31 July 2023

ECSDA Response to the IOSCO

Policy Recommendations for Crypto and Digital Asset Markets Consultation Report

Question 1: – Are there other activities and/or services in the crypto-asset markets which Recommendation 1 should cover? If so, please explain.

ECSDA welcomes the direction chosen by IOSCO in this consultation.

ECSDA agrees that crypto-asset trading, other crypto-asset services and the issuing, marketing and selling of crypto-assets should be regulated and supervised in a manner consistent with IOSCO Standards. Doing so will support overall supervision, investor protection and also mitigate fragmentation between member jurisdictions.

Conflicts of interest must be avoided. In general, the usual rules of traditional finance should be followed by the crypto-asset industry.

In the context of the Recommendations as they apply to all types of crypto-assets, including Stablecoin Arrangements (SAs), ECSDA suggests including safekeeping or custody/trust as a service subject to Recommendation 1. There is a need for a sufficient regulatory and supervisory framework that maximises trust in SAs. For this reason, the provider of custody/trust services for reserve assets should also be in line with IOSCO Standards.

In pursuit of investor protection and market integrity by responding to corresponding risks, the issuer and/or system operator should be authorised and supervised firms. A strong rulebook should be required including clear and transparent rules for the management.

Question 2: – Do respondents agree that regulators should take an outcomes-focused approach (which may include economic outcomes and structures) when they consider applying existing regulatory frameworks to, or adopting new frameworks for, crypto-asset markets?

It is essential that regulators avoid duplication and fragmentation of the PFMIs while ensuring the *"same business, same risks, same rules"* principles. ECSDA is unclear as to the meaning of an "outcomes-focused approach". However, it will be useful for regulators to focus on an 'outcomes approach' with regard to, for example:

- **The risks posed by 'probabilistic finality':** Considering the significant risks posed by forks, CASPs should only be allowed to use DLT models that do not leave any ambiguity in regards to the settlement finality; and
- A differentiation between stablecoins and global or systemically important stablecoins.

In this vein, regulators should apply its rules so that they pursue a level-playing field and limit systemic risk in financial markets.

In pursuit of an 'outcomes-focused approach', ECSDA underlines that not all crypto-assets should be treated in the same way. The recommendations could differentiate between digital assets (e.g. DLT issued securities) versus payment assets (like stablecoins or asset-reference tokens) Especially, the digital assets considered equivalent to traditional financial instruments (be it native

European Central Securities Depositories Association, aisbl
Rue Royale 75, 1000 Brussels – ecsda.eu – info@ecsda.eu
RPM/VAT : BE0464619112 – Tribunal de l'entreprise francophone de Bruxelles I
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or asset-backed digital assets) should be treated as financial instruments and fall under already existing regulation/principles.

Question 3: – Does Chapter 2 adequately identify the potential conflicts of interest that may arise through a CASP's activities? What are other potential conflicts of interest which should be covered?

By creating a hybrid entity combining all roles, concentration risks are significantly increasing. This risk is accentuated by the potential conflict of interest that may arise through a CASP's activities, as seen during recent DLT initiative collapses.

In respect to the requirement of "separation of legal entities", we believe a reasoned analysis should be followed, to avoid disproportionate burdens that hinder innovative businesses. This analysis should assess the negative/positive consequences and drawbacks of a combination of roles while considering financial stability and level-playing field concerns.

Once such an analysis is made, policymakers must assess how best the concerns related to a combination of roles can be limited. From a preliminary standpoint, these measures must include 1) clear governance, 2) splitting particular functions, 3) establishing effective conflicts of interest policies, procedures and controls, and 4) providing public disclosure and reporting. Whether a "separation of legal entities" should be a strict requirement or a measure of last resort will be determined in that frame.

To mitigate to the extent possible the risks associated with vertical aggregation of activities, regulators should pursue the *"same business, same risks, same rules"* principle. Due to local and supra-national financial market regulations, CSDs have robust conflict-of-interest management procedures to ensure ethical and fair practices. This involves implementing policies and mechanisms, including the compulsory separation of legal entities, that prevent any undue advantage or bias among the businesses owned by the group. Transparent governance structures, independent oversight, disclosure requirements, and compliance frameworks are some of the measures that have been proven to mitigate conflicts of interest effectively.

