BP2S FEEDBACK ON THE EUROPEAN COMMISSION PROPOSAL FOR A REGULATION ON A PILOT REGIME FOR MARKET INFRASTRUCTURES BASED ON DLT

GENERAL COMMENTS

As a multi-asset servicing specialist, BNP Paribas Securities Services (BP2S) is committed to helping our clients achieve their ambitions both in terms of investments and cross-border distribution. In a changing world, we understand the changing market landscape and the intricacies of the securities services industry. Our extensive network of over 90 markets and the rich diversity of our people enable us to provide our institutional clients with the connectivity and local knowledge they need to navigate change in a fast-moving world. As a forward-thinking business, we continuously invest in new technologies, sustainability and innovation. We understand the potential behind the digitization of financial assets, and the opportunities and impact of tokenization on the global financial system. More than ever conscious that traditional financial markets and the "crypto-asset" space are beginning to converge, BP2S is actively participating to the various discussions on the topic, which we believe will eventually create improved investor experiences and satisfaction.

As such, BP2S welcomes the Commission's proposal for a Regulation on a pilot regime for market infrastructures based on DLT ('**PRR**'), which aims to implement a sandbox approach at EU level to experiment with DLT and gain a better understanding of the technology as well as of its underlying risks. Facilitating the uptake of DLT in financial markets is of crucial importance for the development of crypto-assets, especially for security tokens.

The adoption of the crypto-asset legislative proposals could give the EU a 'first-mover advantage' and could inspire other jurisdictions to follow its path and create similar crypto-asset regulatory frameworks. For that reason, and keeping in mind the objectives of promoting innovation and ensuring market stability, the creation of this pilot regime constitutes a necessary first step to enable DLT in financial markets. Indeed, to date there remains very little use of DLT in the regulated financial markets. As a result, the security token market has failed to thrive. To effectively promote innovation and strengthen the EU's first-mover advantage, we believe a bolder proposal, with the correct safeguards in place, would greatly benefit the EU.

Accordingly, we believe the pilot regime would benefit from higher thresholds. **Widening the scope of financial instruments** admitted to the pilot regime would go a long way in allowing a more rapid uptake of DLT in financial markets, and attract the required investments from regulated entities.

Furthermore, **the PRR would greatly benefit from the inclusion and expertise of serious and concrete industry projects**, which uptake has stayed limited due to the legal uncertainty surrounding the applicability of EU financial services rules. In our view, the PRR should build on the

valuable expertise and knowledge that current projects have now been building for several years. This will in turn enhance the quality of the data input for any regulatory follow-up actions.

To ensure the pilot regime remains relevant, we believe the pilot regime should **provide further exemptions for DLT FMIs** and **projects led in partnership with regulated financial entities** such as banks and CSDs.

In any case, any crypto-asset regulatory framework should strive to **maintain a level playing field between existing and future crypto-asset service providers**. In its current form we fear the proposal would not only lower the **threshold of investor protection**, but would also create an uneven level playing field, while failing to help existing European DLT projects to scale-up.
In addition, **it should be possible for an investor to use an asset service provider, such as a custodian, to access a DLT market infrastructure and to benefit from other services** like reporting services, for instance, information, financial advice, tax-related services and so on. This should be reflected in the pilot regime accordingly. The definition for custody should also be applied consistently across MiCA and the pilot regime.

In order to promote innovation, and considering the difficultness in anticipating every regulatory obstacles to the development of an EU security token ecosystem, we would **recommend a more flexible approach regarding the scope of exemptions DLT market infrastructures may request**.

For the sake of the pilot regime's success, and to leverage the EU's first-mover advantage, the EU should seriously consider **shortening as much as possible the delay before the pilot regime effectively enters into force**. An entry into application on 1 September 2021 or 1 January 2022 at the latest would seem more in line with its objectives.

Finally, the proposal does not include a **third-country regime**. In order to build on its first-mover advantage and to ensure global reach, the development of an efficient EU crypto-asset framework could require the establishment of equivalence regimes for third-country DLT market infrastructures. In any case, legal certainty should prevail.

