

INNOVATION



SUBJECT: REPORT ON THE ACTIVITIES OF CYSEC'S INNOVATION HUB

DATE OF ISSUE: 10 FEBRUARY 2020

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1. INTRODUCTION

- 1.1. The Cyprus Securities and Exchange Commission (“CySEC”)’s mandate is to ensure the smooth functioning of the capital markets in Cyprus, underpinned by market integrity and robust investor protection. The emergence and wide-spread adoption of financial technology has dramatically changed the landscape in which our regulated entities operate. Whilst this presents an exciting chapter for firms and end-customers, characterized by innovation, it also poses new challenges from a supervisory perspective. How to ensure investors are adequately protected without stifling innovation is paramount when approaching Fintech.
- 1.2. Equally, we are encouraged that firms are looking seriously at how to best administer their compliance obligations before bringing new products to market. CySEC has a firm commitment to support firms deploying regulatory technology to streamline compliance processes and procedures.
- 1.3. How to best engage with regulated entities around both Fintech and Regtech as part of an overarching approach to *‘innovation’* has long been a bigger-picture challenge on CySEC’s agenda. Ultimately, CySEC’s mandate is to support the broader national goal of fostering a best-in-class jurisdiction for innovative financial services companies to thrive, and consequently finance the real economy. It is therefore critical that CySEC’s engagement with regulated entities results in them building in a *‘compliance-first’* culture from day one.
- 1.4. Therefore, in October 2018 the Innovation Hub was launched to serve as the formal point of contact between CySEC and domestic and international entities involved in the financial and regulatory technology space. Since then, we have worked with 19 companies innovating Fintech and Regtech to help work through their specific compliance needs, and used the Hub to engage with more third parties (approximately 10) on broader *‘innovation’* themes.
- 1.5. This update report provides an overview of the activities of the Innovation Hub since its inception. It will shed light on the types of firms CySEC has engaged with through the Hub, and on the kind of work it helps firms to achieve. It also serves as a reminder of what kinds of companies are eligible to work with the Innovation Hub, and highlights the extent to which companies are deploying Regtech solutions to more effectively manage their compliance obligations.

2. AIMS OF THE INNOVATION HUB

- 2.1. *The Innovation Hub serves as a platform for both supervised and non-supervised entities to come together and share knowledge.*
- 2.2. The Innovation Hub allows for the easy transfer of information on how existing regulation applies to new products or business models, whilst helping identify what regulatory frameworks might need to be established to meet evolving needs - without stifling innovation.
- 2.3. The businesses engaging in the Innovation Hub have the opportunity to understand how regulation might affect them. Access to the Hub's experts helps them clearly determine whether their innovative products or services fall within the existing regulatory framework, meaning they can seek guidance on any relevant compliance obligations.
- 2.4. CySEC takes a '*technologically neutral*' approach to assessing innovation and Fintech. The technology itself is not subject to regulation as a result of simply being new or innovative. Rather, CySEC looks at the end product or service that the technology enables, which is analysed to see whether it is captured by existing legislation. If the end product does come under an existing framework, the technology is then assessed in a second step of the process for any specific risks associated with that technology.
- 2.5. Overall, the primary aims of the Innovation Hub are to:
 - Optimise the operations of supervised entities, enhancing investors' protection;
 - Help firms deploy new technologies that streamline the compliance burden;
 - Improve the efficiency of the market by reducing costs and time for supervised entities and investors to conclude transactions;
 - Enhance the tradability of illiquid assets;
 - Foster market competition.
- 2.6. However, the knowledge-sharing goes both ways. Real engagement with the frontline firms developing innovative financial technology means CySEC can analyse and react to arising supervisory needs more quickly and efficiently. The insight derived from the Innovation Hub means CySEC can devise tailored regulatory and supervisory programmes with an informed, accurate view of the potential risks and opportunity for investors and broader market integrity.

3. THE BROADER NATIONAL APPROACH TO FINTECH

- 3.1. CySEC's approach to innovation fits into the broader national agenda of aiming to create a robust ecosystem in which Fintech firms can flourish in Cyprus. The national agenda is wide-ranging, covering everything from [tax incentives](#) for Fintech firms, the [Cyprus Startup Visa Scheme](#) to attract and retain tech talent, and the establishment of a €20 million fund with an emphasis on start-ups and innovative companies, which

is in progress. This consolidates and corroborates the private sector's support of innovative industries through accelerators, incubators and Tech Sprints.