ECSDA agrees to split particular functions, establish effective conflicts of interest policies, procedures and controls as well as provide public disclosure and reporting. It would be useful, also in the context of SA, that specific services are owned and operated by one or more identifiable and responsible entities.

In addition, ECSDA emphasises the importance of clear lines of responsibility and accountability and adherence to appropriate governance arrangements. To ensure clear liability and governance frameworks as prescribed under PFMIs, certain variations of DLT are better suited. Finally, a potential for "conflicts of interest" is not the sole risk that can arise from the vertical integration of activities and functions. Other ones like financial stability and systemic risk, competition risk and fragmentation risk can derive from this consolidation within one single legal entity. It would, therefore, be critical for global standard setters such as IOSCO to investigate whether measures would be needed to mitigate those risks as well.

Question 4: – Do respondents agree that conflicts of interest should be addressed, whether through mitigation, separation of activities in separate entities, or prohibition of conflicts? If not,

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please explain. Are there other ways to address conflicts of interest of CASPs that are not identified?

Please see the response to question 3.

Question 5: – Does Recommendation 3 sufficiently address the manner in which conflicts should be disclosed? If not, please explain.

ECSDA agrees with Recommendation 3 in respect to disclosure requirements. It may also be useful to require an ongoing/yearly review of the disclosures made to the public and regulators in all jurisdictions where the CASP operates, and into which it provides services.

In this way, prospective clients, the public and regulators are aware of the new services or possible conflicts of interest that may arise considering the number of differing services being offered by CASPs.

Question 13: – Which measures, or combination of measures, would be the most effective in supporting cross-border cooperation amongst authorities? What other measures should be considered that can strengthen cross-border co-operation?

The measures found under Recommendation 11 serve as a solid basis for supporting cross-border cooperation among authorities. It is useful and necessary to create cooperation arrangements and/or other mechanisms between 1) CASPs and their regulators and relevant authorities in other jurisdictions, as well as 2) regulators and relevant authorities in other jurisdictions.

That being said, it is unclear which competent authority(ies) would be involved in case of crypto-asset issuance, trading and other activities. Due to the number of services offered by CASPs which may fall under different national supervisory remits, member jurisdictions may take a different approach in regulating these activities. As highlighted by the consultation, this risk and regulatory arbitrage are accentuated due to the little substantive presence within any jurisdictions.

For this reason, before the bilateral and multilateral steps for effective supervision and enforcement are taken by national supervisors, ECSDA suggests global alignment in identifying those relevant and competent authority(ies).

Question 14: – Do the Recommendations in Chapter 7 provide for adequate protection of customer crypto-assets held in custody by a CASP? If not, what other measures should be considered?

Building on the set of requirements proposed under Recommendation 14, it may be useful to include robust risk management tools. In particular, the methodology of mitigating and monitoring credit and liquidity risks. This includes CASPs as well as SAs that are characterised by multiple interdependencies with other entities.

It is also important to note that due to the multiple interdependencies with other entities, a risk management framework will vary depending on the CASP. This is due to the different risk appetite for each CASP resulting from the organisational structure and services provided. For this reason, it may be prudent to create a baseline of risk management criteria that applies to all CASPs. On top of this, additional risk management requirements may be used, commensurate to the level of risk.

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Question 15:

(a) Should the Recommendations in Chapter 7 address the manner in which the customer crypto-assets should be held?

To maximise trust in crypto-asset and stablecoin service providers, the providers of the custody/trust service should be regulated and of the highest creditworthiness possible. There is merit in holding crypto-assets and stablecoins, particularly global or systemically important stablecoins in low-risk entities subject to appropriate legislation/regulation and proven safe places, including in times of crisis and market turmoil.

Question 17: – Are there additional or unique technology/cyber/operational risks related to crypto-assets and the use of DLT which CASPs should take into account? If so, please explain.

