

Response to CSD Regulation

02/02/2021

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Motivation of the Response

■ General comments on the response

Distributed ledgers technologies (DLTs) enable operating on the financial markets in a more efficient and automatic way through digital representations of assets (i.e., tokenised assets) settled through digital platforms. The **technology-neutrality** principle demands CSDs and providers to be able to handle both 'traditional' and 'tokenised' assets. This leads to two important implications; (i) having CSDs and contracting parties ready to adopt new roles according to the technology paradigm and (ii) having regulations inclusive enough to allow the execution of transactions governed by the blockchain logic. These are the principles to identify the potential obstacles of the current CSDR framework when addressing DLTs.

New role. Blockchain and DLTs propose a new and efficient architecture to perform settlement operations among tokenised assets by involving several actors who have access to a distributed register, making both trade and post-trade operations more fluid. Intermediaries and contracting parties are called, in both cases, to interact with the technology and to trigger the settling transactions. This requires clarifications with respect to current regulatory framework on CSD. Clarifications are expected whether SSS and CSD shall or shall not qualify as crypto-asset service providers to interact with the technology and operate as intermediaries within the blockchain layer. Moreover, concerning crypto-asset service providers (CASP) there is the need to clarify whether there is the possibility for these types of actors to offer settlement services by reconverting their business. In this specific case, clarifications should be provided on the obligations for CASP to be qualified as SSS and CSD.

The technology cannot replace the role of CSD or SSS since the algorithm per se needs to be triggered in order to function. The triggering operations that could be launched by contracting parties or intermediaries identify the actor acting as an SSS or CSD. Hence, the definitions should be generalised in order to take into account situations where SSS and CSD can be intermediaries or both contracting parties acting as smart contract triggering agents.

Inclusiveness. All the operations will be registered on the immutable ledger providing a cleaner and transparent track of records. The encoding of the settlement operations within a smart contract (i.e., a piece of code) requires the regulation to provide legal clarity when operating within this framework by clearly identifying and understanding the responsibilities of the involved actors.

Moreover, requirements and restrictions for traditional CSD and SSS may not have the same implications when addressing blockchain applications, hence the need to translate the traditional obligations in the DLT framework.

Finally, rules on cash settlement do not allow for the use of any settlement asset issued and traded on DLTs. Hence, according to the regulation digital representation of cash cannot be traded for digital asset on the blockchain. This poses limitations in terms of both efficiency and competitiveness. Settlement transactions via DLTs significantly reduce both counterparty and operational risks. Moreover, DvP transactions involving cash represent an important and certainly non-negligible part of settlement operations. The possibility to tokenise cash and to operate with this digital representation of cash represents a great opportunity for intermediaries such as CSD and SSS to significantly reduce failures in daily DvP operations.

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Specific Questions

Responses in this section to Questions 18,19 and 20.

Question 17. Do you consider that certain changes to the rules are necessary to facilitate the use of new technologies, such as DLT, in the framework of CSDR, while increasing the safety and improving settlement efficiency?

Response. Yes

Question 18. Would you see any particular issue (legal, operational, technical) with applying the following requirements of the CSDR in a DLT environment? Please rate each proposal from 1 to 5 (1 = not a concern ; 2 = rather not a concern ; 3 = neutral ; 4 = rather a concern ; 5 = strong concern ; no opinion)

- Definition of 'central securities depository' and whether platforms can be authorised as a CSD operating a SSS which is designated under Directive 98/26/EC (Settlement Finality Directive (SFD)) → 1
- Definition of 'securities settlement system' and whether a blockchain/DLT platform can be qualified as a SSS under the SFD → 1
- Whether and under which conditions records on a DLT platform can fulfil the functions of securities accounts and what can be qualified as credits and debits to such an account; → 2
- Whether records on a DLT platform can be qualified as securities account in a CSD as required for securities traded on a venue within the meaning of Directive 2014/65/EU (MiFID II) → 2
- Definition of 'book entry form' and 'dematerialised form' → 2

- Definition of “settlement” which according to the CSDR means the completion of a securities transaction where it is concluded with the aim of discharging the obligations of the parties to that transaction through the transfer of cash or securities, or both; clarification of what could qualify as such a transfer of cash or securities on a DLT network/ clarification what constitutes an obligation and what would qualify as a discharge of the obligation in a DLT environment → 2
- What could constitute delivery versus payment (DVP) in a DLT network, considering that the cash leg is not processed in the network/ what could constitute delivery versus delivery (DVD) or payment versus payment (PVP) in case one of the legs of the transaction is processed in another system (e.g. a traditional system or another DLT network) → 4
- What entity could qualify as a settlement internaliser, executes transfer orders other than through an SSS → 1

Question 18.1 Please explain your answers to question 18 (if needed), including how the relevant rules should be modified.

