FINTECH REGULATION – THE EU APPROACH

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What should be the regulatory approach to FinTech? Should it be about bringing FinTech under the roof of the current regulatory regime and possibly banning any parts that cannot fit? Should it be about leaving FinTech alone and unregulated? Do we need a bespoke regulatory regime? Should disruptive innovation be encouraged or held back? This article presents the emerging EU regulatory approach to FinTech in relation to financial services. The European Commission has embraced a forward-looking policy towards digital finance aiming to regulate innovation in and not out, while at the same time addressing and monitoring the potential risks and challenges resulting from FinTech and BigTech. The article focuses in particular on two examples of innovative legislative frameworks currently in the pipeline: the recently agreed proposal for a Distributed Ledger Technology pilot regime and the proposal for a Regulation on Markets in Crypto-Assets. Both are examples of new innovative frameworks directed at FinTech. Together, they have the potential to spur innovation in the field of financial services and to help bringing them to the next technological level.

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FinTech (short for financial technology) is a term that refers to the integration of technology into offerings by financial companies to enhance the use and quality of financial services and their delivery to consumers. Until recently, FinTech was considered to be an emerging, still marginal phenomenon. However, technological advances and recent events such as the global pandemic have accelerated the increase in offerings of and demand for FinTech solutions in financial services and other sectors to an extent that by now FinTech has irreversibly altered the way we perceive the provision of financial services across all fields of financial activity.

FinTech companies come in all shapes and sizes. They can be micro startups, SMEs, established financial institutions that wish to develop internally their own FinTech solutions as part of their business model, or even large technology companies (the so-called "BigTech" companies) trying to enter the market and replace or enhance the usage of financial services provided by existing financial companies. With recent technological developments and the increased availability of FinTech solutions, more companies are able to enter the market and provide financial services. BigTech companies in particular often act as intermediaries, bundling their services and products with associated financial services. These companies can scale up their services quickly, given their large number of users. This has the potential to radically change market structures.

Digital technologies have made it possible for firms to specialize in a particular link of the value chain. Thus, technology is contributing to breaking up previously integrated value chains for certain financial services. This can increase competition and improve efficiency. However, it also makes value chains more complex, making it harder for supervisors to have an overview of the related risks. If some actors in the value chain are not regulated entities, the supervisory authority may lack full information of or control over the whole structure. The new business models need to be examined and analyzed carefully to understand the risks and opportunities associated with them and to propose the right policy solutions.

Financial regulation needs to adjust to technological developments and the new types of companies that emerge and provide services. It needs to address associated risks for consumers, counterparts, and the financial system. The European Commission has committed to adapt, where necessary, the existing conduct and prudential EU legal frameworks to safeguard financial stability and market integrity and to protect consumers.

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FinTech is often not about an entirely new product or a new service or a new type of service provider. It is frequently about new technology that may enable already existing products or services to be offered in a different and more efficient way, reaching a greater number of potential users. When developing policy on FinTech, therefore, the issue is not so much about devising a new tailormade framework to regulate the new technology, but rather about finding ways to allow this new technology to be used by existing products, market infrastructures and service providers, while addressing any additional risks that this technology might pose, in particular to consumers.

The European Commission has opted for a forward-looking approach to digital finance aiming to regulate innovation in and not out, while at the same time addressing and monitoring the potential risks and challenges resulting from FinTech and BigTech. It has realized early on that if Europe is to reap the benefits of innovations such as distributed ledger technology, artificial intelligence, and cloud computing, it has to maximize the European single market's potential so that companies can scale up across borders. This is how efficiency gains can be made and consumers can get more choice and access to cutting-edge digital tech, with better products and services at lower prices. This is essential if European companies are to compete with their peers, for example from Asia or the United States.

The Digital Finance Strategy[2] set out the Commission's intention to review the existing financial services legislative frameworks to protect consumers and safeguard financial stability, protect the integrity of the EU financial sectors, and ensure a level playing field. It highlighted that faster, more open, and collaborative innovation cycles call for regular examination of and adjustments to EU financial services legislation and supervisory practices, to ensure that they support digital innovation and remain appropriate and relevant in evolving market environments. Rapid and disruptive change based on technological progress is testing regulation and supervision in many fields, but it is particularly challenging in the area of FinTech.

