



November 2020

The proposed EU pilot regime for DLT-based market infrastructure

The Digital Regulator

Table of Contents

Executive summary	2
1. EC proposal for an EU pilot regime for DLT-based market infrastructure	3
2. Other noteworthy developments	4
3. Conclusion	5

Authors

Mattia Rattaggi
External Regulatory Analyst
METI Advisory AG

Yves Longchamp
Head of Research
SEBA Bank AG

Contact

research@seba.swiss



Executive summary

The European Commission's (EC) Digital Finance Package (DFP), issued on 24 September 2020, includes a proposal for a pilot regime for market infrastructures based on the distributed ledger technology (DLT). The EC acknowledges that no sustainable and expanding primary crypto-asset market is possible without a secondary market that provides liquidity. The proposal for a pilot regime is, therefore, a logical complement to the recommended EU regulatory framework on crypto-assets reviewed in the October issue of The Digital Regulator. Despite recognising the mutual dependency of the two proposals, the EC takes a very cautious approach by proposing rules for a pilot regime with sandbox characteristics, as opposed to offering a regulation for a fully-fledged regime. The European Council and the European Parliament will decide the fate of the pilot regime, five years after it comes into force. Meanwhile, Switzerland has adopted a full-fledged and final crypto-asset regulation, also covering DLT-based market infrastructure, which comes into force next year after the ongoing consultation on implementing ordinances is over.

The month of October 2020 recorded some other noteworthy regulatory developments in the digital space. The Bank for International Settlements (BIS) issued principles for Central Bank Digital Currencies (CBDCs). The Financial Stability Board (FSB) published final recommendations about Global Stable Coins (GSCs). On the compliance side, the US Financial Crimes Enforcement Network (FinCEN) seeks to lower the applicability threshold for the 'Travel Rule', while the UK Financial Conduct Authority (FCA) banned the sale of crypto derivatives to retail consumers due to suitability concerns.

The proposal for a pilot regime is, therefore, a logical complement to the recommended EU regulatory framework on crypto-assets reviewed in the October issue of *The Digital Regulator*.

Despite recognising the mutual dependency of the two proposals, the EC takes a very cautious approach by proposing rules for a pilot regime with sandbox characteristics, as opposed to offering a regulation for a fully-fledged regime.

1. EC proposal for an EU pilot regime for DLT-based market infrastructure

As part of the DFP, the EC issued a proposal for a pilot regime for market infrastructures based on DLT. The proposal aims to allow the development of a secondary market for crypto-assets and is a necessary and ideal complement to the proposal for a regulatory framework on crypto-assets, which was reviewed in the previous issue of the *Digital Regulator*. The proposed regime for the DLT-based market infrastructure shares the characteristics of a sandbox, as it imposes clear limits on operators and grants regulatory exemptions within these limits; moreover, it has a maximum duration of six years.

- **DLT infrastructures**

The proposed pilot regime distinguishes between two types of DLT market infrastructures: a DLT multilateral trading facility (MTF) and a DLT securities settlement system (SSS). The DLT MTF shall be operated by a market operator regulated by the Markets in Financial Instruments Directive II (MiFID II). The DLT SSS shall be operated by a central securities depository regulated by the Central Securities Depositories Regulation. National competent authorities (NCAs) grant the permissions to operate a DLT market infrastructure for a period of up to six years. The permission comes as an addition to the authorisation as CSD or investment firm. The EC shall issue a recommendation to the European Council and Parliament regarding its future, five years from establishing the pilot regime.

- **Requirements**

In principle, DLT market infrastructures—be it MTF or SSS—are subject to all requirements applicable to traditional MTF or SSS under the current financial regulations. However, the proposed regulation foresees several exemptions for DLT market infrastructures, which must be requested at the NCA, while also imposing a few restrictions on their operations. DLT market infrastructures are subject to specific requirements covering the business plan, functioning of the DLT, IT/cyber arrangements, safekeeping arrangements, disclosure obligations, and exit strategy. Finally, the market infrastructures shall report on a semi-annual basis to the NCA—the European Securities and Markets Authority (ESMA), in their oversight function, may require corrective measures and may even withdraw the authorisation.