▪ SCOPE OF FINANCIAL INSTRUMENTS ADMITTED

We believe the pilot regime would benefit from higher thresholds. The limits put in place regarding the scope of DLT transferable securities admitted to the regime are too restrictive: the thresholds relating to the market capitalization of issuers and the issuance size of bonds – on which the activation of the transition strategy relies – might be in insufficient in their current form to justify substantial investments from EU financial institutions.

The limit placed on the market capitalization of issuers (€ 200 million) could be seen as too restrictive since it would only allow a fraction of SMEs to benefit from the regime. As the CMU High-level Forum recommended in June 2020[1], the criteria for SME qualification should be reconsidered: businesses with a market capitalization under € 1 billion should qualify as SME and benefit from the

[1] *https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf*

regime. Alternatively, the PRR could provide a maximum value in terms of issuance size (the same as for bonds: € 500 million) rather than focusing on the market capitalization of the issuer.

Regarding the maximum value of DLT transferable securities allowed to be recorded on a DLT MTF or DLT SSS (€2.5 billion), this threshold seems unlikely to attract regulated financial entities. The latter could indeed quickly reach the threshold (e.g. five €500 million bond issuances) and find themselves unable to pursue any other projects for the following years. A threshold of at least € 10 billion would seem more in line with a pilot regime set to remain in place for several years.

Widening the scope of financial instruments admitted to the pilot regime would go a long way in allowing a more rapid uptake of DLT in financial markets, and attract the required investments. A more flexible scope would have the benefit of including current market players who have been experimenting with security token solutions for some time now, but for which regulatory uncertainty remains a blocking point.

ADDRESSING THE COMPLETE LIFECYCLE OF A SECURITIES TRADE

We believe charting the right regulatory course from the outset, as subsequent adjustments would cause an irretrievable loss of time on this key issue. 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.

By allowing financial institutions to participate directly to the regime, EU policymakers would create opportunities for decentralisation, driving greater efficiencies in trading and settlement. Some European Member States are already incorporating those options into their laws, therefore incorporating similar provisions at the EU level will be crucial in ensuring that Europe takes a harmonised approach to innovation.

For the sake of the development of the still nascent security token ecosystem, we believe the European sandbox should include a wider scope of regulated market infrastructures (e.g. custodians, trade repositories or other regulated entities who have or are in the process of developing partnerships with technical providers). Indeed, the past few years have seen a multitude of DLT and security token projects being led and developed in partnership with regulated entities and technical providers (e.g. custodial wallet solutions, security token market infrastructures).

It would therefore 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, can 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).

Moreover, some concerns remain that operating a DLT MTF (Multilateral Trading Facility)/SSS (Securities Settlement System) will represent a significant undertaking, not only in terms of technical implementation, but also with respect to the necessary legal assessments. Without the prospect that the DLT market infrastructure will still have permission to operate at the end of pilot period, market participants could be reluctant to participate, notably due to the cost of obtaining a permission to operate. To mitigate this issue, we believe that a grandfathering arrangement should be put in place

to allow a successfully operating DLT FMI to be able to continue operations under any final regime without the requirement to apply for permissions a second time.

In any case, any crypto-asset regulatory framework should strive to maintain a level playing field between existing and future crypto-asset service providers. In its current form, the text proposal limits the reach of the pilot regime to certain business models only, while other models with the same development potential are withheld from benefiting from the pilot regime.

The pilot regime also enables DLT SSS to be exempt from traditional outsourcing rules (see Recital 21 of the proposal), notably by allowing them to "share the responsibility of running its distributed ledger on which the transferable securities are recorded with other entities, including with its participants", therefore creating an uneven level-playing field.

