ECSDA views on the legislative proposal for an EU framework for a Pilot regime for market infrastructures using DLT

General Remarks

ECSDA supports the development of new technologies that could make the financial markets safer and more efficient. DLT is currently being tested in different projects by several CSDs and we would like to highlight the CSD role as a driving force in innovation for capital markets. Therefore, ECSDA would like to take the opportunity to outline its views in the context of the European Commission (Commission) initial Proposal for a Pilot Regime for Market Infrastructures (MIs) based on DLT (Proposal).

We see this Proposal as an opportunity to test the legislation addressing the function of recording and settlement of securities. Currently, at least one of the existing CSDs in Europe is already partly powered with a DLT-based infrastructure. Consequently, although some uncertainties remain, Regulation (EU) 909/2014 (CSDR) level 1 does not constitute a barrier to the development of DLT within the financial sector and retains its technology neutrality. The creation of separate legislation for these functions as a result of the use of new technology would be neither technology-neutral nor future-proof. In a form of a temporary framework allowing to test the regime though, this Proposal supports our efforts of driving innovation. **Yet, it still raises serious questions, and we believe that some adjustments will be needed to ensure that the fundamental and indispensable principles such as consumer protection, market integrity and level playing field are safeguarded.**

Executive Summary of ECSDA major concerns

Consequences of combining trading and post-trading within a single entity

ECSDA notes that further attention must be given to the assessment of the consequences of the possibility for an MTF to combine trading and post-trading services. We believe relevant public and private stakeholders have distilled three main impacts that have not been sufficiently considered: 1) financial stability and systemic risks, 2) increased fragmentation of the EU capital market and 3) governance and competition issues.

DLT Market infrastructure should meet the expectations of safety and ensure the same level of protection

The Commission Proposal foresees that DLT MTFs can perform core CSD services without being required to meet the same regulatory requirements as CSDs (e.g. CSDR and SFD). ECSDA notes that the disparity in terms of legal requirements between those of DLT MTFs and DLT SSSs could negatively impact the rights of investors, but also lead to increased risks to financial stability and other systemic risks.

From a policy-making perspective, an increased '*function perspective*' is needed in conjunction with a further alignment with the '*same business, same risk, same rules' principle*.

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Termination of the Pilot Regime

The DLT technology has not been regulated in the past and the policymakers may be willing to gain deeper knowledge of the areas to be addressed in an eventual more permanent regulation of the functions that caters for the use of innovative technological developments, including but not limited to DLT technology. So, we subscribe to the need of having a temporary pilot for the regulation of DLT MIs. However, given the need for technological neutrality, as well as avoiding regulatory arbitrage and that the trading and post-trading functions are already regulated, it is important to align and integrate the lessons learned in the existing regulation of these functions, i.e. MIFID/R, CSDR and eventually EMIR.

Final remark: ECSDA Reflections on the Draft Report concerning the Pilot Regime

In the context of this position paper, ECSDA would also like to highlight the Draft Report concerning the DLT Pilot Regime (Draft Report), compiled by Rapporteur MEP *Van Overtveldt*. ECSDA echoes several concerns raised by the Rapporteur, especially the ones linked to the level-playing field. In that regard, we see that the proposal to introduce the concept of DLT TSS is addressing the level playing field by requesting a DLT market infrastructure providing core CSD services to apply. In that sense, the proposal of TSS:

- Clarifies that a DLT MTF providing core CSD services would be a new type of Market Infrastructure (this was not reflected as such in the European Commission's proposal);
- Ensures that this DLT market infrastructure and its operator follow the appropriate regulatory requirements for the activity undertaken (i.e. that it is licensed under both MiFID and CSDR);
- Allows DLT SSSs and their operating CSDs to perform trading services, in the same way as DLT MTFs and their operators are allowed to perform notary/settlement services.

However, while keeping in mind that the amendments to ensure a level playing field in the Proposal is a pre-requisite, we do remain highly concerned about the negative impacts that the combination of trading and post-trading services in a single legal entity may bring to the EU and its CMU. **ECSDA promotes deeper reflections on the consequences of the creation of two parallel ecosystems. This is very much needed to respect the fundamental principles elucidated in the paper, namely consumer protection, market stability, market integrity and financial soundness. ECSDA welcomes the ongoing discussions within the European Parliament, and the Council and stresses the importance of findings of the European Central Bank on the Proposal.**

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In further detail

Comment 1: Consequences of combining trading and post-trading within a single entity.

