EXPERT OPINION

PILOTE SCHEME

The regulatory framework to stimulate innovation in finance

An experimental framework that is unique in the world, the Pilot Scheme represents a fundamental step in the adoption of Web 3 technologies by institutional players. First introduced in September 2020 by the European Commission, the Pilot Scheme regulation officially **came into effect on 23 March 2023 and will last for a period of 3 years.** It is renewable once.

With this Regulation, the European Union affirms its "strategic interest in studying, developing and **promoting the adoption of transformative technologies in the financial sector**, including the adoption of distributed ledger technology (DLT); crypto-assets [being] one of the main applications of distributed ledger technology in the financial sector".

This European regulatory framework is unprecedented and demonstrates the strengthened determination of the European institutions to support the **digital transformation of financial activities.** It is in line with the European strategy for digital finance, which aims to "enable and support the development of digital finance through innovation and competition while limiting the associated risks".

Below is a retrospective of one of the most eagerly awaited regulations in the financial sector.

The pilot scheme, a text full of ambitions

Alongside the Regulation on markets in crypto-assets (MiCA) and the Regulation on digital operational resilience (DORA), the DLT Pilot Regime is one of the key elements of the EU's digital finance package. As such, the Regime shares **the same objectives of ensuring legal certainty, supporting innovation, protecting consumer rights, as well as financial stability**.

Unlike the previous Regulations, the Pilot Scheme specifically addresses DLT market infrastructures with the aim of "facilitating experimentation with distributed ledger technology by providing exemptions for its use in the trading and post-trading of assets in the field". To put it simply, the French terminology of "distributed ledger technology" (DLT) corresponds to the English terminology of "**blockchain**". In other words, the new regulatory framework proposed by the Pilot Scheme authorises market infrastructure operations on blockchain.

Blockchain is a Distributed Ledger Technology (DLT) that enables transactions to be recorded and stored securely, transparently and immutably. Unlike a centralised ledger, where a single entity has control, blockchain is decentralised and operates on a network of nodes (computers) that work together to validate and record transactions.

During **the 3 years of** the Pilot Regime (renewable once), certain market infrastructures may apply for **exemptions** from various European laws applicable to financial services. The exemptions will bring freedom from a number of constraints that hinder the development of innovation, while guaranteeing investor protection, market integrity and financial stability.
This duality is made possible by the **restriction of authorisation** of this type of experimentation. Given the complexity of the subject and its potential impact, the Pilot Scheme cannot apply to all players, and is therefore restricted to the largest players with heavy authorisations. In other words, **few start-ups** will be able to obtain such authorisation.

Finally, the ambition of the pilot scheme is to **integrate the new Web 3 technologies directly into** traditional **players** and thus avoid the potential systemic risks associated with the development of unregulated and uncontrolled superstructures. The desire to experiment with the creation of **tokenised** financial securities within traditional finance represents a real break with the approach of the regulatory authorities and confirms Europe's pre-eminent position in Web 3 technologies at the global level.

Financial instruments concerned

While the links between Web 3 technologies and traditional finance have long been ignored, the Régime Pilote aims to create a bridge between these two worlds, notably through a revolutionary concept: **tokenisation**.

Tokenisation involves registering an asset of any kind in the blockchain.

The potential offered by tokenisation is virtually infinite. As Larry Fink, CEO of BlackRock, announced in his annual letter to investors in March 2023, "**tokenisation could make financial markets more efficient** by simplifying the value chain and lowering costs for investors".

As far as the Pilot Scheme is concerned, the new regulatory framework offers the possibility of tokenising financial instruments, i.e. creating a digital representation of a property right such as shares, bonds and units in collective investment schemes. More specifically, DLT financial instruments must meet certain conditions:

- **Shares**: The issuer of these securities has a market capitalisation of less than €500 million.
- **Bonds**: All money market instruments with an issue volume of less than €1 billion. Corporate bonds issued by issuers whose market capitalisation did not exceed €200 million at the time of issue will be excluded from the calculation of the threshold.
- **Units in undertakings for collective investment with a** market value of assets under management of less than €500 million.

Of the many benefits that tokenisation of financial assets could bring, 8 stand out in particular:

1. **Increased liquidity**: Tokenisation can increase the liquidity of shares, particularly for companies where secondary markets (i.e. after the shares have been issued) are limited or non-existent. The ability to exchange tokens can easily make these assets more attractive to investors.
2. 2. **Fractionability**: An asset, regardless of its value, can be divided into several tokens representing fractions of that asset. This means that investors can buy or sell a small part of the asset (e.g. 0.00001% of a share), making it accessible to a larger number of investors.
3. 3. **Democratised access**: Assets previously reserved for institutional investors or wealthy individuals are becoming accessible to a wider public. This is particularly true of shares in unlisted companies. For the time being, this aspect is limited due to the absence of specialised stock exchanges (or market places).

