# Comments

## of the Association of German Banks on the proposal of the European Commission for a pilot regime for market infrastructures based on DLT

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Miye Kohlhase/Dorit Bockelmann/René Lorenz

Telephone: +49 30 1663-3310/-3360/-3350
miye.kohlhase@bdb.de/dorit.bockelmann@bdb.de/rene.lorenz@bdb.de

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Prepared by Ks/Bc/Hy/To

Association of German Banks
Burgstraße 28
10178 Berlin | Germany
Telephone: +49 30 1663-0
Fax: +49 30 1663-1399
www.bankenverband.de
USt.-IdNr. DE201591882

## A. Summary

- The Association of German Banks **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.
- We also agree with the notion of "substance over form", meaning that current capital markets regulation should 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 to make it absolutely clear that the way in which or means with which a financial instrument is issued does not change the nature of its character as a financial instrument.
- We therefore 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** in a pilot project for multilateral trading. We 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 the view of capital market protagonists, i.e. **investors and issuers,** in the pilot operations and not only the view of market infrastructures alone. Although a regulation on market infrastructures based on DLT will understandably be focused on market infrastructures, it should also be mindful of market participants (like investors and issuers) and of the 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. 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 desired or obliged to do so.
- Therefore, the whole range of today's trading activities, **including bilateral trading**, should be taken into account. As a pilot project model, **systematic internalisers** (SIs) of DLT financial instruments should be included as a market infrastructure 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 an SI. Market operators and investment firms could then apply for permission under the pilot regime to run a DLT MTF, OTF or SI.

- 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.
- 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.
- In particular, 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. In addition, investment funds should not be precluded from taking 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 to exercise 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.
- The procedure for obtaining permission to operate a pilot project seems to be very complex and time consuming. 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.
- The interplay of the pilot regime and **national civil law** should be considered, especially where cross-border transactions are concerned.
- Last but not least, 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.

## B. Approach of the pilot regime

In its response to the European Commission's consultation on an EU framework for markets in crypto-assets, the Association of German Banks proposed using a sandbox approach to identify, analyse and then implement required changes to existing regulation of financial instruments and related services. We therefore welcome the pilot regime approach proposed by the Commission as part of its Digital Finance Package, published on 24 September 2020.

We agree with the Commission's reasoning that, while a large number of crypto-assets are not covered by existing EU regulation and therefore pose a variety of challenges, established financial instruments that are issued using DLT may also fall under the term crypto-asset. As a result, these financial instruments **are also subject to existing EU regulation** although many of the rules and requirements cannot be applied to DLT financial instruments because legislators did not draft them with DLT in mind.

However, in order to promote technical innovation in the capital markets whilst at the same time providing legal certainty and safeguarding overriding principles such as investor protection, market integrity and market stability, we believe the Commission's pilot regime is precisely the right approach to take. The principles and protective purposes of **today's capital market requirements must continue to apply** during the pilot period and in any future regulation.

Since the use of DLT requires completely different organisational procedures and processes than those of conventional processes and market infrastructure systems, the first course of action is to determine which of the existing rules could be amended to facilitate the use of new technologies such as DLT. This will require alternative safeguards to be developed and legally enshrined, which will take real experience and not just theoretical considerations. We therefore consider it a very sensible approach to conduct a careful analysis and evaluation by supervising the new processes that enable DLT and can be monitored appropriately during the pilot – not least because ESMA is to ensure these processes are standardised throughout the EU, thus preventing fragmentation across member states. When granting exemptions from regulatory requirements that have been identified as obstacles to developing DLT-based infrastructure, it is right to ensure that compensatory measures are put in place which correspond to the original purpose and objectives of the requirements for which the exemption was granted (see recitals 14 and 19). Such measures under an authorised pilot regime operation should be required to demonstrate the existence and effectiveness of those safeguards, which could serve as a model for the future framework.

We also think it would be very useful not only to look at a specific service related to financial instruments issued using DLT, but also to include their **entire lifecycles** in the analysis – from

issuing and custody/asset servicing to trading. We therefore fully support the proposal that market infrastructures which facilitate activities relating to DLT financial instruments should be able to extend these activities to include all services, from initial registration, trading and settlement, to custody and asset servicing (see recital 9, Article 2(3) and Article 4).

We would like to stress that it is essential to the success of the pilot regime to chart the right course from the outset – subsequent adjustments would cause an irretrievable loss of time on this key issue for the future. The EU would leave the design of the market to third jurisdictions and would be unable to achieve its objective of "shaping Europe's digital future" in this field. It is especially important to base the design of the regime on realistic scenarios that allow competitive diversity and ensure that as many providers as possible can operate in the market. With this in mind, it is vitally important to consider all trading opportunities relating to DLT financial instruments, i.e. both **bilateral and multilateral trading**. As things stand, an investment firm would have hardly any commercial incentives to set up a DLT MTF since it would be very difficult to make compliance with the necessary organisational requirements pay off. To operate an MTF, a firm would have to comply, in particular, with the operational requirements of Article 19 of Directive 2014/65/EU and Delegated Regulation (EU) 2017/584. One to two years of preparatory work would hardly be worthwhile given that the regime may only run for five years. And even without this five-year limit, it would make little sense to enter the market at such a late stage as it would be virtually impossible to compete with established operators.