2 COM (2020) 591) adopted in September 2020.

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The strategy points to risks for the financial ecosystem and for financial services value chains. Technology companies – large and small – are increasingly entering financial services markets. For example, several of these companies already provide payment services but responses to the Commission's public consultation suggest that they are likely to expand into other financial services as well.

The European Commission has embraced FinTech as a development that can potentially bring great opportunities and has adopted a number of proposals aimed at regulating several key elements of FinTech, which are related to technology and to activities linked to crypto-assets. This article focuses on two examples of innovative legislative frameworks currently in the pipeline: the recently agreed Distributed Ledger Technology pilot regime and the proposal for a Regulation on Markets in Crypto-Assets which is still being negotiated.

As part of its Digital Finance Strategy, the Commission proposed the Markets in Crypto-Assets Regulation ("MiCA"), which seeks to promote responsible innovation within crypto-asset markets and ensure that market integrity, consumer and investor protection and financial stability are preserved. The EU has been ahead of other jurisdictions in proposing a comprehensive regulatory framework and aims to set the benchmark in crypto-assets regulation. The proposal was necessary because existing EU law did not cover adequately the dimension of crypto-assets as a major FinTech development.

The proposed MiCA framework addresses the issuance of crypto-assets, the requirements for crypto-asset service providers and the supervision of issuers and service providers for crypto-assets. It covers crypto-assets not qualifying as financial instruments and distinguishes between asset referenced tokens ("ARTs"), electronic money tokens ("EMTs"), and those crypto-assets that fall into neither of these two categories. Asset referenced tokens are those types of crypto-assets that aim to maintain a stable value by referencing one or several fiat currencies that are legal tender, one or several commodities, one or several crypto-assets or a combination of these. Electronic money tokens (or e-money tokens) are those types of crypto-assets that are intended to be used as a means of exchange and that aim to maintain a stable value by referencing the value of an official currency of a country. Both ARTs and EMTs are also generally known as stablecoins. Any other digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology is considered to be a crypto-asset.

The MiCA framework seeks to provide legal certainty for innovators to allow them to navigate financial legislation and scale across the EU. It builds on three main principles:

- Preserving market integrity;
- Ensuring consumer and investor protection;
- Securing financial stability – if and when crypto-assets acquire a market presence that could trigger stability issues.

MiCA implements international recommendations from the Financial Stability Board ("FSB") as regards stablecoins and also from the Financial Action Task Force ("FATF"), ensuring that together with the updated AML framework, all AML/CFT risks are appropriately mitigated.

From early on, the EU has been promoting international coordination in the area of crypto-assets and in particular of stablecoins and has been actively participating in all relevant fora such as the G7, FSB and FATF. These innovations present the biggest opportunities but also the biggest risks, where their use across borders offers global efficiency gains, and the EU will continue and step up their work with international partners to promote cooperation and supervisory convergence based on common principles and standards.

By the time the Commission presented its MICA proposal there were already signs of fragmentation in the EU, with some Member States establishing rules for crypto-assets. The need to comply with multiple and sometimes conflicting rules puts an additional burden on companies operating in this space and hampers their ability to develop and scale up across the internal market. An EU-wide harmonized framework will replace existing national rules, reduce complexity and administrative burden, provide legal clarity, and facilitate crossborder activities. It will mean that a crypto-asset service provider authorized in a Member State will benefit from an EU passport and be able to operate across the entire EU single market.

A concern that is frequently raised in the context of FinTech is that crypto-assets could offer opportunities for illicit activities like money laundering or terrorist financing. The notion of "virtual currencies" is defined under the existing EU Anti Money Laundering Directive. Providers engaged in exchange services between virtual currencies and fiat currencies and custodian wallet providers are considered to be "obliged entities" for the purpose of anti-money laundering rules and as such, are required to follow anti money laundering checks and procedures. The objective of the Anti-Money Laundering Directive regarding virtual currencies was to control the "gatekeepers," i.e. the providers of services to EU consumers which makes the link between the virtual sphere and the real world.

However, the crypto-assets area is evolving very fast and compared to the Financial Action Task Force's Recommendation adopted in June 2019, the Commission has identified some gaps that need to be closed: The notions of "vir-

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tual asset" and "virtual asset service provider" as included in the FATF's recommendation are broader than the notions of "virtual currency" and the above-mentioned services providers covered in the current Anti Money Laundering Directive. The MiCA proposal therefore uses the terms "crypto-assets" and "crypto-asset service providers" that are in line with the FATF Recommendations.