The current market architecture is the consequence of the conclusion of the policy-makers on the necessity to segregate the risks attached to the different trading and post-trade functions. It was not the technology that prevented the trading, clearing and notary/settlement functions from being combined under a single entity in the past. The awareness of the overseers of the functions required that the functions are split.

The choice to integrate the trading and post-trading functions into one single infrastructure may enable venturing players to fundamentally change the existing capital market architecture. Indeed through the Proposal, a new 'hybrid' market infrastructure may combine trading and post-trading roles. According to Article 4(2) of the Proposal, a DLT MTF may request exemption from Article 3(2) of the CSDR to be able to admit to trading DLT transferable securities that are not recorded through a CSD, but rather, recorded on the distributed ledger of the DLT MTF (renamed Trading and Settlement System (TSS), in the Draft Report of the rapporteur of the EP ECON Committee J. Van Overtveldt). This would enable a DLT market infrastructure to provide core services of a DLT MTF and a CSD, thereby, merging the currently separate functions in a single legal entity.

This will result in the existence of two parallel market architecture models, with all the intended and unintended consequences that this will entail. We believe that the policy-makers should not be making blind choices without having made a deeper assessment of this major market-changing step. It is important to assess the characteristics of the models and any legal, technical and operational risks of the proposed solutions, particularly concerning the derogation from article 3(2) CSDR. The creation of a combined FMI model could have the following consequences:

- **Governance and competition:**
  By creating a hybrid entity combining all roles, all relevant concerns, for example, need for competition in the market, impacts of system unavailability or technology disruption and others, are further accentuated due to the increase of concentration risks. The business model of the entity should not foresee that issuer and investor should use one single legal entity for both the trading and notary/settlement services. The exemption from open access between FMIs present in MiFID, EMIR and CSDR (as currently proposed by the Commission) will increase their level of dependence and decrease the choice of issuers or investors to diversify service providers. The governance and competitive landscape offered to issuers and investors would run the risk of deteriorating to the detriment of the issuers and investors because entities could be combining the trading and post-trading roles.

- **Financial stability and systemic risks:**
  One may argue that systemic risk and financial stability are not relevant considerations for the volumes allowed under the Pilot regime. However, the pilot regime is meant to test the regulation to ensure the viability of the latter after the end of the pilot.

  The policymakers incorporated the lessons from previous turmoil, particularly the consequences of the 2007-2009 global financial crisis in the current EU legislation of FMIs, ensuring an adequate level of investor protection and market resilience to systemic risks. Crypto-assets should inspire the same level of confidence to citizens and market participants. Regardless of the technology used, a high standard of safety for the investor must be ensured. This can only be achieved by the same level of regulatory standards applied to DLT MIs, i.e. to DLT SSS and DLT MTF, like the ones

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of FMIs using other technologies. **So, the new architectural model should be regulated with due consideration of expectation of the same safety for the issuers and investors, to ensure due protection from downturns.** *(We focus specifically on the safety concerns in comment 2).*

Furthermore, as the Pilot Regime does not contain the proposal of a DLT CCP – we understand that the EC has taken an assumption that CCPs would not be needed in the DLT environment at all. We, however, see no reason why this function would not be useful at least for a portion of securities transactions recorded on a DLT; we are not sure that all of the transactions on a DLT will happen in real-time. Today, EU CSDs allow for real-time settlement, however, in many cases, market participants agree on a differentiated settlement period (in line with CSDR, T+2 at the latest). Netting can, therefore, be an additional valuable technique to reduce the risks for some transactions on a DLT as well.

- **Market fragmentation:**
  Should the policy choice be to keep the alternative option to provide services through a single entity, full interoperability and access between market architecture models, i.e. the one based on a combination of services in a single entity and the model including the separation of roles and risks across TVs, CCPs and CSDs, should be ensured to avoid fragmentation.