4. **Simplified transactions**: The blockchain facilitates peer-to-peer transactions, reducing the number of intermediaries and thus cutting transaction costs and times.
5. **Transparency and traceability**: Every transaction carried out on the blockchain is immutably recorded, guaranteeing complete traceability of an asset's ownership.
6. **Security**: Blockchains are secured by cryptographic mechanisms that reduce the risk of fraud or manipulation.
7. **Automation**: With the use of smart contracts on the blockchain, many processes, such as the distribution of dividends or the sale of a security, can be automated, reducing costs and errors.
8. **Built-in compliance**: tokens can be programmed to ensure that transactions comply with local regulations, for example by restricting sales to accredited investors.

The opportunities offered by tokenisation already seem to be convincing many traditional players, who are rushing to take up the subject. To name just one of the most advanced, **SG Forge** remains the most advanced player in the field of digital assets.

Forge, a Société Générale subsidiary dedicated to digital assets, specialises in token issuance. In particular, it supported the European Investment Bank (EIB) in its first digital bond issue, worth €100 million, on Ethereum. It has also worked on investments in digital securities with major insurers such as AXA and Generali. What's more, on 30 November 2023, **Societe Generale issued its first digital green bond in the** form of a "Security Token" directly registered by SG-FORGE on the Ethereum blockchain with ESG data transparency and traceability. The tokens were fully subscribed by two leading institutional investors, AXA Investment Managers and Generali Investments, through a private placement.

The entry into force of the Pilot Scheme celebrates much more than the tokenisation of certain financial assets; it also celebrates a genuine **revolution in the infrastructures and organisational models of investment companies**.

DLT market infrastructures

The experimental phase of the Pilot Regime allows certain market infrastructures to apply for exemptions from various European laws applicable to financial services, in particular MiFID II and CSRD.

The eligible DLT market infrastructures authorised to benefit from the temporary exemption regime may be :

- **DLT Multilateral Trading Facility ("DLT MTF")** consisting of a multilateral trading facility operated by investment firms or market operators authorised under MiFID II, subject to the rules set out in particular in Articles 4 and 7 of the DLT Pilot Regime ;
- **DLT settlement system ("SR DLT")** consisting of a system for the settlement of transactions in DLT Financial Instruments operated by a central securities depository conducting securities settlement operations under the CSDR, in particular subject to the conditions of Articles 5 and 8 of the DLT Pilot Scheme;
- **A DLT trading and settlement system ("DLT SNR")** operated by an investment firm, market operator or CSD and combining the activities of a DLT MTF and a DLT SR.

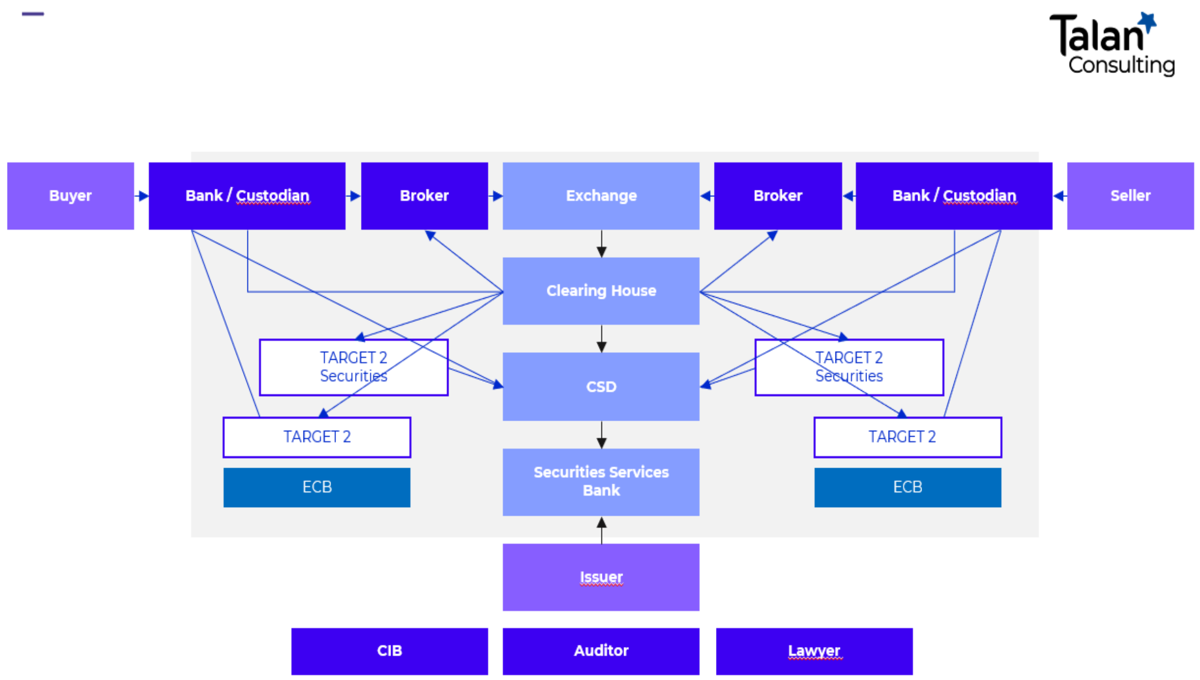
Among the many exemptions granted to security token marketplaces compared with traditional exchanges is the ability to operate as both a **trading operator and a clearing house**. This is unprecedented, as the traditional system requires two separate entities, such as Euronext **and Euroclear.**

Another major benefit is the possibility of **automating reporting** to the regulator via blockchain, whereas traditionally, stock exchanges mobilise numerous teams to carry out their daily reporting.