On top of that, the ban on the use of proprietary capital and on matched principal trading under Article 19(5) of Directive 2014/65/EU would impose a significant constraint on the potential business model of the MTF. The requirement that an MTF must have at least three active members also represents an obstacle. In addition, liquidity would probably be in short supply when trading DLT financial instruments, at least in the initial phase. To overcome this problem, market-making by the issuer would be needed, but the ban on proprietary trading would prevent this.

We are therefore convinced that it is not enough to look solely at multilateral trading (DLT MTFs only). The pilot regime approach, which aims to facilitate the transformation of today's world into tomorrow's, should therefore be comprehensive and also take into account the function of bilateral trading, such as through **systematic internalisers** (DLT SIs). Otherwise, there is a danger that certain business models would be favoured, while other models with the same development potential would unintentionally be held back by the pilot regime. The envisaged technological neutrality should also cover a variety of different business models and services for DLT financial instruments. It should also be designed in a way that caters to the **interests of investors and issuers** alike.

Owing to their experience in dealing directly with **end investors**, SIs are a prime example of a market infrastructure which would also lend itself to distributed ledger technology. A provider of this kind would be well placed to meet the expectations of end investors wishing to buy both DLT

and traditional transferable securities from their bank and sell them back at a later date (secondary market). DLT SIs would naturally ensure full investor protection: they are virtually predestined to do so. They would also be able to satisfy other end investor requirements by issuing tax certificates, for instance. The same applies to their expertise regarding **issuer**-related affairs (e.g. pre-issuance services, market making, agent services, asset servicing/corporate actions/general meetings, etc.).

Including DLT SIs will make it highly probable that several market participants will agree on a strategy as cooperation partners for business models and register them for the pilot. This would be a particularly welcome development if various innovative models and players are to be tested. Cooperative projects would make it possible to avoid focussing too quickly on a single model, which could lead to cannibalising effects that would prevent innovations from reaching their full potential.

At a later stage, it might make good sense for several (bilateral) SIs to go one step further and join forces to become a (multilateral) OTF. To allow this to happen, the pilot regime for DLT venues needs to provide for an exception permitting one and the same legal entity to operate both an OTF and an SI.

In summary, the success of the pilot regime will depend first and foremost on enabling different providers to enter the market. This means that the regime should cover all suitable execution venues – MTFs, OTFs and SIs.

Furthermore, although DLT has the potential to automate processes and establish so-called smart contracts, it should be borne in mind that the aim of technical innovation is to make capital markets more efficient but without forcing this innovation on issuers or investors. DLT can be a useful tool to enhance today's transaction processes but it should not be forgotten that the capital markets' main actors are issuers and investors. Their interests should therefore lead the design of the future regulation.

Issuers and investors should remain able to use service providers where they wish or where they are even obliged to do so: they may want to use agents for corporate action services, for instance, other assets services, safekeeping and custody. In certain cases, they are even required to do so by law and would be excluded from the pilot regime if these obligations were disregarded. More details are set out further below.

## C. Scope

We consider the proposal's intention to achieve technological neutrality and promote innovation to be particularly commendable. While we especially welcome the possibility for all types of services to be provided – issuing, trading, settlement, custody and asset servicing (see

Article 2(3)) – we also see the need to widen the scope by including all suitable execution venues, i.e. MTFs, OTFs and SIs.

1. **Financial instruments**

As mentioned in section B above, we support the Commission's endeavors to establish a pilot regime for DLT transferable securities. In this context, we also support the clarification that instruments issued by means of DLT are to be considered as MiFID II financial instruments. They should be subject to capital markets regulation irrespective of the way in which or means by which they are issued ("substance over form"). However, the concrete wording in the Proposal for a Directive amending Directives 2006/43/EC, 2009/65/EC, 2009/138/EU, 2011/61/EU, EU/2013/36, 2014/65/EU, 2014/65/EU, (EU) 2015/2366 and EU/2016/2341, "COM(2020) 596 final" may give rise to uncertainty as to whether certain or only crypto-assets would be subject to MiFID II. In order to avoid such uncertainty, we would like to suggest amending the explanatory memorandum, recital 6 and Article 6(1) as set out in the annex below.