  Over the last decades, CSDs, market participants and relevant stakeholders have been striving to overcome the divergent laws across the EU Member States. This included divergent national taxation of securities transactions, different company and securities laws in the EU Member States as well as other barriers (see on the latest status of barriers to Single Market, EPTF Report). CSDs have contributed to overcoming some barriers through the harmonisation of the majority of post-trade processes supported by the launch of T2s and other initiatives, however as explained in EPTF report and CMU Action plan, the efforts of removing the remaining barriers should be pursued. **The technology alone will not allow overcoming the long-standing issues creating the barriers to the Single Market,** while the taxation, national securities and corporate laws remain divergent. On the contrary, with the introduction of the different market models, the absence of harmonisation will be even more noticeable.

  The divergent grounds mentioned above need to be brought to a common denominator, either by bringing different regimes closer or by creating a single regulatory environment. The current divergent EU regulatory landscape will not be harmonised through the introduction of DLT technology.

  Based on the interests of the markets of having bigger harmonisation and liquidity pooling effect as well as to improve cross-border efficiency by reducing fragmentation, the infrastructure was undergoing the process of consolidation. The policymakers should be attentive not to undo the positive effects that it brought and ensure that the increasing the number of securities notaries does not increase the fragmentation around the notary service in particular, and thereby increase the challenge of removing the barriers to a Single Market. It should be also prevented that the DLT MI legislation results in higher market complexity due to the need for more inter-EU links or that it increases the interoperability concerns, adversely impacts liquidity, leads to higher inefficiencies and costs for issuers and investors.

The proposal of the Commission to allow a DLT MTF to perform core CSD services (DLT market infrastructure renamed 'DLT TSS' by ECON Committee rapporteur) may entail significant negative impacts for the existing capital market infrastructure in terms of financial stability risks, fragmentation, governance and competition. Before deciding to go in that direction, in our view, more needs to be done

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to ensure that the consequences of the combination of such roles within a single market infrastructure are well understood and addressed. In our view, among the actions to be taken by policy-makers are:

- ***Deeper analysis of consequences of the combination of the different functions in a single legal entity,***
- ***Addressing the drawbacks of the combination of trading and post-trading roles within a single entity by ensuring open access and interoperability among DLT MIs and non-DLT MIs, as well as addressing the amplified risks resulting from the concentration of functions.***

Comment 2: DLT Market infrastructures, as any FMI, should meet the expectations of safety and ensure a high level of protection.

We appreciate that the Proposal builds the new DLT market infrastructure upon the existing regulatory framework. Particularly, the regime for the DLT SSS is built upon the CSDR requirements while at the same time fitting the specific needs of that market infrastructure. From that perspective, we support the approach chosen by the Commission, which is in line with the principle '*same business, same risk, same rules*'.

In those cases, where no exemption from CSDR may be needed but where the CSDR may not be entirely clear on whether the DLT technology fully addresses them, **we would propose to supplement the CSDR with recitals, Level 2 or 3 interpretations allowing for use of DLT based on the lessons learned from the Pilot Regime.** In such a case, the CSDs will be able to perform their core services under the existing regulatory framework (i.e. outside of the Pilot Regime).

The Situation is, however, different for DLT MTFs providing notary and settlement service thus contributing to an unlevel playing field *vis à vis* DLT SSSs.

In the initial Commission proposal, DLT MTF can perform notary and settlement services without being required to have a CSD licence and, hence, without meeting the same level of risk management, governance, and other requirements as CSDs. Indeed, MTFs do not follow CSDR requirements and CPMI-IOSCO standards for FMIs. We believe that safety and market integrity are as important (if not more) when dealing with new and untested technology. In this specific case, no CSD would be involved in the lifecycle of the transacted instruments. CSDR, with its safeguards and protections aiming to ensure market stability, would not be applied. This, in our view, can be considered as a dangerous form of 'deregulation'.

In creating a pilot regime to experiment with the risks and opportunities of novel technology, the focus point should be centred on the functions provided: any system performing the same functions, should be based on the same rules and apply the same level of safeguards. CSDR requirements were carefully calibrated by the policy-makers for the core CSD services to provide a high level of protection to market participants and reduce financial stability and systemic risks. While recital (15) mentions that DLT MTFs must comply with 'equivalent requirements' to those applying to a CSD, article 4(3) of the Proposal only imposes a limited list of rules from CSDR without explaining the rationale of the art 3(2) CSDR derogation. The list of requirements does not include some of the fundamental CSDR requirements in regards, and not limited to, the settlement discipline, passporting, transparency, capital requirements, and business/operational risks. Besides, no CSDR Level 2 and 3 requirements would apply[1]. Not applying these

[1] Please see the ESMA page on requirements currently in place in the area of Settlement and CSD services: https://www.esma.europa.eu/regulation/post-trading/settlement

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requirements would lead to a serious difference of regulatory regimes, a clear unlevel playing field and an injection of serious risks into the markets.