- 3.2. Distributed Ledger Technology has played a central part in this strategy. In June 2019 the Cabinet published its standalone [National Strategy on Distributed Ledger Technologies](#) (the "DLT National Strategy"), which aims to assess the risks and benefits of DLT. Developed following a consultation process with the government, CySEC and the Central Bank of Cyprus, the DLT National Strategy provides a platform for both public sector initiatives and public-private cooperation to progress DLT programmes. These range across real estate, customs and taxation, financial applications and digital certification.
- 3.3. CySEC is committed to ensuring its supervisory aims are aligned to those of the national agenda, as well as broader international goals and best-practice.

4. ORGANISATIONAL STRUCTURE AND JOINING THE INNOVATION HUB

- 4.1. As outlined above, the Innovation Hub is the designated point of contact for Fintech and Regtech businesses from Cyprus and abroad. A dedicated team, which undergoes constant training and development on Fintech and RegTech issues, and vets inquiries to the Innovation Hub on a first come first served basis.
- 4.2. Applications to join the Hub are examined by this team, under the coordination and oversight of the Policy Department of CySEC, in consultation with other CySEC's Departments, depending on the specificities of each case. Part of this initial assessment and consultation aims to determine the risks posed by the technology used. CySEC often invites the applicant to talk through the application, and, where necessary, to demonstrate the product.
- 4.3. The criteria for engaging with the Innovation Hub are broad in nature, provided the product or service in question qualifies as innovative. Fintech and Regtech firms or supervised entities seeking support from CySEC's Innovation Hub are assessed against certain criteria, including:
 - The extent to which a firm's products or services are new to the market, and the degree to which these products and services are covered by existing regulation. CySEC prioritises truly innovative businesses.
 - The innovation and emerging technology provided by the applicant is directly related to the financial services supervised under CySEC's remit, namely the securities and investment markets;
 - The applicant is already underway in determining its compliance with the regulatory framework and/or aspects of the legislation currently in place for its business model to advance. This means that the project notified to the Innovation Hub is already mature in terms of development, in order to enable a conclusive assessment;
 - Prior legal analysis of whether the notified product or service falls within the existing regulatory framework or not. This analysis is not binding for the Innovation Hub, but will form the base for interaction with the applicant; and
 - From an ethical perspective, a deep-rooted commitment to investor protection and a strong ethical culture of compliance must be built-in.