2. **Thresholds**

We feel that the **restrictions** on the types of securities that can be admitted to trading on a DLT MTF and recorded in a DLT securities settlement system should be **redesigned**. This applies both to the **value thresholds** (e.g. issue amount and total volume in the DLT system) and to limitations on the choice/size of the issuer, as a result of which the pilot could only be implemented with illiquid securities from smaller issuers (see also recital 12). We are seriously concerned that the thresholds in Article 3(1) to (3) would prevent the emergence of genuine business cases and therefore discourage use of the pilot regime. We therefore recommend that all parameters resulting in **value thresholds** on the securities to be registered/traded are **removed or redesigned** to make pilot operations under the pilot regime more attractive. If a specific business model requires that certain products or quantities be limited, one solution would be to make permission conditional on such limitations. **Alternatively**, consideration should be given to setting considerably higher value thresholds which would still be seen as attractive by market participants. These could be risk based or issuer oriented. There could be a limitation with regard to issuers or issuances, for instance, or thresholds could be raised over time. Precisely where alternative value thresholds might best be set is a matter we have not yet evaluated in detail at this stage.

We think limiting bond issuances to 500 million euros and the total market value of DLT securities in a DLT MTF or DLT securities settlement system (SSS) to 2.5 billion euros is too restrictive. These thresholds are too low to attract institutional investors. This applies both to securities that can be traded on a secondary market via a DLT MTF and to those that are part of a buy-and-hold investment strategy.

We also consider it too restrictive to limit the market capitalisation of share issuers to 200 million euros. It would only allow relatively small issuers to take part in the pilot regime. And even then, there would be no guarantee that their market capitalisation would remain below this threshold

permanently. Issuers would therefore have to be made aware from the outset that there was a risk of having to switch to a non-DLT segment, especially in view of Article 3(5) ("shall activate the transition strategy") and Article 6(6). This would substantially reduce, if not totally eliminate, the attractiveness of DLT issues.

It is important to emphasise that DLT financial instruments are generally subject to existing capital market requirements and must therefore comply with all protection mechanisms. According to recital 12, only non-liquid shares and bonds are to be approved under the pilot regime in order to maintain financial stability.

We doubt that financial stability can best be preserved by a pilot operation with exclusively non-liquid instruments. We believe it is more appropriate for thresholds that seem necessary to ensure orderly business operations to be discussed in the concrete permission procedure. Furthermore, the decentralised or distributed approach of DLT will make an important contribution to financial stability as it will minimise the risk of a single point of failure. Opening up the pilot regime to various market participants (banks, CSDs, stock exchanges, etc.) without restricting them to particular quantities of illiquid classes of securities would provide a much better opportunity to explore how the use of DLT might further promote and improve financial stability.

### 3. Client groups

In principle, the pilot regime should be open to all client groups. The repeatedly used term "retail investor" should be replaced by the term "end investor", which – judging by the spirit and purpose of the proposal – is probably what is meant anyway. The complementary proposal for a Directive amending, inter alia, Directive 2014/65/EU makes it clear in Article 6 which customers lawmakers wish to focus on. These are not "retail clients" within the meaning of Article 4(1)(11) of Directive 2014/65/EU. A DLT platform would not only give retail investors direct market access without the need for an intermediary, but also professional investors and eligible counterparties, i.e. all investors.

It must be ensured, in any event, that all DLT end investors benefit from the relevant investor protection provisions of Directive 2014/65/EU, irrespective of the DLT execution venue they use to trade in financial instruments. We consequently have serious concerns about the provisions in Article 6(4) of the proposed Directive amending, inter alia, Directive 2014/65/EU. While the pilot regime is to be established by means of a regulation, investor protection measures will essentially be left to national competent authorities. We see a danger of NCAs competing with one another to the detriment of investors. It must also be ensured that the same investor protection rules apply to all DLT execution venues. There is otherwise a risk, in the event of losses in a less regulated area, of contagion spreading to more highly regulated areas.

### 4. Role of custodians and depositaries

At first sight, the use of DLT would appear to put an issuer in a direct relationship with its investors without the need for any intermediaries. However, investors wishing to buy or sell DLT tradeable securities would have to find a trading counterparty. A DLT SI, OTF or MTF would therefore be required. The recording, settlement and safekeeping would also have to be processed by a third party, which could be the DLT SI, OTF or MTF, or a CSD operating a DLT securities settlement system.

Furthermore, an investor who does not wish to have direct access to a DLT market infrastructure but would like to benefit from the services of a **custodian** should be able to do so. Offering direct access does not necessarily mean that investors should be forced to access the DLT market infrastructure directly, especially if they do not have a sufficient level of ability, competence, experience or knowledge (see also recitals 17 and 22). It should therefore be possible for an investor to use an asset service provider, such as a bank, to access a DLT market infrastructure and to benefit from other services like reporting services, information, financial advice, tax-related services and so on. This should be reflected in the pilot regime.

In certain cases, moreover, it is not legally possible for investors to dispose of assets freely and therefore access DLT market infrastructures directly. This would be the case for investment funds like UCITS, for instance, or pension funds which do not hold proprietary assets but collective investments for their investors or clients. For investor protection reasons, an investment company is obliged to appoint a single **depositary** for each of the funds that it manages (cf. Article 22(1) of the UCITS V Directive or Article 21(1) of the AIFMD). The depositary is entrusted with the safekeeping of the assets and with certain control functions. The pilot regime should therefore take into account the role and functions of depositaries. Any exemptions under the pilot regime can only be granted to the operator of the DLT market infrastructure regarding legal obligations normally imposed on the operator but not regarding obligations imposed on investors. This could be reflected either by clarifying that access is provided to the depositary instead of the fund investing in the DLT transferable securities or by clarifying that access restrictions imposed on investors will continue to apply under the pilot regime.