Financial institutions should also be given the opportunity to request exemptions as the proposed exemptions are only applicable for MTFs and CSDs. A solution could be to amend Article 2 of the PRR to include a wider scope of regulated actors, especially regarding the operation of a DLT SSS:

ARTICLE 2 - DEFINITIONS	
Current wording	***Proposed wording***
(4) 'DLT securities settlement system' means a securities settlement system, operated by a 'central securities depository', that settles transactions in DLT transferable securities against payment;	*(4) 'DLT securities settlement system' means a securities settlement system, operated by a 'central securities depository', **'credit institution' or 'investment firm'** that settles transactions in DLT transferable securities against payment;*

▪ INVESTOR PROTECTION AND DISINTERMEDIATION RISK

We strongly support the experimental approach taken by the pilot regime, which is essential to the development of a safe regulatory framework for security tokens. While fostering innovation is key, we believe investor protection should remain at the heart of any regulation. In its current form, the proposal could not only create an uneven level-playing field but also lower the threshold of investor protection while failing to help current European DLT projects to scale-up. Existing protection mechanisms, notably in terms of investor protection, market integrity and financial stability, should remain applicable under the pilot regime and future framework: the pilot regime should not remove successful layers of protection for customers or leave the tremendous responsibility of this protection to stakeholders that do not possess the same level of knowledge, tools and skills.

European banks are committed to their responsibilities as valued intermediaries in today's financial ecosystem. Subject to a number of legal, conduct and prudential requirements aiming at protecting clients' interests and based on significant resources, proven operational structure and experiences, they secure anti-money laundering efforts, provide Know-Your-Customer checks and uphold consumer/investor protection. Where MiCA Recitals 17 and 22 of the Pilot Regime target

disintermediation, we caution against the implicated loss of established security instruments, binding investor protection regime, transparency efforts and safeguards by European banks.

For instance, the ability for DLT CSDs to provide settlement and custody services directly to retail investors (Recital 22 of the Regulation) could raise issues regarding the application of national securities law. In France for example, the registration of a security in book-entry form constitutes proof of ownership. However, to this date, registration of a financial instrument on DLT is still unrecognized by French jurisdictions as proof of ownership (except for a few non-listed securities). In case of loss of security tokens or a problem with the DLT system itself, investors would be faced with a significant legal risk.

Furthermore, by enabling DLT MTFs to offer services traditionally reserved to CSDs *(settlement, custody)*, without being subject to the same settlement discipline requirements (buy-in regime, penalties), the pilot regime would ultimately favour DLT MTFs. The PRR needs to clarify these aspects.

ROLE OF CUSTODIANS AND DEPOSITARIES

When using DLT, it seems possible to put an issuer in a direct relationship with its investors without any intermediaries. However, an investor who does not wish to have direct access to the respective 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 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 custodian, to access a DLT market infrastructure and to benefit from other services like reporting services, for instance, information, financial advice, tax-related services and so on. This should be reflected in the pilot regime accordingly.

Moreover, in certain cases it is legally not possible for investors to dispose of the assets freely and to therefore access the 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. Art. 22(1) UCITS V Directive or Art. 21(1) AIFMD). The depositary is to be 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 with respect to legal obligations normally imposed on the operator, 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 into DLT transferable securities. If retail clients are included in the pilot regime (see Recitals 17 and 22) this should be even more the case for investment funds.

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). Existing rules for safekeeping and safeguarding of client assets, especially Article 16(8) to (10) of the MiFID II and the delegated directive (EU) 2017/593 with regard to safeguarding of financial instruments and funds belonging to clients should be applied.

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. In case exemptions are foreseen for the safekeeping of DLT transferable securities pursuant to Article 6(5), alternative investor protection mechanisms would have to be complied with in order to meet the objectives pursued by safekeeping rules and in particular the requirements regarding safeguarding of client assets.

Furthermore, there is also some concern that the PRR could increase fragmentation in the field of custody of security tokens. As the exemptions would only be granted to DLT SSS and DLT MTFs, this could lead to a situation where custodians providing safekeeping services for security tokens would be required to respect the entire set of financial services rules (MiFID, AIFMD, UCITS, Omnibus Directive), while DLT SSS and DLT MTFs would be able to benefit from exemptions through the PRR. This would create *de facto* two distinct regimes for the safekeeping and custody of security tokens, which could have impacts in terms of investor protection and liquidity.

In any case, EU policymakers should clarifying requirements related to custody, including:

- Whether assets held on a DLT MTF/CSD will be considered assets held in custody;
- The potentially broad liability imposed (as described in MiCA section above); and
- Whether the rules of AIFMD/UCITS on depositary liability for financial institutions would apply.