- **Exemptions**

The EU financial services legislation contains several specific requirements that would prevent a DLT market infrastructure from developing, if not lifted. Thus, a DLT MTF shall be exempted from the book-entry requirement and the recording with a Central Securities Depository (CSD), provided it ensures recording on a DLT solution, segregates the securities on a client basis, and grants robust settlement procedures and custody arrangements. A DLT SSS may be exempted from several provisions, including those concerning transfer of orders, securities accounts, and recording of securities, provided it demonstrates the incompatibility of such provisions with the use of its particular DLT solution and ensures segregation of securities on client basis—among other requirements. Any DLT market infrastructure shall be allowed to use the so-called settlement coins to clear transactions and be able to request an exemption from the obligation of intermediation (to provide direct access to retail clients).

- **Restrictions**

The DLT market infrastructure shall only admit DLT transferable shares of issuers with a market cap of less than EUR 200 million, and bonds with an issuance size of less than EURm 500. No sovereign bonds shall be admitted/recorded by DLT market infrastructures. The infrastructure shall also not record securities with a value exceeding EURbn 2.5.

The proposal for a pilot regime for market infrastructures based on DLT is a necessary complement to the proposal for a regulatory framework on crypto-assets; both suggestions have been presented by the EC as part of the DFP. The proposals differ in that the latter indicates an element of finality in the regulation, while the former proposes a pilot regime that contains elements of a sandbox and is at best an intermediate step towards a final proposed regulation. This dichotomy evidences great circumspection by the EC in regulating crypto-asset markets and promoting regulatory certainty. The European Council and Parliament will decide the future of the pilot regime five years after it has come into force, even as the Swiss crypto-asset regulation, also covering DLT-based market infrastructure, launches next year.

2. Other noteworthy developments

Switzerland has commenced consultation on the blanket ordinance in the area of blockchain. The amendments to the relevant Acts and Ordinances will enter into force during the first half of 2021.

- On 25 September 2020, the Swiss Parliament unanimously adopted the Federal Act on the Adaptation of Federal Law to Developments in DLT. A blanket ordinance is now being planned to incorporate the legislative amendments into law at the federal ordinance level. The consultation will run until 2 February 2021, and it is expected that the amendments to the Financial Services Act and the Financial Institutions Act will come into force during the first half of 2021.

The BIS and the FSB issued principles and recommendations for CBDCs and GSCs, further reinforcing regulatory certainty in these spaces.

- The BIS recognises that CBDCs ‘could provide a complementary central bank money to the public’ and support ‘a more resilient and diverse domestic payment system’. Its report outlines the common principles and key features of a CBDC and a supporting infrastructure. A CBDC should promote innovation and efficiency. A central bank should not compromise monetary or financial stability by issuing a CBDC and should ensure that the CBDC can coexist with and complement the existing forms of money. The BIS anticipates that the next stage of CBDC research and development will focus on practical policy analysis and applied technical experimentation of CBDCs by central banks.
- The FSB framed high-level recommendations for the regulation, supervision, and oversight of GSC. The report notes that such coins may raise the risk of violating the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) and can result in governance challenges as well as market, liquidity, and credit risks associated with the specific stabilisation mechanisms and redemption arrangements. GSCs may pose operational and cyber-security risks in terms of their infrastructure and transaction management technology. The report offers 10 recommendations for the promotion of effective regulation for GSCs. It calls for regulation, supervision, and oversight proportionate to the risks and stresses the value of flexible, efficient, inclusive, and multi-sectoral cross-border cooperation, coordination, and information sharing arrangements among authorities that consider the evolving nature of GSC arrangements and the attendant risks over time.

The Bank of Japan (BoJ) will begin working on its own CBDC next year, while the Bahamas has become the first country to introduce a retail CBDC.

- The BoJ will conduct the first phase of experiments on issuance and distribution of a CBDC in early 2021. While it aims to create a retail CBDC, the BoJ plans to have financial institutions and other private entities serve as intermediaries between the central bank and end-users, rather than have companies and households hold deposits directly with the BOJ.
- The Central Bank of the Bahamas made available nationwide the country’s ‘Sand Dollar’, making the Bahamas the first country to officially roll out a CBDC. Residents can use the digital currency at any merchant with an e-Wallet approved by the central bank. Each Sand Dollar is pegged to the Bahamian dollar, which is in turn pegged to the US dollar.

The US FinCEN wants to lower the applicability threshold for the ‘Travel Rule’ from USD 3,000 to USD 250, while the UK FCA banned the sale of crypto derivatives to retail consumers on suitability concerns.

