

Deadline to Comment on European Blockchain Technology Regulation Quickly Approaching

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The European Securities and Markets Authority is soliciting public comment on its recently published discussion paper on the benefits and challenges of using Distributed Ledger Technology.

The European Securities and Markets Authority (ESMA) has published a discussion paper on the potential use of Distributed Ledger Technology (DLT) in securities markets. In its paper, ESMA outlined the potential benefits and risks of applying DLT to European markets and analyzed how it might fare under the existing European Union regulations. ESMA has requested feedback no later than September 2, 2016.

ESMA Is Deciding the Future of Blockchain Technology in Europe

ESMA is determining whether and how new regulations will be developed, and it is asking for the industry's input. Specifically, ESMA seeks answers to:

- Are there potential regulatory impediments to the deployment of DLT in securities markets, and how should regulators react to this deployment?
- In which transactions, settlement activities and securities-related services would DLT be used, and how can compliance with regulatory requirements be ensured?
- How would your organization benefit from the introduction of DLT? Are you working on a concrete application of DLT to securities markets, and what are your practical achievements in this endeavor?
- Could DLT be used for safekeeping and record-keeping purposes and regulatory reporting purposes, and how can compliance with regulatory requirements be ensured?
- What are some challenges and risks associated with DLT that are affecting your organization?

- What are the potential challenges and risks of DLT, and what solutions exist for them? Are there current initiatives directed toward these challenges and risks?

ESMA on DLT Benefits

ESMA outlined what it believes to be the benefits of blockchain technology.

Efficiency: DLT has the potential to increase the efficiency of reconciliation and accelerate the clearing and settlement of certain financial transactions through process automation and by reducing the number of intermediaries. Moreover, clearing and settlement transactions could merge into a single step to become almost instantaneous, thereby reducing counterparty risk and the need for collateral. Additionally, the shared nature of the ledgers and algorithms would increase the speed of the reconciliation process to reach settlement finality.

Tracking Securities and Other Assets: DLT provides a unique reference system across securities markets, which provides a number of advantages. It may: facilitate further transparency into ownership records and safekeeping of assets; reduce the uncertainty in contract terms and increase the automation of some post-trading activities through smart contracts; issue digital securities and track their ownership; and improve methods of moving collateral across market participants.

Costs: The technology may also save on costs and increase market security. Costs are reduced through the automation of certain activities and the supervisory authorities' direct access to information stored on ledgers for reporting and oversight. At the company level, the costs of maintaining individual ledgers and developing business continuity plans may be reduced.

ESMA on DLT Risks

ESMA also outlined perceived risks of DLT:

Scale: It is unclear whether DLT can scale up to cater to the broad range of instruments and participants in the securities market. Moreover, the technology may not seamlessly integrate with existing market infrastructures, requiring a bridge between DLT and incompatible legacy technology.

Limited Transactions: DLT may have limited value in certain transactions. For example: in cleared financial derivative transactions, the absence of netting could increase the need for collateral and capital. It is also difficult to engage in short sales when trading in securities underpinned by DLT because transacting on DLT requires the possession of assets.

Regulatory Framework: New regulatory frameworks will likely be required to address the use of DLT in securities markets. For example, a set of rules must be devised to govern "permissioned" and "non-permissioned" networks, intellectual property concerning technology, and territoriality of applicable law, as well as fraud, error, correction mechanisms, and penalties for infringement. Furthermore, it is unclear how an error in the DLT's immutable shared ledgers would be handled from a technological and governance point of view. For supervisory authorities, a DLT network may be unduly complex due to multiple nodes established in multiple jurisdictions. Interoperable ledgers may also increase systemic risk by allowing contagions to spread even more quickly between and among financial markets.

Safety: A successful cyber-attack may expose the full breadth of information recorded on the ledgers. The same is true when encryption techniques are hacked. Dishonest nodes may gain control of the network

and manipulate the consensus process, and private/public keys may be lost or stolen to be used fraudulently to record fictitious transactions. The risk of money laundering and terrorist financing may be heightened because it is easier to conceal identities or hide the transaction records.

Call for Submissions

ESMA is forming its opinions on Blockchain Technology's role in the European Markets. The opportunity today is clear: Establish your institution as a reliable source of information for ESMA's decision-making process and ensure your voice is heard. The Blockchain Technology Focus Team at Pillsbury can assist with the preparation of a submission to ESMA as well as a larger blockchain technology strategy in the EU.

If you have any questions about the content of this Alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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