Otherwise, we see a danger that investment funds would be precluded from investing in DLT transferable securities. This is not the intention, in our view. If retail clients are to be included in the pilot regime (see recitals 17 and 22), this makes it all the more important to also include investment funds, which could enable retail clients to invest in DLT transferable securities in a more diversified way.

Likewise, a DLT execution venue wishing to outsource safekeeping functions to a custodian should be able to do so under the same conditions of the pilot regime as if these functions were performed by the DLT MTF.

In this context, clarification is needed with respect to **Article 6(5)**. Our understanding is that all existing regulation governing financial instruments, in particular regulation aimed at ensuring investor protection, market integrity and financial stability, should in principle be retained under the pilot regime and 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 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. Should exemptions be envisaged for the safekeeping of DLT transferable securities pursuant to Article 6(5), we would expect that the infrastructure operator would have to comply with compensatory measures which the competent authority granting the specific permission deemed appropriate in order to meet the objectives pursued by safekeeping rules and, in particular, the requirements regarding safeguarding client assets. Since these rules have the objective of investor protection, we would presume that the concept of "exemptions from existing rules versus alternative safeguards" would be followed here, too.

**5. Financial instruments not recorded in a securities settlement system**

According to Article 2(3), DLT transferable securities may be traded, but also initially recorded, settled, held in custody and managed, on a DLT MTF. According to Article 4(2) and (3), an investment firm or a market operator may request exemptions that cover recording DLT transferable securities using DLT and other services. The requirement being that these instruments are not recorded in a CSD's SSS in accordance with Article 3(2) of the Central Securities Depositories Regulation (CSDR).

This complements the traditional system, in which transferable securities that are to be traded on a trading venue need to be recorded centrally in a CSD, with an innovative system where DLT transferable securities can be traded on approved DLT execution venues and their custody and settlement can be carried out by a CSD or by the DLT execution venue operator itself by means of DLT. For reasons of legal certainty, it would be desirable to clarify in **Article 4** that, when approving exemptions in accordance with Article 4(3) and (4), the procedures described do not imply application of the detailed CSDR provisions and procedures but that the competent authorities, in cooperation with ESMA, may define alternative safeguards suitable for the specific business model.

The special protection of the confidence enjoyed by CSDs and the strict requirements they have to meet in order to operate a traditional securities settlement system should, in future, be ensured through the functionality of the DLT. It is therefore understandable that Article 4(2), sentence 1 stipulates that DLT transferable securities may be recorded by a DLT MTF if they are not recorded in a CSD in accordance with Article 3(2) of the CSDR. Consequently, it should be clarified that, if the operator of a DLT MTF/execution venue requests an exemption pursuant to

Article 4(1), the DLT MTF/execution venue will not be regarded as a trading venue within the meaning of Article 3(2) CSDR, either. Although the market participant operating the DLT MTF/execution venue would be exempt from the provision of Article 3(2), the situation with regard to other market participants, such as issuers, is unclear. To avoid double recording on the DLT MTF/execution venue and in book-entry form in a CSD, transactions on an exempted DLT MTF/execution venue should not be considered transactions under the CSDR. The aims of the exempted rules should instead be adequately reflected in effective compensatory measures under the pilot regime. We are of the opinion that the use of DLT is highly suited to this purpose.

In contrast, the inclusion of a CSD with a traditional SSS and the inclusion of a DLT SSS requires further discussion. No mandatory interoperability should be specified here, as this does not even exist in today's systems. Instead, the particular expertise of CSDs and their role should serve to act as a valuable building block in cooperating on the redistribution of tasks, responsibilities and processes in DLT market infrastructures.

### 6. Optional regime

It should be clarified in the text of the regulation itself 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. So far, this has merely been confirmed by the Commission after publication of its proposal at public occasions like the Commission's webinar. Furthermore, although the pilot regime will offer the opportunity to operate the technology with many parties involved, existing regulation does, in fact, already allow single real-life DLT business cases to be tested out.

## D. Definitions

Where definitions already exist in current EU legislation, reference is rightly made to these. Where new terms have been defined in the Proposal for a Regulation to build markets in crypto-assets (MiCA), reference should be made to these as well in the interests of consistency.

We note, however, that the term "sovereign issuer" is used differently for the purposes of the pilot regime regulation than it is under MiFID II. Whereas issuances by issuers pursuant to Article 2(14) are possible under the pilot regime, they would normally be considered issuances by sovereign issuers pursuant to Article 4(60) of MiFID II, which would be prohibited under the pilot regime pursuant to Article 3(1)(b). In the interests of regulatory coherence we would like to suggest clarifying the reasons for this different treatment in a recital.

The term "execution venue" should be introduced and defined to cover the different forms of trading under the pilot regime: DLT MTF, OTF and SI.