The overhauled AML framework proposed in July 2021, cross-refers to MiCA, bringing in scope a range of new crypto-asset service providers as obliged entities. At the same time, the proposed update of the Transfer of Funds Regulation has also included information requirements for transfers of crypto-assets. This will lead to the implementation of the so-called "travel rule" from the FATF.

A second cause of concern regarding FinTech in general and crypto-assets in particular relates to the environmental footprint that is caused by the mining of certain crypto-assets. This concern refers to the environmental impact and high energy needs of DLT, notably for certain crypto-assets. As set out in the European Commission's strategy for financing the transition to a sustainable economy,[3] this is an area where the EU will need to assess the sustainability impact of digital finance technologies. The Commission argues that the EU should take the lead in making these infrastructures climate neutral and energy efficient by 2030. For this purpose, it can build on previous initiatives to promote sustainable data centers.

A further, equally important framework related to FinTech is the Commission proposal for a Distributed Ledger Technology Pilot Regime Regulation ("DLT Pilot") on which a political agreement was reached in November 2021. It will soon become part of the legislative framework and will apply from next year. Distributed ledger technology is a technology that supports the distributed recording of encrypted data. It is a way of keeping records of transactions and is shared across a network whereby these transactions are validated and stored and can be traced when needed. It is an important innovation because where previously transactions were created and stored only by intermediaries, DLT can run without third party involvement and is also highly transparent, secure, and tamper-proof.

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In the area of trading and settlement of financial instruments DLT can bring a number of benefits, notably in terms of efficiency, security, and transparency. However, the current rules have not been written with this technology in mind and may hamper the wider use of this technology the trading and post-trading areas. While the use of DLT has the potential to improve efficiency more information is needed before legislation can be overhauled. The DLT pilot regime aims to achieve just that, by allowing for some limited and temporary exemptions from existing rules where they could pose technical obstacles to achieve the full benefits of using DLT. The DLT pilot will enable market participants to safely experiment with DLT to issue, trade and settle securities in a controlled setting.

The pilot will run for five years and will be reviewed at the end of this period in order to determine whether to make it permanent, amend it or abandon it. It means that DLT is currently tested in a 'sandbox'. The experience gained will inform future policymaking and could potentially lead to more wide-ranging changes. This framework is a first of its kind in the EU and will enable the EU to move the forefront of innovation in this field. The experience gained can also be useful to develop general principles for the implementation of regulatory sandboxes in other fields.

Also in data driven finance, work is progressing in the Commission on the creation of an open finance framework to allow the access to and the reuse of business-to-business and business-to-consumer data with customer consent across a wide range of financial services. This framework will be developed in a bottom-up approach, building on a close cooperation with experts and stakeholders. For that purpose, an expert group is analyzing different use cases and assessing issues of data availability and data accessibility in finance. An open finance framework will build on the Commission's broader European Data, which aims at the creation of an internal market for data through cross-sectoral rules on data use that are, in principle, also applicable in the financial sector.

Ensuring fair competition and a level playing field, including with technology firms, within an open data space is an essential aspect in this context. Due consideration will also have to be given to the opportunities and the risks in light of the lessons learnt from the implementation of the second Payment Services Directive ("PSD2"),[4] which led to new players entering the payments market, offering new and innovative solutions previously unavailable. Open finance will mean to give more control to the users of financial services, be it consumers or firms, when it comes to the way their data is used and to who can access the data. It is a FinTech innovation with the potential to sig-

3 COM (2021) 390, July 6, 2021.

4 COM (2020) 66, February 19, 2020.

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nificantly improve the consumer and user experience in financial services.

What is then the EU's approach to FinTech? It is about recognizing the potential of FinTech and improving the regulatory environment to be more conducive to innovation while minimizing its risks. It is about enabling the scaling up of FinTech services across an EU-wide internal market and beyond. And it is about staying ahead of the game and embracing technological change where it increases efficiency and is beneficial to consumers and companies and to society at large. Responsible innovation in FinTech can and will improve the products and services offered, and the European Commission will be there to help see it through.

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