Probabilistic Settlement

One of the main issues is the possibility of a misalignment between technical and legal finality due to the "*probabilistic settlement*" feature of DLT. In this regard, we support that clear and final settlement should be ensured regardless of the underlying technology and the operational method used. It is, however, important to note that this issue only persists with some types of DLT models but not all of them.

There is a need to clearly define the moment of finality but also to reverse transactions in case misalignment between technical and legal settlement occurs. While we understand the rationale behind such guidance, we believe it may be more appropriate for the PFMIs to prevent CASPs from using DLT models that entail probabilistic settlement rather than requesting them to mitigate the uncertainties it creates. We believe that attention should be focused on the need to set up an appropriate risk control mechanism aimed at pre-emptively avoiding, not mitigating, the potential emergence of a settlement finality misalignment. This mechanism should be structured in light of the specificities of the given technology and operating arrangements.

Indeed, considering the significant risks forks can represent, CASPs should only be deemed compliant with PFMIs when they use DLT models that ensure clear and final settlement and do not leave any ambiguity in regards to the settlement finality.

Use of Permissioned or Permissionless

Certain distributed technology protocols provide for an ecosystem of user anonymity and the lack of a centralised service – two aspects that render the identification of liability problematic. In this context, it may be useful that the PFMIs cater for a category of distributed technology that conditions its use on an appropriate mechanism ensuring the appointment of liability. This may ensure technology neutrality of the PFMIs and also not stymie innovation.

Building on the need for identifiable and responsible legal entities outlined by the Report, the lack of a clear allocation of responsibility and accountability of certain DLT protocols may be solved by incorporating a permissioned DLT environment. This will create an ecosystem where market infrastructures can accept and monitor participants in the protocol. In this context, Trusted Third Parties (TTP) may act as the master/full node, which in turn would help in creating a clear liability regime.

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Question 21: – Are there additional features of stablecoins which should be considered under Chapter 10? If so, please explain

ECSDA notes that the current proposals of EU legislation (CSDR, MiCA and DLT Pilot Regime) do not foresee the possibility of stablecoins to be a settlement asset for CSDs. We outline the following risks that should be managed in the context of stablecoins as a settlement asset.

Stablecoin Arrangement (SA) as a reserve asset:

- Assets of the reserve should be kept at a central bank or with regulated/supervised institutions (CSDs or credit institutions); the insolvency remoteness of the entity holding the reserve assets will also be a crucial factor for investors.
- Assets of the reserve should be highly liquid, with a limited market and credit risk.
- Prudent risk parameters should be applied for the reserve: e.g. the composition of the reserve (cash vs. securities), concentration risks, the definition of volume caps per currency, and ratios of asset classes amongst each other. If reserves are in the form of cash, then ideally, they should be held with central banks; if cash reserves are held with commercial banks, additional risks need to be considered and addressed.

Sufficiency of the regulatory and supervisory framework:

- To maximize trust in the arrangement, the provider of custody/trust services for reserve assets should be regulated and of the highest creditworthiness possible. For that reason, when the reserves of a global or systemically important stablecoin are composed of securities, we believe there is merit for these assets to be safekept in CSDs, which are low-risk entities subject to appropriate legislation/regulation and proven safe places, including in times of crisis and market turmoil.
- To address the corresponding risks, the issuer and/or system operator should be authorised and supervised companies. A strong rulebook should be required including clear and transparent rules for the management

Rights of the Holder

- Clarity and enforceability of the legal claims, titles, interests and other rights and protections accorded to holders of stablecoin:
- A clear enforceability regime may only exist once the SA has a clear design of the liability framework for participants. Once clarity can be achieved on the contractual relationships in the system, the nature of the rights associated with the stablecoin can be identified. On this basis, enforceability can ensured.
- Furthermore, if certain DLT protocols were to be employed, the technology may not lead to clear enforceability of legal claims etc. This, however, supports the case for permissioned blockchain applications with (a) clearly defined liable legal entit(y)ies.

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