- The US FinCEN, with the support of the Federal Reserve, anticipated lowering the USD 3,000 threshold established in 1995 for international transactions, subject to full exchange of information regarding the paying and receiving entity. The target is USD 250 and would specifically apply to virtual currencies through the dedicated ‘Travel Rule’.
- The ban on the sale of crypto derivatives to retail consumers in the UK, promulgated by the FCA, rests on the conviction that retail consumers in the country can suffer harm from these products as they cannot be reliably valued. The ban also applies to instruments in the form of exchange traded products (ETPs).

The European Council and Parliament will decide the future of the pilot regime five years after it has come into force, even as the Swiss crypto-asset regulation, also covering DLT-based market infrastructure, launches next year.

3. Conclusion

The EC's proposal for a pilot regime for DLT-based market infrastructure naturally complements the recommended regulatory framework on crypto-assets reviewed in the October issue of the Digital Regulator. The latter regulates the primary market; the former supports the secondary market. This mutually reinforcing complementarity appears at odds with the 'pilot' nature of the secondary market regime compared to the 'final' nature of the proposed primary market framework. The EU has chosen a very circumspect approach, while Switzerland will witness the adoption of a fully-fledged regulatory framework for crypto-asset markets and broader DLT applications in early 2021.

October 2020 was characterised by several noteworthy regulatory developments in the digital space, including the start of the consultation in Switzerland on implementing ordinances in the area of blockchain, the issuance of principles for CBDCs by the BIS, and the publication of recommendations about GSCs by the FSB.

Disclaimer

This document has been prepared by SEBA Bank AG ("SEBA") in Switzerland. SEBA is a Swiss bank and securities dealer with its head office and legal domicile in Switzerland. It is authorized and regulated by the Swiss Financial Market Supervisory Authority (FINMA). This document is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial investment or to participate in any particular investment strategy. This document is for distribution only under such circumstances as may be permitted by applicable law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject SEBA to any registration or licensing requirement within such jurisdiction.

No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document, except with respect to information concerning SEBA. The information is not intended to be a complete statement or summary of the financial investments, markets or developments referred to in the document. SEBA does not undertake to update or keep current the information. Any statements contained in this document attributed to a third party represent SEBA's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party.

Any prices stated in this document are for information purposes only and do not represent valuations for individual investments. There is no representation that any transaction can or could have been elected at those prices, and any prices do not necessarily reflect SEBA's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions by SEBA or any other source may yield substantially different results.

Nothing in this document constitutes a representation that any investment strategy or investment is suitable or appropriate to an investor's individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgment in making their investment decisions. Financial investments described in the document may not be eligible for sale in all jurisdictions or to certain categories of investors. Certain services and products are subject to legal restrictions and cannot be offered on an unrestricted basis to certain investors. Recipients are therefore asked to consult the restrictions relating to investments, products or services for further information. Furthermore, recipients may consult their legal/tax advisors should they require any clarifications. SEBA and any of its directors or employees may be entitled at any time to hold long or short positions in investments, carry out transactions involving relevant investments in the capacity of principal or agent, or provide any other services or have officers, who serve as directors, either to/for the issuer, the investment itself or to/for any company commercially or financially affiliated to such investment.

At any time, investment decisions (including whether to buy, sell or hold investments) made by SEBA and its employees may differ from or be contrary to the opinions expressed in SEBA research publications.

Some investments may not be readily realizable since the market is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. Investing in digital assets including cryptocurrencies as well as in futures and options is not suitable for every investor as there is a substantial risk of loss, and losses in excess of an initial investment may under certain circumstances occur. The value of any investment or income may go down as well as up, and investors may not get back the full amount invested. Past performance of an investment is no guarantee for its future performance. Additional information will be made available upon request. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. Tax treatment depends on the individual circumstances and may be subject to change in the future.

SEBA does not provide legal or tax advice and makes no representations as to the tax treatment of assets or the investment returns thereon both in general or with reference to specific investor's circumstances and needs. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of individual investors and we would recommend that you take financial and/or tax advice as to the implications (including tax) prior to investing. Neither SEBA nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information provided in the document.

This document may not be reproduced or copies circulated without prior authority of SEBA. Unless otherwise agreed in writing SEBA expressly prohibits the distribution and transfer of this document to third parties for any reason. SEBA accepts no liability whatsoever for any claims or lawsuits from any third parties arising from the use or distribution of this document.