5. THE INNOVATION HUB'S DAY-TO-DAY OPERATIONS

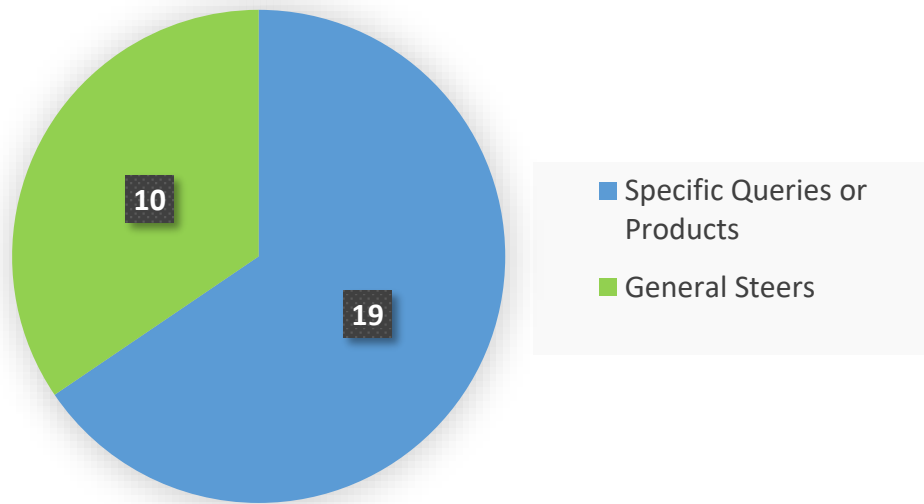
5.1. GENERAL OVERVIEW

- 5.1.1. The Innovation Hub attracted full-spectrum interest from both Fintech and Regtech companies, supervised entities and entities not subject to supervision, from Cyprus and abroad. CySEC is encouraged that all applicants that have interacted with the Innovation Hub have done so proactively, in order to clarify the regulatory requirements that may be potentially applicable to the products and/or services in question. This proactive and prudent conduct from the applicants' side ensured that no unauthorised business operations were carried out.
- 5.1.2. Supervised entities are urged to thoroughly evaluate products in a testing environment and/or in conjunction with other traditional verification measures. This is to establish a successful track of proper operation on reasonable and demonstrable grounds, before incorporating such solutions to their day-to-day operations. Such evaluation should be challenged and revisited by the supervised entities on an ongoing basis in order to ensure that is up to date. The basis upon which the supervised entity has established proper operation on reasonable and demonstrable grounds must be documented and be kept available for a review by CySEC at any time.
- 5.1.3. In addition to the above, interested parties should be able to demonstrate in the event that an innovative technology underpins a product or service offering which is a regulated activity, that the usage is in line with the existing regulatory framework. Interested parties are expected to be in a position to provide the legal and technical analysis that demonstrates they have a sound and informed understanding of the specific risks involved, including their risk mitigation strategy.
- 5.1.4. Since inception, the Innovation Hub has **engaged with nineteen firms and stakeholders** around specific queries and demonstrations of specific solutions.
- 5.1.5. The business models represented in the Innovation Hub include:
- Regtech (regulatory and AML) compliance tools based on big data analytics and data reporting;
 - Those that use Distributed Ledger Technology for the offering, transferring and verifying the ownership of financial instruments;
 - Artificial intelligence tools for both Fintech and Regtech purposes;
 - A venture capital fund investing in blockchain start-ups;
 - Tools for asset managers operating on the basis of big data; and

- Trading facilities intending to operate on the basis of Distributed Ledger Technology.

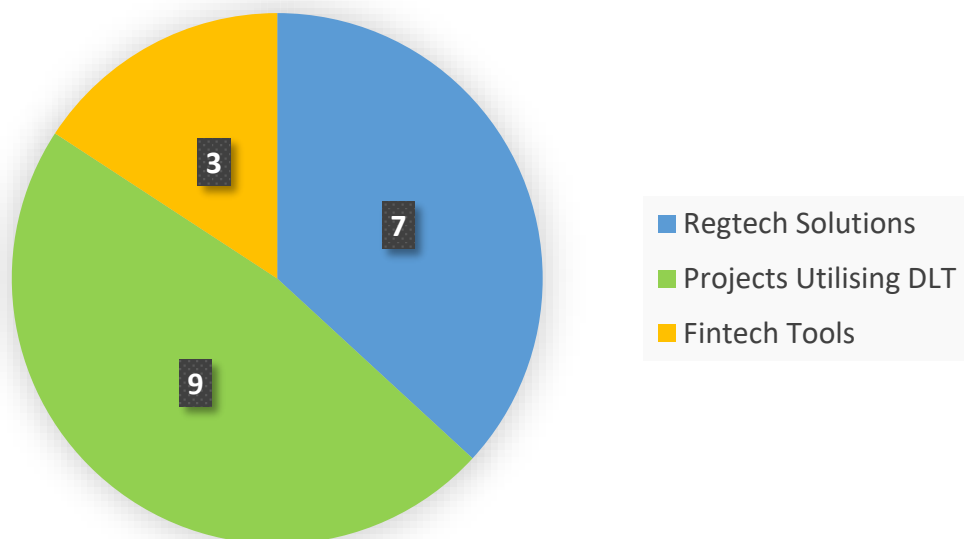
- 5.1.6. The predominant business models communicated to the Innovation Hub were the Regtech tools for regulatory and/or AML compliance purposes operating mostly on the basis of big data and data reporting and Distributed Ledger Technology utilisation for the offering, transferring and verifying the ownership of financial instruments.
- 5.1.7. Entities engaging in Crypto Asset activities were provided with the opportunity to present their policies and procedures to CySEC, and received informal steer. Such engagement allowed interested parties to grasp a better understanding of CySEC's expectations, particularly on AML safeguards. This means they are prepared for the incoming 5th AML Directive, which brings Crypto Assets' activities under the scope of the AML legislation.
- 5.1.8. One notable update concerns CySEC's approach to alternative financing methods, and particularly Crowdfunding. Through its engagement with the Innovation Hub, CySEC discouraged interested parties to commence operations until bespoke rules were introduced, that ensured appropriate investor protection. Such rules were introduced in early 2020 via Directive DI87-10 on Investment Based Crowdfunding, and was communicated via a Policy Statement (PS-01-2020 is available [here](#)).
- 5.1.9. Entities providing payment services and/or issuing electronic money were not eligible for support by the Innovation Hub, as the oversight of the provision of such services do not fall under CySEC's remit. The National Competent Authority for the oversight of such entities is the Central Bank of Cyprus.
- 5.1.10. Lastly, delegates from the Innovation Hub also **engaged with more than ten third parties**, including Legal practitioners, Auditing Firms, University representatives, Credit Institutions and Associations, who were seeking to grasp a better understanding on CySEC's view on financial innovation. Engaging with these institutions means all parties are abreast of current and upcoming trends.

