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European Commission proposal: Regulation on a Pilot Regime for Market Infrastructures based on Distributed Ledger Technology

General remarks

The European Banking Federation **welcomes** the European **Commission's intention to run pilot operations** to identify what adjustments need to be made to existing EU regulation of services involving the issuance, safekeeping and asset servicing, trading and settlement of DLT financial instruments and, in parallel, to develop practicable proposals for a suitable regulatory framework and targeted adjustments to selected EU legislation.

Against this background, we also believe that the current proposal would stand to benefit from **further clarity** in relation to key questions, which this document elaborates.

The EBF agrees with the notion of **"substance over form"**, meaning that current capital markets regulation would have to be applied to financial instruments issued by means of DLT. The envisaged clarification in the **MiFID II definition of "financial instrument"** should, however, be slightly amended in order to state without any doubt that the way or means how a financial instrument is issued does not change its character as a financial instrument.

European banks strongly support the aim of a **technology-neutral approach** and the **open and flexible strategy** of enabling both market operators and investment firms to demonstrate the potential of the new technology using **DLT MTFs** as a pilot project for multilateral trading. We therefore expressly welcome the fact that services covering the **entire lifecycle** of DLT financial instruments will be covered by the pilot regime. We see a need to also include pilot operations for bilateral trading, having in mind that, albeit **bilateral trading** does not necessarily need a market infrastructure per se, it should be operated under a pilot regime to allow for technological innovation be developed in all kinds of trading activities. As a pilot project model, **systematic internalisers (SIs)** of DLT financial instruments should therefore be treated as equivalent to market infrastructures under the pilot regime, so that the development of DLT-based trading activities does not end up benefiting multilateral trading venues alone. Bilateral trading should also be made possible and its potential for development analysed under the pilot regime. At a later stage, it might make good sense for several (bilateral) SIs to join forces and become a (multilateral) OTF. To allow this to happen, the pilot regime needs to provide for an exception permitting one and the same legal entity to operate both an OTF and a SI. Therefore, market operators and investment firms could apply for permission under the pilot regime to run a DLT MTF, OTF or SI. We believe such an approach would allow for granting access and interoperability on one hand, and on the other hand would result in avoiding unnecessary potential creation of new 'vertical silos'.

Likewise, it should be possible under the pilot regime to establish pilot operations for settlement and safekeeping of DLT transferable securities. The current proposal **limits the opportunities to CSDs only**. It should however be taken into account that DLT-based networks are decentralised networks by design and therefore imply the redistribution of today's roles and activities. The EBF believes that **investment firms and credit institutions offering safekeeping and custody services** should also be able to apply for a permission to operate a securities settlement mechanism. Especially where they operate mechanisms with regard to unlisted DLT transferable securities, this would already

be possible under the existing legislation, but including them under the pilot regime would reveal the full potential under ESMA's auspices and would offer more valuable experience when shaping the future regulation.

Last but not least, the pilot regime should also consider the **interests of issuers and investors** who may wish to use service providers and would not like to be troubled by technological issues.

Scope of the Pilot Regime - Remarks

For markets in both types of crypto assets to develop and to demonstrate its full potential, intermediaries, and the services provided by intermediaries, will be necessary.

Although a regulation on market infrastructures based on DLT is understandably focused on market infrastructures, it should also be mindful of other market participants (like **investors and issuers**) and of necessary functions of **asset service providers** (like custodians or depositaries for investment funds, in particular). Ignoring the interests of investors investing in DLT transferable securities or ignoring the functions and services of established asset servicers would have a negative impact on the success of the pilot regime in our view and would pose competitiveness issues. Furthermore, some categories of investor (pension funds / investment funds) are obliged to use intermediaries in order to invest in assets. Therefore, the functions of **custodians** and **depositaries** should be considered in two ways: a) DLT market infrastructures should be entitled to make use of their services and b) investors and issuers should, likewise, be able to use them when obliged or desired.

Moreover, the EBF believes that **all regulated entities**, i.e. market operators, investment firms and CSDs, should have the opportunity to operate a **DLT securities settlement mechanism** (rather than "systems" in the sense of the Settlement Finality Directive) under the pilot regime. This would demonstrate the full potential of technological innovation and subsequent changes to current market infrastructures.

In various respects, the **scope of the pilot regime** is therefore **too limited**, in our view. We believe major adjustments are needed if the objective of establishing an appropriate and sound EU framework for DLT market infrastructures is realistically to be achieved. The proposed **thresholds** seem too restrictive in this context.

Experience using DLT should be gathered from real business cases. To interest and involve **institutional clients** in the pilot regime, products need to be sufficiently attractive in terms of the choice of issuer and value thresholds. Illiquid products, which are unattractive in terms of volume, are not suitable for this purpose. Also, investment funds should not be precluded to take part as investors under the pilot regime. Since investment funds are obliged by law to appoint depositaries for each fund managed, depositaries would also need to be integrated in the pilot regime for their specific safekeeping and control functions.

Retail customers naturally need particular protection. This protection is already adequately ensured by existing regulation, however. To operate a test under the pilot regime, compliance with investor protection rules should be ensured through equivalent alternative safeguards if exemptions from certain existing requirements are granted. We do not, by contrast, consider it appropriate in this context either to permit only illiquid products and special issuers.

The pilot regime should consequently be more open to **business models** that reflect real life. Otherwise, there is a risk that the future framework will be based on business models that are out of touch with reality or impracticable. The proposed restrictions in terms of

time frames and volumes would also discourage market participants from participating in the pilot regime, despite the fact that it is a project worth supporting.

