's role in this context is to make sure that the regulatory framework provides relevant safeguards to investor protection, financial stability and orderly markets at all times.

In securities settlements, differences in the timing between the delivery of securities and delivery of funds introduces settlement risks between counterparties and/or their intermediaries. To the extent that DLT technologies are designed to replace traditional reliance on trusted intermediaries to ensure settlement, they will need to demonstrate their ability to eliminate settlement risk. This is still more critical when the delivery of securities and the source of funding takes place on two different platforms.

I also want to stress that we believe the relevant regulation (i.e., MiFID/MiFIR, EMIR) is technology agnostic. Supporters of the technology need to consider existing rules when designing DLT solutions. There exist regulatory guardrails within the clearing and settlement sector for good reason. Safety and soundness of financial institutions and markets in the field of clearance and settlement are fundamental to financial stability. We expect the private sector to share responsibility for deploying new technologies in ways that are at once consistent with existing regulation and have a thorough understanding of risks and how best to manage them.

We believe it is premature to appreciate all the technological changes and the potential regulatory response that may be needed, as the technology is still in its infancy. In analysing the responses to our Discussion Paper, we have not identified major impediments in the current EU regulatory framework that would prevent the emergence of DLT. Meanwhile, a number of concepts or principles, e.g., the legal certainty attached to DLT records or settlement finality, may require clarification as DLT develops. Also, ESMA realises that beyond pure financial regulation broader legal issues, such as contract law, insolvency law or competition law, may impact on the deployment of DLT.

ESMA will continue to closely monitor market developments around DLT to assess whether a regulatory response may be needed. Meanwhile, regulators must actively engage with market players to ensure both that the technology does not create unintended risks and that its benefits are not hindered by undue obstacles. For their part, we believe that the industry should work towards common solutions to the issues posed by the technology.

Conclusion

Regulators face a balancing act. We work to understand the risks that new products or processes may introduce, cautious in allowing innovations to disseminate so widely such that in the event of unanticipated risks, they cannot be rolled back while at the same time not wanting to stifle innovation by restricting the use of certain technologies. We are responsible for designing and supervising the rules of conduct by which financial institutions operate with the aim of minimizing disruption to the markets and harm to market participants. In turn, regulated entities gain access to markets and certain safety nets by applying regulatory standards, and suffer penalties for non-compliance.

The existence of DLT does not free market participants from complying with the existing regulatory framework, which provides important safeguards for the well-functioning of financial markets. Yet, we at same time realise that DLT may over time render some processes redundant or change the role of certain market participants. Some regulatory requirements could become less relevant. Meanwhile, additional requirements might be needed to mitigate new risks.

We have said that our framework for monitoring financial innovation is a principles-based approach. In turn, our framework needs to remain flexible and adaptive to market events. It also needs the subtlety to know when to respond in a supportive as opposed to a protective manner, a tipping point of sorts. We intend to revisit the framework on a regular basis to ensure it remains effective and relevant. And we need to keep working together to strike the right balance between the regulation and the technology.

Thank you for your time this morning.