SECURITIES POST-TRADING

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How to steer the DLT pilot regime? Navigating between potential and challenges

Technological change is the driving force of our times – and Covid-19 has further accelerated the pace of change. Digital technologies are advancing in all segments of finance: contactless payments have boomed during the pandemic, robo-advisors offer fully automated investment tools to customers, and distributed ledger technology (DLT) looks set to play a much more important role in securities settlement in the future.

A crucial factor for all new technologies is the regulatory environment – without a stable and predictable set of rules, innovations face strong headwinds that may prevent them from taking off. At the same time, regulators need to ensure that consumers do not board vessels that are too risky for them and the market as a whole. In other words, regulating emerging technologies is about striking a balance between potential and challenges. The EU has developed a pilot regime to steer and stabilise the development of DLT for trading and securities settlement.

In essence, the initiative is about creating a kind of “regulatory sandbox” in the EU for the development and operation of market infrastructures based on DLT. Having a ring-fenced sandbox means that newcomers are able to play and experiment in a safe and supervised environment. The regulation takes the form of a pilot regime and has four main objectives: first, to create legal certainty for DLT market infrastructures within the EU; second, to support innovation in the EU by removing barriers to the application of new technologies in the financial sector; third, to safeguard consumer and investor protection and market integrity; and fourth, to guarantee financial stability.

Creating a pilot regime for DLT market infrastructures is the right approach. However, we need to keep two key issues in mind. First, when we enable this pilot to gain speed and take off, we need to be able to call it back and force a safe landing at any time if its objectives are not met. There are, of course, reasonable limits incorporated into the pilot regime, concerning both the duration and certain value thresholds to limit the size and risk of the regulatory sandbox. Nevertheless, we need to communicate to the market that winding down the regime will be a viable option if significant risks are identified that cannot be addressed in any other way.

The second key issue is that we need to prevent fragmentation of the European settlement landscape. New solutions based on DLT promise to increase the efficiency of securities settlement, but this depends on the specific design and development of the market. Creating many different non-interoperable DLT sandbanks or islands each with its own settlement asset will not enhance overall settlement efficiency in Europe. The sandbox concept is good but there would have to be a common one without major barriers to transactions, meaning that DLT infrastructure providers would need to ensure a high level of interoperability with existing legacy systems.

DLT offers significant efficiency gains for the European settlement landscape. However, we can only achieve these gains if we find the right balance between enabling potential and mitigating challenges. Avoiding fragmentation will be key to reaping the benefits of the pilot regime.

NIELS BRAB

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DLT is good, except when it’s not (regulated)

Yes, the EU finds itself at a crossroads. With unprecedented public debt levels and pressure on the monetary policy as well as the banking system, the untapped growth potential by boosting the EU’s capital markets becomes critical now. With the Brexit being a reality, the time has come to act – and the reflections around sovereignty and a stronger Euro are the right way ahead.

But in all this misery, there are also some good news: The G20 reforms have paid off! Despite all the turmoil and volatility over the past year, markets remained stable. Let us not forget that the post-trading sphere is playing a key role in this context as the backbone of security, stability and reliability in the financial system – fundamentals that should never be compromised.

This is where the CSDR comes in – and it is fair to say that we have come a long way: Shorter settlement periods or significantly enhanced organisational and prudential requirements for CSDs are only some of the key fields of progress. While it is good to ensure the functioning of the framework, a full sweep review occurs misplaced

given that certain requirements have never been phased in, such as the settlement discipline regime. And after all the impact assessments and years of preparations, it would occur premature to simply change or delete certain requirements at this stage.

This holds in particular true for the buy-in regime, notably considering that the Eurosystem still faces significantly higher settlement fails than other leading jurisdictions. Enforcing discipline is needed – as it means that market participants need to stand in for what they promised and cannot simply get away with misbehaviour to the detriment of the integrity of the EU's markets, such as non-delivery of securities.

By contrast, it makes sense to review some aspects that require adaptations to bring the EU's endeavour on the CMU front forward by strengthening the post-trading integration and making the internal market more efficient, resilient and competitive. These include, for example, the need to boost cross-border competition by enhancing the passporting regime and streamlining the approaches by NCAs, the ability of CSDs to service intra-group, or the ability to provide ancillary banking services.

...ensure the CSDR remains future-proof while safeguarding its fundamental stability and integrity prerogatives.

Let us not forget to highlight the importance of technology in this context. With the next big digitalisation wave in full swing, it will be key to ensure the CSDR remains future-proof while safeguarding its fundamental stability and integrity prerogatives. The DLT Pilot Regime proposals should therefore still find the right balance between innovation and security, respecting the principle of "same business, same risk, same rules", avoiding conflicts of interests and ensuring technology-neutral legislation.