The term "system" in Article 2(4) needs further discussion. A securities settlement system is commonly associated with a designated and notified system under Directive 98/26/EC (Settlement Finality Directive, SFD) and enjoys harmonised safeguards in the event of the insolvency of system participants. Although we believe that a DLT securities settlement mechanism could also qualify as an SFD system, this does not necessarily have to be the case if, for example, the mechanism does not have systemic relevance. To avoid misunderstanding in this respect, we would like to suggest using the term "mechanism" instead of "system". Where such a mechanism qualifies as a designated and notified system under the SFD, it would also enjoy the benefits of the SFD.

## E. Business models, limited permission and report/review process

Irrespective of the question of commercial viability, we have concerns about the permission process and the legal and operating expenses associated with a pilot operation. It should be borne in mind that operating a DLT market infrastructure will be a mammoth task not only in terms of technical implementation but also with respect to the necessary legal assessment and consultation with national supervisors and customers. Our members believe a virtually insurmountable obstacle will be the **uncertainty** as to whether a business case submitted to, and approved by, competent authorities can be maintained **after the six-year period has come to an end**. The pilot projects are intended to serve as a model for future services and processes in the capital market and thus be geared to permanent operation outside of the pilot project. The expense involved will only be worthwhile, however, if there is a prospect that the DLT MTF or SSS will still have permission to operate at the end of the six years under the existing or new framework.

A major cost-saving factor for market participants would be full automation of a large number of processes (such as revenue streams, corporate actions, etc.), enabling existing post-trade processes to exploit future technology and be extensively reformed and harmonised across the EU. Where large volumes are involved, such with as buy-and-hold clients, even small cost reductions would soon add up.

We therefore anticipate that a considerable number of market participants willing to operate pilot projects will not even launch a test because the cost of obtaining permission to operate under the pilot regime would not be economically justifiable given the uncertainty surrounding the future of the project. They will consider it important that operations can carry on after the end of the test phase and do not have to be discontinued or fulfil today's (existing) requirements simply because the time period for the pilot has elapsed. It would be helpful to have a description of a potential way forward, showing how the testing phase could transition to a permanent operation mode with permanent permission (under the new regime).

It would certainly be conceivable to design a scaled-down, simpler or purely theoretical business case which easily qualified for the relevant exemptions, could easily implement any

compensatory measures and could be discontinued after six years. But it would not be a model that could be scaled up to handle high volumes. This cannot possibly be the objective of the pilot regime. On the other hand, setting up an entire MTF is a highly challenging exercise, so smaller, limited tests should not be excluded from the outset.

The **six-year limit** on the permission for DLT market infrastructures to operate **should therefore be dropped**. Alternatively, it should be made clear that a successfully operating DLT market infrastructure will automatically be able to continue under the final regime without needing to apply for permission again (**grandfathering** arrangement).

This is also important when it comes to selecting the products to be registered for, and traded on, the DLT execution venue since the term of the products would have to be geared and adapted to the limited nature of the operating permission. If, for example, a pilot project had permission to operate for another two years, any bonds would have to mature within two years as well. But it is unrealistic, in our view, to require the products involved in the test phase to mature within an increasingly short space of time.

It should, in addition, be borne in mind that several parties will be involved in developing a project designed to further innovation. It is in the nature of DLT that processes are decentralised and distributed. This means that, in future, tasks and responsibilities will also have to be shared or distributed to a greater extent between market infrastructure providers and intermediaries. So a decision to prolong or terminate permission will affect a number of different participants in the test phase as well as, ultimately, the investors using the DLT market infrastructure.

It should also be remembered that existing requirements, which are today fulfilled by various different participants, especially different intermediaries, will in future have to be fulfilled by DLT market infrastructures, too, except where adequate safeguards are in place for a specific exemption from such a current requirement. Take, for instance, customer/investor identification or the provision of information to investors – tasks currently fulfilled by different intermediaries and which will in future have to be performed by the DLT market infrastructure, especially if it can be directly accessed by investors. One of the major questions the pilot regime will answer is whether and to what extent DLT will enable these tasks to be taken over by a market operator or CSD, or whether investment firms with their access to customers will have a role to play in a DLT market infrastructure. We assume that tasks and responsibilities will probably be shared. Later on, the same will apply to establishing a global network and when accessing other markets outside the EU.

We therefore believe that it would be useful in this context to revise the reporting and review process envisaged by Article 10. In our opinion, it will be crucial to have an ongoing assessment and an early review of the pilot operations with the aim of identifying where appropriate amendments should be made to existing regulation. Competent authorities should therefore monitor the pilot projects as well as any associated new developments and improvements or

upgrades during their operation. We take the view that continuous auditing and adjustment of a pilot project would be more beneficial than a one-off review shortly before the end of the project. Likewise, we would recommend more flexible handling and close supervision of the projects rather than rigid and inflexible timelines.