We believe CSDR requirements should be applied to DLT MTFs allowed to perform core services in the same way as they are applied for DLT SSSs.

Although consolidation risks will persist, ECSDA appreciates the proposal of the ECON Committee rapporteur to require that a DLT TSS (i.e. a DLT MTF allowed to perform notary and settlement services) should be licensed under CSDR in addition to MiFID II as an attempt to help mitigate consequences from such a combination of functions. This solves the level playing field and financial stability/systemic risk concerns in comparison with the initial proposal.

It remains to be analysed further if additional requirements are needed to address the risks related to the cumulation of functions in a single entity.

Comment 3: Level playing field should be ensured between DLT SSSs and DLT MTFs.

The difference of regulatory regimes as outlined above also raises questions in terms of a level playing field. DLT MTFs would be combining core services of CSDs with MTF services, which provides this DLT market infrastructure with a tangible advantage in comparison with DLT SSSs. We note that the opposite, i.e. a possibility for a DLT SSS to provide DLT MTF services, is not currently foreseen in the Pilot regime.

Additionally, it should be avoided that operators of DLT MTFs are placed in a position where they are able to service a broader range of assets than other relevant operators. Indeed, market operators or investment firms operating an MTF would be allowed to provide services for crypto-assets not considered as DLT transferable securities, while this is not allowed for CSDs under CSDR. This limitation would not apply to the operator of a DLT MTF, which would, therefore, be allowed to service both types of instruments.

We believe that the pilot regime should provide equal possibilities. If there is an intention to allow a single entity to provide trading and post-trading services, this possibility should be given to both DLT MTFs and DLT SSSs. Furthermore, when providing similar services, the same rules and requirements must apply to all types of DLT market infrastructures.

We have been made aware of proposals to allow CSDs to operate a DLT MTF. ECSDA notes that despite the positive intention, this amendment will not solve the concern of an unlevel playing field. Such an amendment will limit a CSD to provide DLT services only through a DLT MTF, i.e. being required to operate two DLT market infrastructures in parallel - a DLT MTF and a DLT SSS. Furthermore, this created an unlevel playing field in terms of duplication of licences, authorisation, exemptions (and compensatory measures linked to them), reporting to authorities, etc. It also leaves open the question of the possibility to operate a single system between notary, trading, settlement and other functions and the responsibility for the system.

Some proposals also raise the possibility to introduce additional exemptions to the DLT SSS regime that would aim at bringing DLT SSS closer to the less regulated DLT MTFs. This is in our view an attempt to decrease the level of safety for the totality of DLT Market Infrastructures. The attitude should be reversed to bring the level of safety of DLT MTFs providing core CSD services (or DLT TSS) closer in line with the level of safety expected from a Financial Market Infrastructure. From that perspective, we would like to reference the Principles for Financial Market-Infrastructures that set a global set of minimum requirements to FMIs,

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including those proving CSD and SSS functions. MTFs are not required to comply with CPMI-IOSCO and therefore should not be compared with FMIs in terms of safety that their operations are providing.

We also reference the ECB opinion on the Proposal concerning the level-playing field between DLT CSDs and MTFs[2].

We believe that the EP Rapporteur's proposal of creating a DLT TSS solves the concern that a DLT market infrastructure doing both trading and custody/settlement services should be authorised under both MIFID and CSDR. We support the proposal of equal possibilities for DLT MTFs and DLT SSSs, although draw attention to the need for deeper analysis (as per our previous remarks).

Comment 4: Legislators should carefully calibrate the thresholds.

To limit the potential risks caused by the exemptions of the Pilot Regime for DLT SSSs and DLT MTFs, the Pilot Regime imposes some thresholds to the activity allowed by the entities. The principle is, in our view, appropriate and necessary. We agree that the scope of the Pilot Regime should be carefully calibrated considering that it is still experimental in nature and has the objective to test DLT in a safe environment without exposing the market to undue risk. **Given the objectives of market integrity, investor protection and financial stability for the supervisory authorities and the market infrastructure, the thresholds must not imply a significant increase of those risks during the tests,** while simultaneously, be proportional to the objectives of the test regime to try the technology in live conditions.