When Deutsche Börse Group made the markets electronic in the 90s, we did not see any regulatory relief for our business case. History illustrated that we were nevertheless successful. Today, Deutsche Börse Group has a number of DLT based offerings on the market – again, without receiving regulatory relief.

If new technology is claimed to be incompatible with fundamental principles of financial regulation, we should carefully reflect if it is our fundamentals or the technology that is not fit for purpose.

GUILLAUME ELIET

Head of Regulatory, Compliance and Public Affairs, Euroclear S.A.

Making the DLT pilot regime a success for the EU

As a financial market infrastructure, Euroclear has always been supportive of the development of new technologies that could make the financial markets safer and more efficient. On DLT, we already highlighted the potential of this technology in several strategy and legal publications, and we are involved in different initiatives to explore and leverage its benefits. Like many market players, we believe DLT has the potential to reshape in some ways the securities markets, by introducing new services and new players.

This reshaping has the potential to bring benefits in terms of efficiency and transparency, but market authorities need to be careful on how this transformation takes place. EU regulators have a crucial role to play in setting the fundamental objectives of the DLT pilot regime. We believe that the reform should be based on two main drivers: (i) bring benefits to the EU and its CMU (ii) do not compromise on the safety and stability of the financial system. The EU will achieve the digital finance agenda's ambitious targets only if it successfully manages to combine these two elements.

The objective must be to develop DLT technology, not for itself, but as a catalyst for a more integrated and safer CMU.

Indeed, creating a space for DLT into the regulatory landscape should not only serve the mere objective of developing a new technology. It should also bring benefits for the CMU, contribute to better market integration and help the development of more cross-border flows of funding. In this respect, the DLT pilot regime should be designed in a way that avoids creating market fragmentation, which would be detrimental to issuers and investors. While the current proposal aims to test very innovative concepts such as the combination of trading and post-trading within one single legal entity, questions remain on whether it would be in line with the necessity to offer issuers and investors more open, interoperable and competitive markets.

The introduction of DLT may lead to exemptions justified by some feature of the technology, to the extent however that they do not result in increased financial stability and systemic risks. The legislative framework must, in this respect, remain technology neutral. To ensure a certain level of security, a common feature of most analysis was to highlight the importance of having a market infrastructure dedicated to operating the DLT platform and performing key roles such as ensuring the integrity of the issuance, managing the governance, performing the due diligence, etc. We believe this role of gatekeeper, which was also supported by the High Level Forum on CMU, could bring additional safety and thus confidence in the new regime.

Euroclear is supportive towards the project of setting up a pan-European experimentation zone for DLT, which can indeed be a great additional tool to bring the EU forward in the digital age. The objective must be to develop DLT technology, not for itself, but as a catalyst for a more integrated and safer CMU. The political discussions at the European Parliament and European Council shall keep firmly this objective.

SWEN WERNER

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The DLT pilot regime – a path to Europe's 'next-gen' market infrastructures?

Distributed ledger technology (DLT) is a foundational technological innovation that could bring long-term benefits to create more efficient markets. The European Commission's proposed DLT pilot regime aims to support the digital transformation of financial markets. If adopted, it would allow the operation of market infrastructures based on DLT.

The pilot regime adopts a sandbox approach to creates certain exemptions from specific requirements embedded in EU legislation such as MiFID or CSDR. At present, there are over 50 countries which have implemented comparable 'sandboxes' that allow for temporary relief from certain regulatory obligations in order to promote experimentation particularly in the field of emerging technologies.

Previous consultations from the EU Commission concerning new technologies showed that many respondents, aside from some of the current infrastructure providers, believe that the existing EU framework is insufficiently technology neutral. This could undermine the successful deployment of new technologies such as DLT. The pilot regime is a way to address this issue:

- it recognises the potential need for regulatory change in light of new technologies,
- identifies areas that may be insufficiently innovation friendly,
- requires those seeking to create a DLT market infrastructures to prove that existing EU rules are incompatible with DLT.

The real success is the engagement model created between the private and public sector and the transparency around such engagement.

Consequently, the barometer of success for the pilot regime is not necessarily its widespread adoption, since the regime should only be used if existing regulation would not allow for it.