Scope of the Pilot Regime - Questions

MiCA creates a **regulatory framework for the provision of services by intermediaries**. The pilot regime does not create a specific regulatory framework, as there are existing regulatory frameworks for the provision of services relating to financial instruments. As a result, under both MiCA and the pilot regime the legal nature of the crypto assets is a matter for member state law.

The **key questions** relating to the role of intermediaries in the context both of MiCA and of the pilot regime are:

A/ Legal questions

- If crypto assets are held through an intermediary, what is the **legal nature of the ownership rights** of the end investor? Are there specific legal risks?
- The interplay of the pilot regime and **national civil law** should be considered for the future framework, especially where cross-border transactions are concerned.

B/ Operational questions

- Neither MiCA nor the pilot regime sets out rules relating to **access rights**. The procedure for obtaining permission to operate a pilot project seems to be very complex and time consuming. This creates that possibility that a crypto-asset issuer/platform operator (either explicitly, or inadvertently through the design of the system) does not allow third parties (brokers, custodians, etc) appropriate access so that they can provide services relating to the crypto-assets. Is this a problem? Is there a need for additional protections to be included in the legal text?

In order to grant enough time for the actual operation of the pilot project, this should be adequately reflected in the permission process. The aim should also be to ensure that a **successful pilot operation** can result in **permanent operating permission** (outside of the pilot).

- Neither MiCA nor the pilot regime contains requirements relating to **standardisation** of **data definitions**, and of **messaging**. These are important to facilitate access, and to allow for interoperability, so that additional requirements might be necessary.

C/ Fiscal questions

- Neither MiCA nor the pilot regime covers **fiscal aspects**. Does the holding cross-border of crypto assets raise cross-border fiscal issues? Will crypto-assets fall under existing DTAs?
- Does the European Commission (DG TAXUD) need to take into account crypto assets in its work on Action 10 of the CMU Action Plan?

Safeguards

We share the conviction that all the protective purposes of existing regulation, such as investor protection, market integrity and financial stability, should be retained under the pilot regime and future framework. **Exemptions** from specific requirements under the pilot regime should therefore be well justified and require effective **alternative safeguards** to be put in place which would meet the objectives pursued by the provisions from which an exemption is requested or would ensure investor protection, market integrity and/or financial stability. An authorised test operation under the pilot regime should be required to demonstrate the existence and effectiveness of such safeguards, which could serve as a model for the future framework.

Consequently, existing rules for the **safekeeping and safeguarding of client assets** should continue to apply, especially Article 16(8) to (10) of MiFID II and Delegated Directive (EU) 2017/593 with regard to safeguarding of financial instruments and funds belonging to clients.

It is therefore unclear whether the "additional requirements on DLT market infrastructures" stipulated in Article 6(5) are to be understood as exemptions from specific safekeeping requirements under the pilot regime. Any exemptions envisaged for the safekeeping of DLT transferable securities should be compensated by adequate measures which the competent authority granting the specific permission deems appropriate in order to meet the investor protection objectives pursued by safekeeping rules and, in particular, the requirements regarding safeguarding of client assets. In this context, clarification is needed with respect to Article 6(5).

Transition to definitive regime

EBF members support the establishment of a pilot regime to allow for a careful assessment of risks and opportunities connected to the regulation of services involving the issuance, safekeeping and asset servicing, trading and settlement of DLT financial instruments. In this respect, EBF members remain cautious as to the desirability of a **"one size fits all"** approach.

In particular, EBF members believe that the **duration of the pilot regime** should take into consideration the fact that technological innovations could be implemented rather quickly for certain types of activities. Therefore, it would be appropriate to bring such activities within the standard regulatory framework well before the expiry of the sandbox regime, thus **avoiding the risk of possible indirect subsidies** to innovative models coming to the detriment of "legacy" participants by ensuring **legal clarity** and **level playing field**.

During the lifecycle of the transitional regime, it is important that it be subject to **early** and **frequent review/evaluation**, in order to maximise information for operators of the pilot projects about the future rules under the definitive regime. In this respect, it is essential that the review process be as transparent and participatory as possible, in order to allow for a correct assessment of investment by market operators.

EBF members believe that early and frequent evaluations should also take into consideration the existence of **established market practices** that present **specific features** relevant for the future EU framework for markets in crypto-assets.

It should be made clear that the pilot regime will not preclude the **further development of technology** in the capital markets and supervised testing of new business models, i.e.

smaller sandbox approaches or laboratories outside the approval process of the pilot regime.

Next steps

As already mentioned, the EBF **welcomes** the possibility to ask for temporary exemptions and to be allowed to develop experimentation. This will require close interactions and **cooperation** in the financial industry. The EBF stands ready to initiate and maintain an open and constructive **dialogue** in close partnership with the EU institutions, market infrastructures and other stakeholders (the so-called eco-system, including other and numerous agencies and services providers).

EBF members welcome future potential developments, including the tokenisation of existing financial instruments. Although potentially seen as disruptive developments, we also need to find the **right balance** between innovation, market efficiency, adaptation costs and revised procedures/processes and services, while maintaining the financial stability, investor protection and financing the EU economy in the context of the **CMU** and the **EU Green deal**. The **ownership** and **governance** aspects of the new solutions will also deserve appropriate attention (EU versus third country decentralisation).