

USE OF FINTECH BY CSDs

Interview with Thibault Gobert on the latest developments in European Settlement Regulation



At the beginning of August, the European Securities and Markets Authority (ESMA) published a report¹ on the use of FinTech by Central Securities Depositories (CSDs). Amid targeted amendments to the Central Securities Depositories Regulation (CSDR), a regulation on crypto-assets (MiCA)², a DLT pilot regime³ and an eWpG⁴, I totally lost my bearings on where we are with the current and future post-trade infrastructure regulation. So, I asked our Head of Liquidity Pool, Thibault Gobert, to help unpick this knot of terminology.

Thibault, first of all can you put into layman's terms which of these regulatory initiatives are really relevant?

Well, unfortunately, they're all relevant. However, you may not pay so much attention to MiCA when you focus on the post-trade universe. And you can ignore the eWpG when you're located outside Germany.

And if I am based in Germany?

Well, the Law on the Introduction of Electronic Securities or, eWpG, is a German regulation for digital securities custody. Under the eWpG, a security can be issued as an electronic security. An electronic security is issued by making an entry in a newly created electronic securities register instead of issuing a (paper) security certificate. In principle, an electronic security should have the same legal effect as a security that has been issued by means of a security certificate. The issue can take place as a normal electronic security that is registered with an approved central securities depository, or as a crypto security that is registered with a crypto security register. Initially, it only covers bearer bonds.

MiCA aims at uniformly governing transparency and disclosure requirements for the issuance and trading of crypto-assets as well as the approval and supervision of providers of crypto-assets and their issuers. The regulation is intended to regulate the operation, organisation and management of issuers of asset-referenced tokens as well as e-money tokens and service providers in the field of crypto-assets.

As for the CSDR and the DLT pilot regime, I thought the former was for non-digital settlement and the latter for the crypto-related assets – now it seems ESMA is mixing it all up?

It's a bit more complicated...

...I had hoped you would say that...

...Then again, it's not that tricky and you're not wrong at all. ESMA introduced the DLT pilot regime to address operators of market infrastructures that trade and settle transactions in financial instruments in crypto-asset form. As with existing regulation (CSDR), the combination of trading and post-trading activities within one legal entity is not permitted – in order to prevent conflicts of interests, trading and settlement must be performed by separate market infrastructures.

Accordingly, a DLT market infrastructure, under the pilot regime, can be either a DLT multilateral trading facility (DLT MTF) or a DLT securities settlement system (DLT SSS). The operational governance frameworks are similar to the existing ones, i.e. a DLT MTF must be operated by a market operator that is approved under the laws of MiFID, whereas a DLT SSS must be operated by a CSD approved under the laws of the CSDR. In short, DLT market infrastructures are subject to the same requirements already applicable for non-DLT market infrastructures.

However, there are a set of exemptions which must be applied for at the relevant national competent authority (NCA) and some operational restrictions, too. Taking these into account the DLT pilot regime is, in my view, a suitable framework for both start-ups and established infrastructures, the product and service ranges of which suggests occupying the niche that DLT will be opening up.

What are the exemptions and what obligations have been imposed?

Under the DLT pilot regime, DLT market infrastructures are subject to specific business plan requirements, operational requirements especially focusing on IT, safekeeping arrangements, disclosure obligations, and an exit strategy. They must report on a semi-annual basis to the NCA.

A DLT MTF, for instance shall be exempted from the book-entry requirement and from the requirements to record with a CSD, if it can warrant the recording on a DLT-based solution, when the segregation of client securities on a client basis is ensured and when robust settlement procedures and custody arrangements are in place.

A DLT SSS would be allowed to do without transfer of orders and benefit from further alleviations in association with securities accounts and the recording of securities subject to similar operational preconditions as are relevant to DLT MTFs. Both would be allowed to use settlement coins to clear transactions.

On the other hand, DLT market infrastructures would – under this regime – not be allowed to admit DLT transferable shares of issuers whose market capitalisation is above EUR 200 million and no bonds with a notional of over EUR 500 million and no sovereign bonds. The value of securities they record shall also not exceed EUR 2.5 billion.

Within its so-called 'sandbox' approach, the exemptions under the DLT pilot regime allows derogations from existing rules for a period of up to six years enabling regulators to gain experience on the use of DLT in market infrastructures.

Taken all this into account, it is very clear that the DLT pilot regime is a carefully thought put piece of regulation, ensuring that risks to investor protection, market integrity and financial stability can be dealt with; however, it is also very clear that it is not an appropriate framework for the use of DLT by established CSDs which is why ESMA has been looking into necessary amendments to the CSDR in order to address this gap.

What were the main findings of this report?

ESMA, asked by the European Commission to provide this report, interviewed NCAs and market participants about their usage or plans for the usage of DLT for securities services and if or where existing regulation – not the pilot regime but the CSDR – is preventing them from implementing related projects.

The report concluded that, while many CSDs plan to deploy DLT in the coming years, the current usage of innovative financial technology or, FinTech as the report abbreviates it, is rather limited. This includes DLT, cloud computing, machine learning and quantum computing.

ESMA has now promoted the clarification of some uncertainties surrounding DLT by the European Commission before it will have had the chance to gather sufficient feedback and experience from the developments under the pilot regime in a few years from now. Such clarification will prove extremely helpful to established market participants who are experimenting with the application of DLT in post-trading services.

Which uncertain issues are these and what does ESMA recommend?

These are issues related to securities accounts, credits, debits, segregation and reconciliation requirements as well as operational issues or those related to the unambiguousness of legal definitions. For instance, whether digital addresses held in a DLT platform can be considered securities accounts or whether DLT records are the same as credits and debits within the meaning of the CSDR or whether DLT records will qualify for compliance with the account segregation requirements under Article 38 of the CSDR. Similar uncertainty remains as to whether the use of DLT is covered under a paragraph of existing regulation which says that, where internationally accepted standards aren't available on a non-discriminatory basis to any interested party or do not exist, the NCA of a CSD may allow that CSD "to use other messaging standards, until international standards become available". Considering settlement finality, different deployment methods could lead to different systems registering the entry of a transfer as having effectively and irrevocably taken place at different stages – which would lead to inconsistencies between such systems.

ESMA has recommended that the European Commission adopts targeted amendments in the course of the CSDR review or in the form of Q&A guidance to avoid that financial innovation in the EU lags behind international competition. Since the Commission very rarely deviates from ESMA's recommendations, this can be considered a positive outcome.

Earlier, you mentioned niches opening-up through DLT, what do you mean by that?

I believe that a tokenisation of the trading life-cycle will provide opportunities and efficiency gains, which will increase proportionally with a rising degree of digitalisation. That said, for the mass processing of cash or securities settlement orders, it may take some time to materialise. On the other hand – if you look at the legal framework that has been set with the pilot regime – this is not just an opportunity for FinTechs whose background is bank-remote or bank-averse. Spectrum Markets – if I may cite ourselves as an example – offers trading of securitised derivatives on a pan-European level. Subject to the lift of several restrictions and together with some of our partners, we may be well positioned to develop an ecosystem for products that are being issued outside a classic CSD, traded on a DLT MTF and settled outside a classic CSD and all this without the boundaries currently set by national settlement legislation particularities or the costs they entail and which European regulation is so keen on eliminating.

Thank you very much!

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