Portugal

Portugal: DLT – theoretical possibilities hampered by practical legal limitations

Mariana Albuquerque of Morais Leitão explains how theoretical possibilities of utilising DLT in financial services are being hampered by practical legal limitations of positive law

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With financial innovation in the agenda, it is becoming undeniable that decentralised financial technology (DLT) – of which blockchain is a subtype – is the centre piece that will underpin, and drive decentralised financial innovation as a truly transformativeand foundational technology.

However, the pace and the extent to which the technology can flourish in all its theoretical potential and practical deployment relies heavily on the willingness of legislative powers to give statutory legal effect to DLT-based solutions when warranted. The legal world will recognise things and give them meaning in accordance with its own set of rules, which means that certain operations will not have their desired legal effect if the technology is not recognised by law to produce the intended legal outcomes.

For example, the potential to tokenise any asset and have the rights to such an asset be represented on a DLT has now been discussed at length, and while this is true in theory, it may not be possible for a person to transfer certain objects in this way.

In jurisdictions where an object, such as a real estate asset, can only be transferred by execution of a deed or other public document and/or that require public registration of property rights, it is not possible to legally transfer property over such kinds of assets through tokenised instruments without an adjustment of the existing legal framework. The law will not recognise the transaction as valid for this purpose and, while other remedies may be available for the persons holding those tokens, they will not be able to claim the asset or any fraction of the asset in court.

It should in any event be possible to tokenise the economic interests in the asset which leads to the question of how those claims would be structured, considering that the asset does not have legal personality and cannot be a subject of rights and obligations *vis-à-vis* potential investors. This will probably lead to the conclusion that some form of special purpose vehicle (SPV) must be created depending on the alternatives available in the relevant jurisdiction and will invariably attract the legal regime applicable to such figure, whether or not it is desired by the technology driven promoters. Furthermore, it will become necessary to assess the type of instrument being created to represent the claims over the asset and the legal framework applicable to it.

If the objective is to structure a financial instrument or transferable securities, then in principle a whole lot of regulation should come their way. However, there is no certainty or clarity on how these rules would apply to these instruments, as they were created for a completely different paradigm of banking and financial services and their participants which is based upon centralisation. This is but one example from the many that could be mentioned.

In any event, as can be seen from the example, there are a number of legal constructions that are required to be put in place to make the innovative project work from a legal perspective, that would not be necessary from a purely technical and theoretical approach of the technology being implemented. Therefore, it becomes difficult to navigate DLT applications in the banking and financial system, if there is no real effort to provide legal certainty to market participants that are eager to put their proofs of concept into practice.

This effort should be two-fold to include legislative intervention to ensure that there is a clear legal pathway for the application of exemptions from existing rules and the granting of powers to supervising and regulating entities to be able to determine the application of those exemptions in practice. Otherwise, the line between legality and illegality will be blurred in most instances deterring significant investment, technology deployment and scalability of DLT solutions.

This is troublesome if one considers the potential revolutionary impact of DLT to optimise areas of banking and finance such as payments, clearance and settlement systems, fundraising, securities and financial instruments, custody, loans and credit, trade finance, know your customer (KYC), anti-money laundering, prevention of terrorist financing and fraud.

Surprisingly enough, while most EU countries have innovation hubs, only a handful have yet implemented regulatory sandboxes in which DLT solutions could be tested; and while the European Commission has presented its proposal for a regulation for a pilot regime for market infrastructures based on DLT, there is no certainty as to when the legislative process will conclude and the final text will be adopted, and even then the proposal foresees a five year experimental period before a definitive legal framework for DLT market infrastructures can be proposed by the European Commission.

Taking into consideration the importance of legal certainty as a base for the growth, implementation, and adoption of DLT-based solutions in banking and finance on a EU-wide level, and the challenges arising from international competition in this field by other countries, it is worth pondering if the EU and EU countries are not setting a pace that is too slow to answer the needs of this technology and the market participants' expectations.

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