
**21 July 2015**

**ESMA call for evidence "Investment using virtual currency or distributed ledger technology"**
**Euroclear SA/NV feedback**

The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bond, equity, fund and derivative transactions. User owned and user governed, the Euroclear group includes the International Central Securities Depositary (ICSD) Euroclear Bank, based in Brussels, as well as the national Central Securities Depositaries (CSDs) Euroclear Belgium, Euroclear Finland, Euroclear France, Euroclear Nederland, Euroclear Sweden and Euroclear UK & Ireland.

We are pleased to be able to respond to this call for evidence from ESMA. In our submission, we focus on aspects related to securities and securities transfers (i.e. Issues 'b' and 'c' identified in Section 1 of the ESMA paper).

Euroclear SA/NV's public ID number in the EU Transparency Register is 88290282308-75.

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## 1 Introduction

We agree with ESMA that distributed ledger technology (DLT) can lead to disruptive innovation and disintermediation in the securities industry. This is because DLT has the potential to bring issuers and investors into direct contact, without the need for traditional players such as exchanges, brokers, CCPs, CSDs, custodians, etc.

We are convinced that such innovation could bring great value for the real economy and the financial industry in terms of efficiency, speed, lower cost for investors and easier access to funding. This is why Euroclear has been analysing the potential of DLT and the possibility for it to shape the evolution of post trade market structure. We believe it is possible for DLT to become a trusted alternative for managing large volumes of securities transactions.

Although many important open questions remain, we share the view that, combined with parallel innovations in the field of on-line identity management, DLT could have significant beneficial implications for users of the securities business and that the process of realising these benefits may lead to structural change in the industry.

Such an evolution will nevertheless represent significant challenges from a legal and regulatory viewpoint. Global and EU regulatory guidance will be required to ensure that the economic benefits of the technology evolution can be realised in a safe and protected environment, and to ensure that legislative or regulatory constraints do not hold back innovative developments which benefit the market. Existing regulatory Principles and Standards may need to be adapted significantly (eg; the CSD Regulation, CPMI-IOSCO Principles) to capture the different risk profile of DLT.

## 2 Benefits of open, distributed ledgers

The data containing the history and current state of a distributed ledger is maintained by several different parties, operating as peers, with a shared technical protocol that enables them to reach a consensus on the correct state of the data at any given point in time.

Used in conjunction with cryptographic techniques that enable people to assert ownership of, and instruct changes to, records in the ledger directly, a distributed ledger could offer a number of potential advantages for post trade markets:

- Significant reduction of the distance between asset issuers and asset owners reducing intermediation costs as well as operational risks, for example in the processing of corporate actions and redemptions
- Simplification of the exchange of data to find counterparties, negotiate trades and settle transactions, reducing time, risk and capital. The time between trading and settlement could be greatly reduced with settlement taking place very shortly after trading instead of the current T+2 timing (effectively real-time T+0 settlement).
- Creation of open and robust financial infrastructure for new types of assets and transactions (introducing DVP for more asset classes) enabling new, more open business models compared to today's world of competing vertical silos.

- Strengthening the security of the financial system against cyber-attacks and removing single points of failure in the system, which should give greater confidence to create more open accessible infrastructure.
- If combined with innovations in the fields of online identity management, it could offer a highly flexible system where participants could offer different levels of anonymity, eligibility credentials or transparency to different stakeholders in the financial eco-system.
- Offering greater levels of regulatory transparency than are practicable today, without requiring participants to sacrifice commercial confidentiality.

## 3 An appropriate regulatory treatment for DLT arrangements for securities industry

It is likely that the use of DLT could change existing financial infrastructure significantly, modifying or eliminating institutional roles, reducing or eliminating distinctions between trading, clearing and settlement, dissolving the barriers between retail and wholesale business, and even blurring the lines between financial and other transactions. Moving towards a securities infrastructure based on DLT would undoubtedly challenge many existing assumptions, roles and participants in the system. Any new approach will need to operate within existing and/or revised legislative frameworks. For example, the vital concept of settlement finality will also need to apply, not just to existing infrastructures, but also to distributed ledgers operating in the securities settlement space; risks mitigated by settlement finality exist independently of the technology used to achieve settlements. DLT should deliver the same high degree of legal certainty as for existing securities holding and transfer arrangements.

As a regulated financial market infrastructure, we are conscious that DLT evolution can only be acceptable and successful on a large scale if the new environment meets regulatory requirements of financial stability, legal certainty, issuer and investor protection, market integrity and fair access. The current set of global, EU and domestic laws, rules and principles applying to the securities industry and its service providers cannot be easily "transposed" to deal with possible DLT environments. For example, the following may need to be addressed:

- Many of the current CPMI/IOSCO principles for Financial Market Infrastructures (e.g. with regard to operational risk management, business continuity, money settlements, DVP rules, settlement finality, etc) seem relevant for DLT, but may need to apply to a different set of actors than the current FMIs. Other principles might appear to become less relevant (e.g. the role of CSDs in ensuring the integrity of securities issues, rules on segregation and portability). And new principles may need to be added (e.g. specific requirements on those entities that provide identity verification (digital passport) for legal entities and natural persons on a platform; dealing with interoperability between different DLT networks, or with the interaction between the "traditional securities" FMIs and the new DLT networks).
- Whether, and if so how, NCB's would facilitate central bank money settlement in a DLT environment
- Access to DLT networks for issuers and investors might need to be facilitated/sponsored by regulated entities only.
- Laws dealing with securities ownership and transfer might need to be revised specifically to deal with digital securities holdings; the concept of governing law and Place of Relevant Intermediary (PRIMA) dealing with conflicts of law may need revisiting.

- AML concerns must continue to be met, as well as relevant FATF recommendations and sanctions compliance.
- Some prudential requirements for investment firms, CCPs, CSDs included in MiFIR, EMIR and CSDR would be less relevant for decentralised ledgers; prudential requirement may be needed for other actors such as identity verification providers, securities information verification providers, DLT protocol authorities, etc.
- Transaction reporting requirements would need to be revisited.
- To ensure that the introduction of DLT environments for securities benefit the economy and financial markets, the early agreement (and introduction) of common standards/protocols would be advisable. The operation of such an environment might need to be a regulated/licenced activity.

Any large scale implementation of the DLT in the securities environment would require early and comprehensive regulatory guidance. Global authorities, including ESMA, should consider developing a specific set of principles, rules and regulations to deal with DLT for securities holdings and transactions, or review and modify existing laws and regulations. We would welcome working with ESMA, regulators and public authorities to ensure that DLT developments can take place in an adequately controlled and safe environment that meets expectations of financial stability, investor protection, market integrity and fair access.

## 4 DLT for securities – specific regulatory challenges related to interoperability

We see several possibilities for the development of DLT in the securities industry

- Digital securities/investment products exchanged against a Virtual Currency
- Traditional securities (represented as a digital instrument) exchanged against a Virtual Currency
- Digital securities/investment products exchanged against fiat currency (represented as a digital instrument)
- Traditional securities against fiat currency, both represented as digital instruments

It is very likely that the above possibilities would co-exist within the EU and globally, and would co-exist with the traditional pre-digital operation of the securities industry. This means that the EU and global landscape would become (temporarily at least) more complex than today. The interoperability/transition between various DLT networks and between the DLT networks and the pre-digital networks would seem to represent specific regulatory challenges.