We would like to suggest amending Article 10: instead of a report after five years, the national competent authority should provide ESMA and the European Commission with **periodic (e.g. annual) reports** containing the information pursuant to Article 10(1). An aggregated/consolidated report should be published by ESMA. After five years at the latest, ESMA should make suggestions to the Commission for amendments of existing regulation based on the reports and experience with the pilot projects (**review**). There should also be a market consultation, whose findings should feed into the review. Furthermore, ESMA should have the opportunity to recommend individual targeted changes to the pilot regime or to the existing framework at any earlier time. Although we generally support harmonisation of national laws, the proposal envisaged in Article 10(2) would have to take into account various national civil law concepts like contract and property law, as well as national company law.

## F. Individual exemptions and obligations

We have as yet been unable to adequately evaluate this issue in detail. We therefore reserve the right to comment on this individually in more depth at a later date.

In particular, some of the tasks and responsibilities of DLT market infrastructures (e.g. referred to in section B. and C.) will need greater analysis – both tasks and responsibilities which can be assumed by the distributed ledger and also those which will necessarily have to be performed by ledger participants. Take the following, for example:

- Client identification ("know your customer" (KYC), anti-money-laundering and combating the financing of terrorism (AML/CTF))
- Safekeeping and custody
- Control functions under UCITS V or the AIFMD
- How are DLT transferable securities held in custody for investment funds, what exactly may be held in custody (Article 22 UCITS V/Article 21 AIFMD)
- Involvement of depositaries when holding assets in custody for investment funds. For liability reasons depositaries cannot be excluded from safekeeping/custody (even if technically possible)
- Investor protection, including information for investors
- Regulatory reporting
- Market abuse (MAR/MAD)
- Centralised tasks (e.g. under the CSDR, SFD)
- Insolvency law implications, especially immutable functions in smart contracts
- Data privacy

- Implementation of corporate actions, general meetings and (proxy) voting as well as shareholder identification (requirements of the Shareholder Rights Directive II, SRD II).
- Intervention mechanism (if assets have to be transferred back, for instance, or errors need to be corrected)

## G. Implementation timetable

The implementation timetable should provide for more flexible handling and, in particular, the possibility of obtaining permanent operating permission outside the pilot regime (see also above comments in E.). Articles 7(5) and 8(5) envisage that permission will be granted for up to six years under the pilot regime. In addition, ESMA is required to submit a report on the success of the regime five years after the regulation has entered into force (Article 10). A DLT MTF operator has to meet certain conditions, then demonstrate and document that they have been met. Operators will doubtless need to invest considerable time and money before permission is granted.

Market participants will most likely conclude that the numerous restrictions of the pilot regime do not justify this investment. On top of that, they may feel the permission period is disproportionately short if permission is likely to expire at the end of the defined period and there is no prospect of obtaining permission for permanent operations after the pilot project has proven to run successfully. It should be specified that at the end of the test period, the limited permission will automatically be extended indefinitely unless the competent authority provides reasonable and documented reasons for revoking it.

The automatic granting of permanent permission to operate beyond the pilot regime would have the additional advantage that those operating the project had an interest in continuously improving and refining their business model during the test phase/pilot. This is because the huge costs invested in obtaining permission to be involved in the pilot regime and operating the pilot project need to pay off.

For this reason, the option under Article 10(2)(e) of terminating the regime should be dropped. Instead, the Commission's report should suggest what the future EU framework should look like, and what existing EU requirements need to be adapted – and how. If a certain pilot project needs to be terminated because it is not fit for purpose, for instance, the permission could be revoked.

## H. Interaction with national civil law

We welcome the fact that the Commission takes a positive view of technological development and, like the German government, wants to promote innovation through a technology-neutral approach. We support the idea that the existing EU regulatory framework for capital markets should serve as the starting point and basis for DLT-based financial instruments and be adapted

in a targeted manner. We also consider it positive that the proposed pilot regime envisages no requirements that would be fundamentally at odds with national civil law.

The current developments in Germany in the form of a proposal for a German Electronic Securities Act (*Gesetz über elektronische Wertpapiere* – eWpG) are solid and forward-looking, in our view. We assume this will encourage market participants to start implementing their business models, which can then also be rolled out under the EU pilot regime. EU passporting opens up further potential, especially for cross-border transactions. We see signs of similar activity and preparations in other member states as well.

**Recital 42** seems to indicate that national obstacles should not stand in the way of the pilot regime. Article 4(2) and (3) also point in this direction. The consequences of doing so are not entirely clear, however, since the recital merely states that "the Union may adopt measures [...]". Although we generally support harmonisation of national laws, the proposal envisaged in Article 10(2) would have to take into account various national civil law concepts like contract and property law, as well as national company law.