Clarifying these requirements will remove regulatory uncertainty and encourage intermediaries and professional investors to participate in the pilot regime. The definition for custody should also be applied consistently across MiCA and the pilot regime.

▪ SCOPE OF EXEMPTIONS GRANTED

In order to promote innovation, and considering the difficultness in anticipating every regulatory obstacles to the development of an EU security token ecosystem, we would recommend a more flexible approach regarding the scope of exemptions DLT market infrastructures may request.

The current list of exemptions largely focuses on CSDR requirements. However, the healthy development of the security token ecosystem requires key considerations to be addressed, notably regarding the regime applicable to the safekeeping/custody of security tokens. We also believe that the success off the pilot regime will depend on its ability to attract investments towards DLT

transferable securities. As for shares and bonds, we recommend including investment funds and the asset management sector in the ecosystem the PRR aims to create.

European regulated financial entities should also be given the opportunity to request exemptions as the proposed exemptions are only applicable for MTFs and CSDs. They should also be able to participate more directly in the pilot regime (e.g. to act as the registrar on behalf of an issuer, as is possible today).

The pilot should allow market participants to pursue other exemptions (in addition to the six identified), subject to approval by National Competent Authorities (NCAs) and European Securities and Markets Authority (ESMA) supervisory convergence review. The possibility to apply for additional targeted exemptions to the EU financial services legislation (e.g. Settlement Finality Directive, AIFMD or UCITS), in cases where such an exemption would be justified and accompanied by adequate and sufficient safeguards, would ensure that the PRR achieves its objective, remains relevant and future-proof in a sector characterized by its fast-evolving nature.

▪ REVIEW OF THE PILOT REGIME

We believe that the sooner the pilot regime enters into application, the better are its chances of success and the sooner it will deliver results. A quick adoption would not only make sense from a pragmatic point of view but would also allow the EU to position itself in the face of competition from the U.S. (see for example the recent no-action letters from the SEC) and Asia (Singapour, Hong-Kong….).

For the sake of the pilot regime's success, and to leverage the EU's first-mover advantage, the EU should seriously consider shortening as much as possible the delay before the pilot regime effectively enters into force. An entry into application on 1 September 2021 or 1 January 2022 at the latest, would seem more in line with its objectives.

Moreover, the PRR could benefit from a mid-review instead of having to wait five years after its entry into application for a full review. Since the review is the only way to broaden the scope of the exemptions granted, or of the financial instruments admitted to the pilot regime, no adjustments would occur before these five years.

We believe a more frequent review of the pilot regime would ensure its relevancy and allow DLT market infrastructures to fully reap its benefits. For instance, the publication of frequent review reports could allow to make necessary adjustments if need be, in a time-sensitive manner without having to wait five years after its adoption. This would also be in line with the Digital finance objective of adopting a future-proof approach towards regulation.

In addition, the option for pilot termination should be deleted (art. 10 (2) (e)). Considering the large investment costs required and the limited duration of specific permissions (six years under Art. 7 (5) and Art. 8 (5)), there should be an automatic extension option for limited permissions granted. Such an option would give the market participants the confidence they need, incentivize investments and help secure the profitability of tested projects.

THIRD-COUNTRY REGIME

Finally, the proposal does not include a third-country regime. In order to build on its first-mover advantage and to ensure global reach, the development of an efficient EU crypto-asset framework could require the establishment of equivalence regimes for third-country DLT market infrastructures. In any case, legal certainty should prevail.

The absence of a clear and complete third country regime may notably raise legal uncertainties in the following circumstances :

- where a crypto-asset service provider established and authorised in the EU provides services to a crypto-asset issuer or to crypto-asset investors who are established in third countries ;
- where a crypto-asset service provider established and authorised in the EU provides services on crypto-assets that are issued in third countries ;
- where a crypto-asset issuer established and authorised in the EU is provided crypto-asset services by an entity established in a third country (for example, in the USA or Switzerland);
- where a DLT CSD or a DLT* MTF outsources some of its functions to an entity established in a third country;
- where a bank established in a third country wishes to be authorised for the issuance of asset-referenced tokens (ART) or e-money tokens.

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