Currently, the scope of instruments would allow DLT infrastructures to service the great majority of bonds and shares available on the securities market. The thresholds outlined in the Pilot Regime Proposal would make more than 65% of the total EU listed companies eligible to operate in the DLT pilot regime. It would represent more than 80% of bond issuances in the fixed income landscape of the EU.

Finally, we would like to also highlight the concerns of the European Central Bank with regard to thresholds and the possibility of servicing sovereign bonds that ECSDA fully shares[3].

To ensure consistency with the objectives of the Proposal and to protect financial stability, the Commission should carefully calibrate the thresholds under the Pilot Regime.

Comment 5: We encourage to have transparency in the process of granting exemptions.

To avoid regulatory arbitrage and ensure a level-playing field across the European Union, a key point would be ensuring the transparency of the entire process. We would, therefore, ask that the request for exemption and the ultimate decision by the authority(ies) are made public (after appropriate removal of sensitive business information), including the reason for conceding them.

We support the proposal of the ECON rapporteur going in that direction.

[2] Please see ECB Opinion (CON/2021/15), points 1.2-1. 3, 3.2 to 3.5, https://www.ecb.europa.eu/pub/pdf/other/en_con_2021_15_f_sign~2c8a54eaa2..pdf
[3] Please see ECB Opinion (CON/2021/15), point 1. 2., https://www.ecb.europa.eu/pub/pdf/other/en_con_2021_15_f_sign~2c8a54eaa2..pdf

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Comment 6: More thought should be given to the termination of the Pilot Regime.

ECSDA believes that to allow to safely test the regime, more thought should be given to the end of the Pilot Regime. Building on our reflection from 'Comment 2', the models developed under the Pilot Regime may not be designed according to standards that appropriately protect financial stability and against systemic risks.

If the EU framework does not give any clarity in advance on whether the Pilot Regime will be continued after the end of the DLT test period, the business models may be constructed with unclear assumptions. We are concerned that, in practice, due to the ambiguity regarding winding down and transitioning out obligations, entities making use of the Pilot Regime may not be able to demonstrate that they can in fact exit the regime successfully according to Art 6(6) within the given timeframe, as they may need to fundamentally change their set-up.

For example, if an entity has received an exemption from the requirement to settle in central bank money, ending that exemption will require a fundamental and even existential change to its business model. The situation would possibly be even more difficult, if not impossible, for a DLT MTF providing core notary and settlement services. At the end of the pilot regime, their only way out may be to legally segregate the MTF and CSD-type of services. Although the entity will be confronted with the need to address the winding down and transitioning obligations from the moment of applying for an exemption, the ambiguity regarding the actual requirements may lead to unrealistic processes envisaged by the entity which may not be in a position to comply with its initial predictions.

Without further clarity regarding the winding down and transitioning out obligations, the Pilot Regime may ultimately slow down the search after innovative developments and foster ambiguity. It is not attractive for firms to invest in new services if rules might change after the pilot phase. We would kindly ask to ultimately avoid this.

We are aware that some stakeholders advocate initiating procedures to discontinue and reduce activity, rather than revoking the license to operate within the Proposal immediately when exceeding the envisaged thresholds raises further concerns. ECSDA would like to seek further clarity regarding the operational procedures and timeline itself.

We also note the concerns raised in the ECB opinion concerning the exit strategy. We support the suggestion of the ECB that alternatively "there should be specific arrangements in place for the conversion of such DLT transferable securities into 'non-DLT' transferable securities registered in a CSD"[4].

We believe that an 'early-exit assessment report' after three years as proposed by the ECON Committee rapporteur is worthy of consideration as it instils some further legal certainty into the regime and contributes to its viability. At the same time, the report should not provide for a possibility to make a separate permanent regime based on the pilot.

Ends

[4] Please see ECB Opinion (CON/2021/15), point 3.6, p. 13
https://www.ecb.europa.eu/pub/pdf/other/en_con_2021_15_f_sign~2c8a54eaa2..pdf

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