## I. Supervision/EU passporting/harmonised implementation

It would be desirable to have clarification of how NCAs and ESMA are meant to coordinate on the dual supervisory function. Nor is it clear whether and to what extent DLT market infrastructure operators are supposed to cooperate with their NCA or ESMA, or with both of them (cf. Articles 1 and 9). Reporting obligations and reporting channels vis-à-vis the two authorities are in particular need of clarification. It is essential that reporting obligations should be based on current requirements. The guiding principle should be that existing requirements will basically continue to apply when using DLT, meaning there should be no unintentional tightening of reporting obligations and no introduction of obligations that do not currently exist. On the contrary, we assume that the use of DLT will establish a level of transparency allowing supervisors direct access to transaction data, making today's reporting obligations superfluous.

The issue of supervisory fees also needs fleshing out: we consider the proposed arrangements too unspecific.

Nor can potential operators of supervised DLT market infrastructures currently gauge the likely effects of the register of DLT market infrastructures to be maintained by ESMA. Here, too, the purpose and implications should be spelled out in more detail.

Article 6 proposes that DLT market infrastructure operators should prepare detailed, publicly available "written" documentation, which may also be accessible by electronic means and which should specify contractual arrangements, among other things. This requirement raises various questions regarding its implementation. Written documentation and electronic publication fly in the face of one another; contractual documents are normally strictly confidential and can only be

made public with the customer's consent. We reserve the right to comment on further details at a later date.

We warmly welcome the technology-neutral design of the proposed regulation. It is particularly important that there should be no legal specification of precise technical requirements, such as the use of certain protocols or standards. Our members are convinced that market forces will determine developments. They are already working intensively on models that are technologically agnostic and thus capable of connecting and interlinking various different DLT solutions.

We would also welcome a clarification in the recitals that further development of technical processes and the introduction of new business models will remain permissible in close consultation with competent authorities and will not be precluded by the pilot regime. Not every sandbox or laboratory trial necessarily aims at establishing a DLT MTF or DLT SI which would require permission under the pilot regime. Take, for instance, tailored products, temporary projects or a trial involving a few selected participants. It is our understanding that use cases of this kind would remain possible so that innovation in the EU can continue to be encouraged and supported.

And last but not least, we expressly welcome the fact that, in cases where central bank money is not available – which is likely to be the norm for models operating under the pilot regime – DvP settlement will be permitted using commercial bank money, even in tokenised form.

Annex:

| **Pilot Regime provision** | **BdB comments** |
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| Recital 7 | Should also include DLT execution venues, which would consist of DLT MTFs, OTFs and SIs (see section B above). |
| Recital 9a | Description of DLT OTF and SI should be added. |
| Recital 17 | The terms "retail clients" and "retail investors" should be replaced by "end investors" (see section C.3 above). Furthermore, the wording in the last sentence needs to be adapted since "retail investors" would not be fit and proper for anti-money laundering and combatting the financing of terrorism purposes. This phrase seems to address the asset servicers or intermediaries that the investor is using.<br><br>Furthermore, it should be clarified that end investors can have direct access unless overriding legal requirements do not allow this, like requirements for investment funds under AIMFD/UCITS, or where desired differently by the end investor. The investor should have the opportunity to use the services of a (regulated) entity when accessing DLT market infrastructure. |
| Recital 22 | The comments regarding recital 17 also apply mutatis mutandis to recital 22.<br>We would like to stress that it is not an obligation of intermediation which would prevent investment funds from obtaining direct access to the CSD. Rather, investment funds hold assets for and on behalf of other investors, which is why they are not entitled to safekeep those assets themselves but through an appointed depositary. This should be reflected accordingly. |
| Article 1 (scope) | For various reasons systematic internalisers (SIs) should also be permitted to operate as a *DLT execution venue*; in future, cooperation between several DLT SIs is also conceivable. The scope should therefore be extended to include the term "execution venue"; this term should cover "multilateral trading facilities", "organised trading facilities" and "systematic internalisers". All subsequent relevant articles should be adapted to reflect this change; in many cases the term "DLT MTF" will need to be replaced by "DLT execution venue". In the interests of |

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| | clarity, we have not listed all of these follow-up adjustments below. |
| Article 2 (definitions) | Paragraph 2: the term "DLT market infrastructure" should cover "DLT execution venues" and "DLT securities settlement systems".<br>Paragraph 3:<br>- A second subparagraph should be added to define the term "DLT systematic internaliser (DLT SI)". A DLT SI carries out systematic internalisation with transparency and using its discretion; the relevant investor protection provisions of Directive 2014/65/EU must be met. The existing provisions of paragraph 3 apply mutatis mutandis.<br>- A third subparagraph should be added to define the term "DLT organised trading facility (DLT OTF)".<br>- A fourth subparagraph should be added to clarify that the above-mentioned DLT execution venues are not to be regarded as regular trading venues under Article 3(2) of the CSDR.<br>A new paragraph 6a should be added to define the term "systematic internaliser" by reference to Article 1(1), subparagraph 20, of Directive 2014/65/EU.<br>A new paragraph 6b should be added to define the term "organised trading facility" by reference to Article 1(1), subparagraph 23 of Directive 2014/65/EU. |
| Article 3 (limitations) | Paragraphs 1 to 5 should be deleted as thresholds will serve no useful purpose. This will necessitate follow-up changes, which are not described in detail here. Alternatively, other thresholds could be determined which would ensure proper testing under attractive conditions.<br><br>If alternatives are determined, wording covering execution venues should be added to in paragraph 1: "and recorded on a distributed ledger by a CSD operating a DLT securities settlement system **or execution venue that is permitted to record DLT transferable securities on a DLT execution venue".** This seems to be missing in paragraph 1 but is reflected in all following paragraphs. |
| Article 4 (requirements and exemptions for DLT MTFs) | - All requirements/exemptions should apply to "DLT execution venues" in order to cover both DLT MTFs and DLT SIs. |