The real success is the engagement model created between the private and public sector and the transparency around such engagement. Nevertheless, the scope of the pilot regime is limited, i.e. restricted to illiquid securities, subject to a sunset clause and participation is only foreseen for CSDs and MTFs (multilateral trading facilities). This could create unintended outcomes:

- Participation is limited to central infrastructures only: DLT-based networks are decentralised networks by design. This implies the redistribution of roles and activities that currently reside across existing market infrastructure and their users. The pilot regime does not fully allow for this level of experimentation to happen.
- There is continued uncertainty about the exit strategy: there is insufficient clarity on how a successful business model, developed as part of the pilot, can achieve a general stay once the pilot regime expires. This may increase the risk for investors to engage in building such models.
- National regulators are creating potentially more attractive alternatives: various Member States are in the process of amending their national securities law to allow for the creation of securities that are issued in digital form using DLT.This may be more attractive than the pilot regime

The pilot regime is a welcomed example of how EU regulators can flank technological innovation with regulatory flexibility. However, additional effort will be needed to allow for greater levels of decentralised market structures to evolve, which will be beneficial to financial markets in Europe and contribute to the efforts of creating a deep and innovative capital markets union.

ALEX DOCKX

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Improving CSDR settlement discipline to support CMU objectives

The creation of an integrated and efficient European capital market – the goal of the CMU project – is among the most important goals currently being pursued in the EU.

A crucial element of this framework is the safety and efficiency of the arrangements required to finalise securities transactions. There is a clear flow in operations and interdependency between trading and post-trade processes, with efficiencies passing through from one to the other.

In that context, the objective of the CSDR Settlement Discipline Regime (SDR) – to increase settlement efficiency in the market and decrease settlement fails – is the right one. We commend the European Commission for recently consulting on the details of the regime to make sure they are fit for purpose. For example, we believe that a targeted, appropriately calibrated cash penalty regime – as currently envisioned in the SDR – will have a positive impact on settlement efficiency on a standalone basis, sufficiently penalising sellers while compensating buyers for late delivery, ultimately leading to lower settlement fails.

However, we believe one particular provision of the SDR – the mandatory buy-in regime – risks reducing the efficiency and liquidity of European capital markets, leading to greater costs to investing in European securities, contrary to CMU aims. The issue is with the mandatory nature of the buy-in regime for non-CCP cleared transactions, which makes it insufficiently flexible by removing investors' choices and ignoring the particular liquidity profile of the securities.

This is likely to fundamentally impact liquidity providers' ability to make markets. To adjust for the expected cost of being bought-in, market makers may have to add a premium to their prices – widening the bid-offer spread – or they may simply not make an offer price on an enquiry. Asset managers, in turn, may not be able to obtain the securities they want on behalf of investors, and thus may have to make sub-optimal investment decisions or may have to pay a liquidity premium. Issuers could also be negatively affected, with issuance ability and pricing related to the expected liquidity of the instrument.

A mandatory buy-in regime for non-CCP cleared transactions could negatively impact market liquidity and increase costs to end-investors.

Ultimately, a mandatory buy-in regime for non-CCP cleared transactions could negatively impact market liquidity and increase costs to end-investors. This could be especially the case in times of stress when markets become more volatile, and bid-offers and settlement failures increase. Furthermore, while negatively impacting all asset classes, these effects are likely to be disproportionately detrimental to less actively traded or illiquid securities, including instruments issued by SMEs, and high yield and emerging markets securities, which already suffer from lower liquidity and higher costs of trading.

The result is that a measure which was meant to improve settlement efficiency and stimulate European capital markets is likely to come at a high cost. We would therefore suggest replacing the mandatory buy-in regime for non-CCP cleared transactions with a discretionary one, while keeping a strong and robust penalty regime. Such an approach would significantly improve settlement efficiency in the EU and serve the ultimate goals of the CMU.

FRANCISCO BÉJAR

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EU securities post-trading priorities

We are living in an unprecedented time, socially distanced and heavily relied on digitalization and innovation. Here we are, yet again hit by another crisis but by health crisis this time which has paralyzed economies around the globe. The world economic and geopolitical orders will most probably change depending on the policies and strategies countries will and are employing not only in order to recover from the pandemic-led crisis and mitigate the risks but also to achieve the goals they have set for the future. Therefore, we need to complete the Capital Markets Union (CMU) now more than ever, or the stakes are too high.

In September 2020, the European Commission published its Action Plan to boost the CMU by tackling some of the remaining barrier to a single market for capital. One of the barriers, which hinders the cross-border investments and transactions, is the fragmented post-trade landscape or the lack of common CSD ecosystem.

To create a common CSD ecosystem, we need more simplified and harmonized rules such as Central Securities Depository Regulation (CSDR), Settlement Finality Directive (SFD) and Financial Collateral Directive just to name a few. For this, we need (i) to clarify and harmonise the passporting procedures and enhance cross-border provision of services, (ii) facilitate the servicing of domestic issuance in non-national currencies, and (iii) strengthen the supervisory convergence among the national competent authorities.