Research will initiate, update and cease coverage solely at the discretion of SEBA. The information contained in this document is based on numerous assumptions. Different assumptions could result in materially different results. SEBA may use research input provided by analysts employed by its affiliate B&B Analytics Private Limited, Mumbai. The analyst(s) responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting market information. The compensation of the analyst who prepared this document is determined exclusively by SEBA.

Austria: SEBA is not licensed to conduct banking and financial activities in Austria nor is SEBA supervised by the Austrian Financial Market Authority (Finanzmarktaufsicht), to which this document has not been submitted for approval. France: SEBA is not licensed to conduct banking and financial activities in France nor is SEBA supervised by French banking and financial authorities. Italy: SEBA is not licensed to conduct banking and financial activities in Italy nor is SEBA supervised by the Bank of Italy (Banca d'Italia) and the Italian Financial Markets Supervisory Authority (CONSOB - Commissione Nazionale per le Società e la Borsa), to which this document has not been submitted for approval. Germany: SEBA is not licensed to conduct banking and financial activities in Germany nor is SEBA supervised by the German Federal Financial Services Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht), to which this document has not been submitted for approval. Hong-Kong: SEBA is not licensed to conduct banking and financial activities in Hong-Kong nor is SEBA supervised by banking and financial authorities in Hong-Kong, to which this document has not been submitted for approval. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in Hong-Kong where such distribution, publication, availability or use would be contrary to law or regulation or would subject SEBA to any registration or licensing requirement within such jurisdiction. This document is under no circumstances directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO"). Netherlands: This publication has been produced by SEBA, which is not authorised to provide regulated services in the Netherlands. Portugal: SEBA is not licensed to conduct banking and financial activities in Portugal nor is SEBA supervised by the Portuguese regulators Bank of Portugal "Banco de Portugal" and Portuguese Securities Exchange Commission "Comissao do Mercado de Valores Mobiliarios". Singapore: SEBA is not licensed to conduct banking and financial activities in Singapore nor is SEBA supervised by banking and financial authorities in Singapore, to which this document has not been submitted for approval. This document was provided to you as a result of a request received by SEBA from you and/or persons entitled to make the request on your behalf. Should you have received the document erroneously, SEBA asks that you kindly destroy/delete it and inform SEBA immediately. This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in Singapore where such distribution, publication, availability or use would be contrary to law or regulation or would subject SEBA to any registration or licensing requirement within such jurisdiction. This document is under no circumstances directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA"). UK: This document has been prepared by SEBA Bank AG ("SEBA") in Switzerland. SEBA is a Swiss bank and securities dealer with its head office and legal domicile in Switzerland. It is authorized and regulated by the Swiss Financial Market Supervisory Authority (FINMA). This document is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product.

SEBA is not an authorised person for purposes of the Financial Services and Markets Act (FSMA), and accordingly, any information if deemed a financial promotion is provided only to persons in the UK reasonably believed to be of a kind to whom promotions may be communicated by an unauthorised person pursuant to an exemption under the FSMA (Financial Promotion) Order 2005 (the "FPO"). Such persons include: (a) persons having professional experience in matters relating to investments ("Investment Professionals") and (b) high net worth bodies corporate, partnerships, unincorporated associations, trusts, etc. falling within Article 49 of the FPO ("High Net Worth Businesses"). High Net Worth Businesses include: (i) a corporation which has called-up share capital or net assets of at least GBP 5 million or is a member of a group in which includes a company with called-up share capital or net assets of at least GBP 5 million (but where the corporation has more than 20 shareholders or it is a subsidiary of a company with more than 20 shareholders, the GBP 5 million share capital / net assets requirement is reduced to GBP 500,000); (ii) a partnership or unincorporated association with net assets of at least GBP 5 million and (iii) a trustee of a trust which has had gross assets (i.e. total assets held before deduction of any liabilities) of at least GBP 10 million at any time within the year preceding the promotion. Any financial promotion information is available only to such persons, and persons of any other description in the UK may not rely on the information in it. Most of the protections provided by the UK regulatory system, and compensation under the UK Financial Services Compensation Scheme, will not be available.

© SEBA Bank AG, Kolinplatz 15, 6300 Zug, 2020. All rights reserved.