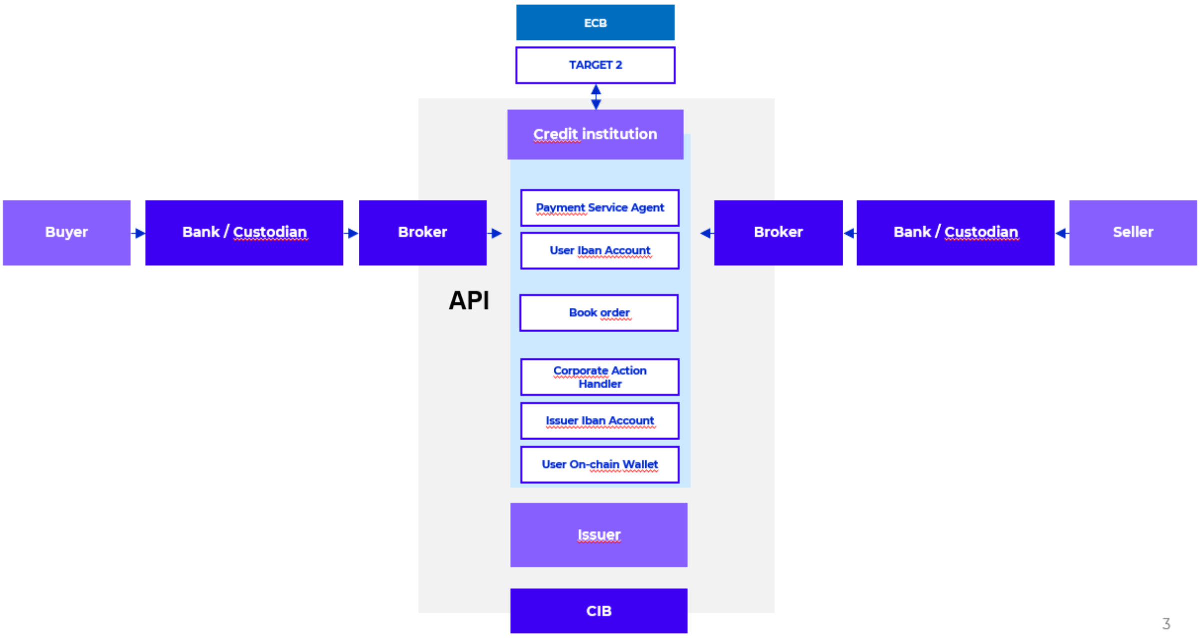
Finally, the authorisation for new marketplaces to **address investors directly without going through an approved broker to access Euronext**. Some intermediaries could thus disappear.

In the long term, the European pilot scheme is seen as an opportunity to **redefine the market infrastructure** to which new building blocks and standards have been added over the last 40 years. The current fragmentation of market infrastructures means that the time taken to deliver assets is around **2 days**. Tomorrow, new infrastructure organisations will make it possible to reduce this time to **instantaneous**. The following two illustrations, taken from The Big Whale, **compare the infrastructure modes of current markets as well as markets organised around blockchain**.

Market infrastructures are currently highly fragmented



Model of a blockchain market infrastructure (here Kriptown)



In addition to cutting delivery times and costs by eliminating intermediaries, these new organisational models **will reduce IPO costs to just** a few thousand euros, compared with an average of €200,000 to €400,000 on Euronext.

However, the major disadvantage of this type of infrastructure is the **barriers to entry** for small players, who are obliged to block €5-10 million of funds and incur annual compliance costs of around €500,000.

Conclusion

At a time when the regulatory framework is proving to be a decisive factor for the geographical areas that covet a place of choice in the crypto-asset market, the European Central Bank is at the helm with a view to preserving its aura, and even extending it.

Indeed, under the impetus of the Autorité des Marchés Financiers, France is in a position to make a strong contribution in this area, in order to develop the regulatory framework proactively, aiming to strike the right balance between controlling risks and stimulating innovation to enhance the attractiveness of the European economic area. The timing of this initiative is interesting, as there is a global trend towards institutional adoption of crypto-assets, especially after Brexit repositioned the heart of Europe as a leading international financial centre.

Given the efforts already made by the relevant authorities within the European Union, it would seem that this part of the world is strengthening its presence on the international stage. The European Union could therefore become an epicentre for this new sector of activity, with the potential to create jobs to support the development of existing players in this field, but also to create the players of tomorrow, who will have the means to emerge as market leaders, thanks in particular to a regulatory framework that supports innovation.

The timing is all the more strategic, given the progress currently being made by the European Central Bank on the digital euro. Through these in-depth reflections, we can see an opportunity for growth in the adoption of the euro against other state reference currencies. Ultimately, the stakes go beyond the crypto-asset sector and extend to the financial and geopolitical power plays that govern the world.

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