EU needs common CSD ecosystem to complete the CMU

Indeed, the consultations issued by the European Commission on CSDR and SFD are in line with the recommendations of the High-Level Forum on CMU and are on the right direction. However, to achieve even better results, it is also important to resolve tax-related matters, simplify the CSD links framework and employ technological innovations.

In the meantime, we have to implement the Settlement Discipline Regime, which is a crucial part of the CSDR and needs further improvement regarding the buy-ins regime, rules on penalties and on the reporting of settlement fails. Rules on buy-ins should be differentiated by the markets, instruments and transaction types. Also, cleared and non-cleared transactions should have same buy-ins regime to avoid de-incentivising central clearing. As for rules on penalties, negative interest rates should be taken into account and some types of transactions should be exempted from the scope.

Digitalisation, the global trend which is evolving very fast and further accelerated by the pandemic, is one of the European Commission's six priorities. Therefore, the European Commission's Digital Finance Package is very timely and highly welcomed.

However, it is important to ensure the level playing field, clarity, and proportionality of the new legislations, Markets in crypto-assets (MiCA), Digital operational resilience act (DORA), DLT Pilot Regime, and their interaction with existing legislations.

Trading volumes have soared during the beginning of the pandemic and the volatility has gone wild. Yet, financial markets infrastructures proved to be resilient and functioned smoothly. However, we have to take another step forward to better CSD legislations to create common CSD ecosystem, complete the CMU and thus, contribute to the well being of people in the European Union.

HÉLDER ROSALINO
Board Member,
Banco de Portugal

Are the actions being taken enough to support the CMU and to strengthen the international role of the euro?

The European institutions, as well as national authorities, are taking actions towards a more integrated, harmonized and efficient financial markets in the euro area, and in this way to enhance the international role of the euro.

The European Commission has recently launched some important initiatives. First, in December 2018, the Commission communicated on the need to move "Towards a stronger international role of the euro". In that communication, the Commission concludes that "strengthening the international role of the euro will require the further strengthening of the structures of the Economic and Monetary Union, including through the adoption of all pending proposals for completion of the Banking Union and decisive progress on the CMU".

Second, a digital finance package was adopted on 24 September 2020, comprising a digital finance strategy and legislative proposals on crypto-assets and digital resilience. Some of the proposals are directly targeted to facilitate innovation and make Europe a more integrated and innovative market while addressing the emerging risks, namely the "Legislative proposals on crypto-assets to draw on the possibilities offered by crypto-assets, while mitigating risks for investors and financial stability" and the "Legislative proposal for an EU regulatory framework on digital operational resilience – Prevent and mitigate cyber threats".

This package also includes a "Retail Payments Strategy for the EU", by which the Commission points out that the development of efficient international payments, including remittances, as well as the issuance of a Central Bank Digital Currency by the Eurosystem, could enhance the international role of the euro and the EU's 'open strategic autonomy'.

Third, a communication entitled "The European economic and financial system: fostering openness, strength and resilience" was disclosed on January 2021. Two of its pillars relate to strengthen the international role of the euro and to develop further EU financial market infrastructures and increase their operational resilience.

This communication includes as a key action the promotion of euro-denominated investments, the facilitation of the use of the euro as an invoicing and denomination currency and a better understanding of the obstacles for its wider use. At the same time, it also establishes that the Commission and the ECB will jointly review a broad range of policy, legal and technical questions emerging from a possible introduction of a digital euro.

Last, the European Commission announced the revision of both the Central Securities Depositories Regulation (CSDR) and the Directive on settlement finality in payment and securities settlement systems (SFD). The proposals embedded in the CSDR and SFD reviews are moving in the right direction, towards a more competitive and levelled playing field European market. All efforts put on the harmonization of definitions, interpretations and implementation issues, as well as streamlining reporting, are very much welcomed.

The ECB and NCBs are also taking important actions in the market infrastructure and payments field to consistently concur to the increased efficiency and integration of financial markets in the euro area. It has to be highlighted all the work done by the Eurosystem in the development of the infrastructure for large-value payments, for post-trading services for financial instruments and for instant retail payments and, still to come, the provision of a central liquidity management system, the development of a single collateral management system and the improvement of the efficiency and safety in cross-borderpayments.

Despite the relevance of the abovementioned initiatives, it has to be acknowledged that a more integrated and energetic European financial market depends also on the capacity of the European players to compete internationally, to innovate and to mitigate the risks arising from their activity.