Response. Definitions shall clarify whether specific algorithm implementations (i.e., smart contract) may execute settling operations. The technology cannot replace the role of CSD or SSS since the algorithm per se needs to be triggered in order to function. The triggering operations that could be launched by contracting parties or intermediaries identify the actor acting as an SSS or CSD. Hence, the definitions should be generalised in order to consider situations where both contracting parties can be intermediaries acting as smart contract triggering agents. These redefinition procedures appear to be quite sensitive from a legal point of view.

The technology operating with a proper data structure can act as a system of record (SOR) fulfilling the functions of securities accounts and should therefore be qualified as such when meeting specific requirements. Certain types of DLTs not embedding a clear account-based structure where debit and credit entries are easily identifiable needs to be accompanied by specific reformulation and re-adaptation in order to be adopted as a book of transaction in dematerialised form. Hence, qualifications of credits and debits should be conditioned to the data output that platforms can provide.

Definitions of settlement, DvP and settlement internalised should be generalised and declined in the DLT framework for the sake of legal clarity and technology-neutrality.

Question 18.2 Do you consider that any other changes need to be made, either in CSDR or the delegated acts to ensure that CSDR is technologically neutral and could enable and/or facilitate the use of DLT?

Response. Yes

Question 18.3 If yes, please indicate the provisions and make the relevant suggestions.

Response. In order for CSDR to be technology-neutral and be able to facilitate digital innovation through the use of DLTs, the regulation should contemplate in a separate manner both centralised and decentralised platforms by extending the current regulation including DLTs with centralized governance structures and developing clarifications on permissionless platforms. Moreover, requirements and obligations shall be the same regardless of whether CSD and SSS (i) operate on a DLT and/or (ii) have offered services on a DLT and/or intend to offer services on a DLT.

In order for CSDR to facilitate the use of DLTs and promote innovation the pilot regime proposed by the European Commission last September could be modified to be:

- **less rigid for small and medium actors operating on DLTs interested in obtaining the CSD or SSS qualification.**
- **more flexible for the new actors operating on DLTs interested in obtaining the CSD or SSS qualification.**

Question 19. Do you consider that the book-entry requirements under CSDR are compatible with crypto-assets that qualify as financial instruments?

Response. Yes

Question 19.1. Please explain your answer to question 19:

Response. Crypto-assets that qualify as financial instruments can be registered by the blockchain technology since the ledger is (for the blockchains intended to be used to trade crypto-assets that qualify as financial instruments) readable by at least the participating actors.

Question 20. Would you see any particular issue (legal, operational, technical) with applying the current rules in a DLT environment? Please rate each proposal from 1 to 5, 1 standing for "not a concern" and 5 for "strong concern" (1 = not a concern ; 2 = rather not a concern ; 3 = neutral ; 4 = rather a concern ; 5 = strong concern ; no opinion)

- Rules on settlement periods for the settlement of certain types of financial instruments in a SSS → 1
- Rules on measures to prevent settlement fails → 2
- Organisational requirements for CSDs → 3
- Rules on outsourcing of services or activities to a third party → 2
- Rules on communication procedures with market participants and other market infrastructures → 1
- Rules on the protection securities participants and those of their clients → 2
- Rules regarding the integrity of the issue and appropriate reconciliation measures → 3
- Rules on cash settlement → 2
- Rules on requirements for participation → 1
- Rules on requirements for CSD links → 1
- Rules on access between CSDs and access between a CSD and another market infrastructure → 3
- Rules on legal risks, in particular as regards enforceability → 4

Question 20.1. Please explain your answers to question 20, in particular what specific problems the use of DLT raises.

Response. The introduction of a smart contract taking care of the settlement operations will on one hand sensibly reduce operational risks and on the other one will deeply revolutionise the organisational structure of traditional CSD now called to interact with a new technology. Rules on settlement periods, fails and participation modes (approval of participating actors) can be translated into code pieces and directly implemented on the smart contracts regulating the settlement operations. Redemption conditions are a more delicate matter to implement since the actors interacting with these digital

solutions are not always in control of the whole procedures. The identification and assessment of the responsibilities throughout a code execution is a delicate legal issue. Hence, it is extremely important to provide for checks and audits of the smart contract code in order to protect the settlement system. We can see that trust and risk management issues are permanently present when addressing any type of settlement operations, they are just differently declined according to new technologies. Concerning organisational requirements, communication with market participants and access between CSDs, we have different actors operating with different systems that are called to operate together. This cooperation can be made possible only when systems can easily inter-operate one with the other.

Question 20.2. If you consider that there are legal, operational or technical issues with applying other rules regarding CSD services in a DLT environment (including other provisions of CSDR, national rules regarding CSDs implementing the EU acquis, supervisory practices, interpretation,), please indicate them and explain your reasoning.

Response. No opinion