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| | - In order to enable several DLT SIs to cooperate in a DLT organised trading facility (DLT OTF), the possibility of one and the same legal entity operating a DLT OTF and a DLT SI should be provided for.<br>- Paragraph 2: at the end of the first subparagraph, a sentence should be added stating that for this reason, an (exempt) DLT execution venue shall not be regarded a trading venue under Article 3(2) of the CSDR. |
| Article 5 (requirements and exemptions for DLT SSS) | New paragraph 4(c): "are not prevented by adverse legal requirements from the admission as a direct participant". (see also Section c.4 above). |
| Article 6 (additional requirements) | Article 6(5) should be clarified. Normally, an entity which ensures the safekeeping of transferable securities would have to fulfil regulatory requirements. It is unclear whether and to what extent paragraph 5 allows for exemptions from such requirements. If this is the case, compensatory measures should be arranged which meet the objectives pursued by the provisions from which an exemption is required. |
| Article 7 (specific permission for DLT MTF) | In Article 7, the term "DLT MTF" should be replaced by "DLT execution venue" throughout. It should also be clarified that a separate legal entity does not need permission to operate a "DLT execution venue". Rather, an "execution venue" with existing permission to operate may apply for permission to operate a corresponding "DLT execution venue". |
| Article 8 (specific permission for DLT SSS) | (No comments) |
| Article 9 (Cooperation) | (No comments) |
| Article 10 (report and review) | Editorial amendments are needed to Article 10 so that it also covers "DLT SIs".<br>The elements in paragraph 1(a) through (l) could be components of a regular, e.g. yearly, report by ESMA on all pilot projects operating under the pilot regime. Based on the reports and ongoing supervision, ESMA should be requested to present a review report on possible amendments to existing regulation.<br>Furthermore, paragraph 2 could include wording on how pilot projects can continue to be operated outside the pilot regime (as a permanent operation) and on how permission is to be obtained or transitioned. |

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| | The option under Article 10(2)(e) of terminating the regime should be dropped. Instead, the Commission's report should suggest what the future EU framework should look like, and what existing EU requirements need to be adapted – and how. |
| Article 11 (entry into force and application) | (No comments) |
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| | Clarification that the pilot regime is optional and does not preclude the testing of further business models. |
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| **COM Proposal for a Directive amending Directives 2006/43/EC, 2009/65/EC, 2009/138/EU, 2011/61/EU, EU/2013/36, 2014/65/EU, 2014/65/EU, (EU) 2015/2366 and EU/2016/2341**<br>COM(2020) 596 final | |
| **Page 5** | It seems that a clarification is intended that financial instruments can also be issued by way of DLT. We agree with this approach. A financial instrument will be subject to capital markets regulation irrespective of the way in which or means by which it is issued ("substance over form"). However, the clarification may give rise to uncertainty as to whether certain or only crypto-assets would be subject to MiFID II.<br>In order to avoid such uncertainty, we would like to suggest amending the explanatory memorandum and recital 6 and Article 6(1) as follows:<br>The first paragraph of Article 6 further contributes to clarifying the legal treatment of **financial instruments issued as crypto assets**. It does so by amending the definition of a 'financial instrument' in Directive 2014/65/EU on markets in financial instruments to clarify beyond any legal doubt that such instruments **are financial instruments even if they are** issued on a distributed ledger technology. |
| **Recital 6** | Currently, the definition of 'financial instrument' in Directive 2014/65/EU does not explicitly **mention** financial instruments issued using a class of technologies |

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| | which support the distributed recording of encrypted data (distributed ledger technology, "DLT"). In order to ensure that such **instruments are not excluded from the definition of financial instruments and** can be traded on the market under the current legal framework, the definition in Directive 2014/65/EU should be amended to include them. |
| **Article 6** | Directive 2014/65/EU is amended as follows:<br><br>(1) in Article 4(1), point 15 is replaced by the following:<br><br>'financial instrument' means those instruments specified in Section C of Annex I, **irrespective of the modalities and technologies used for the issuance of those instruments**; |
| Article 6 (Amendments to Directive 2014/65/EU) | Paragraph 4 envisages that the competent authority may impose "additional investor protection measures for the protection of natural persons" on the DLT MTF. The reference to "additional" measures is superfluous as MTFs do not have to comply with any investor protection rules. It should be made clear that DLT MTFs must comply in full with the relevant investor protection rules of Directive 2014/65/EU. |