THE INNOVATION HUB ENAGED IN TOTAL WITH 29 PARTIES



5.1.11. The firms and stakeholders who interacted with the Innovation Hub around specific queries or solutions could be classified into the following (sub)categories:

BREAK DOWN OF SPECIFIC SOLUTIONS



5.2. DEEP DIVE INTO REGTECH

- 5.2.1. The Innovation Hub engaged with seven Regtech Firms in relation to AML and/or regulatory compliance tools, six of which operate on the basis of data analytics and data reporting. One employed Artificial Intelligence.
- 5.2.2. The compliance areas covered by those tools included client categorization and jurisdictional marketing restrictions, firm reporting, and best execution facilitating compliance with the Investment Services and Activities and Regulated Markets Law (the Cypriot law transposing MiFID II).
- 5.2.3. Regtech tools serving AML compliance purposes were focused on tracking suspicious transactions and carrying out enhanced Client Due Diligence through innovative solutions. For three of the said products an interactive product demonstration took place through which interested parties received informal steer.
- 5.2.4. There were instances where the products demonstrated shared similarities. However, there was a clear tendency for such products to evolve. For example:
 - Tools that facilitate the performance of enhanced due diligence measures for non-face-to-face clients, such as self-taken photo (“selfie”) verification, appeared to evolve over time in order to better address the impersonation risk, for instance by incorporating ‘*liveness detection*’¹; and
 - Transaction monitoring tools appeared to evolve in order to incorporate further details on the transaction’s trail in relation to a specific asset (e.g. bank account details) to create a more comprehensive path, in order to better address the AML risks.

5.3. DEEP DIVE INTO PROJECTS USING DISTRIBUTED LEDGER TECHNOLOGIES (“DLT”)

- 5.3.1. The Innovation Hub engaged with nine entities involved in projects utilizing DLT. Per CySEC’s technologically-neutral policy, the underlying technology is not a key component in evaluating whether a product or service would fall under the regulatory framework – and therefore be eligible to work with the Innovation Hub. Rather, the specific features of the product or service in question are analysed in the context of the standard legal qualification exercise. This said, CySEC’s view is that the underlying technology should be taken into consideration, in order to determine and mitigate the specific risks entailed.
- 5.3.2. Interested parties are expected to be in a position to provide the legal and technical analysis based on which the applicants have formed their view and to outline the technology specific risks involved and their risk mitigation strategy. For some DLT

¹ Smart phone application, requiring the person to follow certain orders (e.g. move their head to certain directions), confirming that the selfie is instantly taken by the respective person.

applicants, further work was required in order for the interested parties to be able to demonstrate that their proposal is mature enough.

5.3.3. In sum, the Innovation Hub engaged with:

- Six entities involved in tokenized projects for real estate-backed offerings of instruments utilizing DLT (including blockchain):
 - four of which were real estate-backed securities token offerings;
 - one project used blockchain technology to make digital assets inheritable when the initial holder of these assets has deceased;
 - one company offered MiFID broker-dealer services in tokens that qualify as financial instruments.
- One company intending to operate an MTF platform for small and medium-sized enterprises operating in a DLT environment, for which an interactive detailed presentation took place;
- One company specializing in developing trading platforms operating on a blockchain technology basis;
- One company producing certificates operating on blockchain technology for which a meeting in person is expected to be held this year; and
- One investment fund (venture capital) intending to invest in blockchain technology start-ups, for which a meeting in person with documentary evidence of the investment project has been provided.

6. OUTLOOK: FURTHER CROSS-BORDER COOPERATION

- 6.1. The Innovation Hub provides a platform for CySEC to put its commitment to the safe, supervised introduction of financial innovation into practice. Through engagement with firms at the coalface of innovation, CySEC can keep abreast of the constantly evolving nature and range of Fintech and Regtech.
- 6.2. Fostering international co-operation is paramount in establishing successful supervision of emergent financial technologies. The work of the Innovation Hub dovetails with CySEC's active participation in European and other international forums. CySEC plays an active role in the Financial Innovation Standing Committee ('FISC') of the European Securities and Markets Authority, where relevant developments are presented and discussed. CySEC delegates participate in IOSCO's Fintech network to co-operate with non-EU securities regulators.