HRVATSKA AGENCIJA ZA NADZOR FINANCIJSKIH USLUGA

The issue of technology neutrality in the pilot regime for distributed ledger technology (DLT) market infrastructures (MTP and CSD) for crypto-assets that qualify as financial instruments

Key remarks:

- Hanfa supports and welcomes the policy idea to introduce a *Pilot regime for distributed ledger technology (DLT)* market infrastructures for crypto-assets that qualify as financial instruments;
- However, the Commission proposal seems to designate "proprietary DLT" as the only possible solution for this pilot regime;
- Only a truly technology-neutral pilot regime can help in creating an innovation-friendly environment for DLT market infrastructures for crypto-assets that qualify as financial instruments;
- Legislators and regulators should not decide, in advance, which type of technology is a "winner" or a "looser" by defining the exact type of DLT that can or should be implemented in the legislative pilot regime (especially not at Level 1);
- More specifically, the *Pilot regime for DLT* should not accommodate only "permissioned" or "proprietary" DLTs, but it must be technology-neutral and let subjects choose between various DLT solutions, depending on the business model and risk profile, as long as the DLT solution can be compliant with the applicable requirements;
- The *Pilot regime for DLT* should be principle based and regulate the outcomes, and not fall into the trap of defining up front a one-size-fits-all technology solution;
- As a possible alternative, instead of "**proprietary DLT**", the term "**proprietary DLT-based application**" could be introduced, as a more innovation friendly solution that would keep all the necessary regulatory safeguards, thereby addressing the concern that the *DLT Pilot regime* might hinder competitive technological developments in the EU;
- Further discussion is needed on how to address the issue of **new entrants** – is it appropriate to limit the use of the pilot regime only for the existing market infrastructures, or should a bespoke regime for new entrants be introduced, which also raises the question on how a unified license for trading and settlement services could be possible in the EU under the current framework;
- The interaction with **insolvency proceedings** and the **Settlement Finality Directive** should be further explored**, possibly through a bespoke regime for DLT infrastructures;**
- There is room to include **more financial instruments** in the scope of the pilot regime.

1. The issue of technology neutrality

Hanfa welcomes the Commission's policy idea to create regulatory "sweet spots" in a limited and niche part of existing financial services regulation. This regime could allow market participants to innovate in an environment of a limited scale before the legislative solution can be applied more broadly, if proved successful.

The EC proposal for *Pilot regime for DLT* seems to accommodate only "proprietary" DLTs. The reason for this may be the assumption that public and "permissionless" DLTs cannot achieve compliance with various regulatory requirements such as GDPR or AMLD5. However, this may prove to be a premature assumption that carries its own risks and drawbacks.

What problem(s) do we solve by introducing the Pilot regime for DLT?

The EU`s existing regulatory framework may not be technology-neutral to the degree we need it to be, meaning that it can leave parts of emerging technologies outside of the existing rules or make them bend to the point of breaking to accommodate rules that were never designed for such new technologies.

From the perspective of legislative technique, this pilot regime would have a corrective function for existing regulation not being technology-neutral enough, and provide an appropriate "testing ground" to try and correct this objective flaw.

However, the goal of creating an innovation-friendly environment for DLT market infrastructures for crypto-assets that qualify as financial instruments can only be achieved through an objectively technology neutral regime. Legislators and regulators should not choose, in advance a technological "winner" or "looser" by defining the exact type of DLT that can or should be implemented in the legislative pilot regime. This is particularly true for Level 1 legislation. The legislation that will introduce the *Pilot regime for DLT* should refrain from defining permissible DLT solutions, so not to interfere with technological developments. It should avoid falling into the trap of tailoring legislation to the specific type of DLT/technology, which is exactly the flaw of the current regulatory framework.

From the perspective of the goals of the *Pilot regime for DLT*, the **effects** of implementing DLT technological solutions should be regulated, and not the DLT solution itself. This is one of the cornerstones of the principle of technological neutrality. The pilot regime should thus serve as a means to achieve an innovation-friendly and more technology-agnostic regulation. From the perspective of technology development, the *Pilot regime for DLT* should not stifle the development of future technology and should not unduly discriminate between technology solutions without a strong and clear rationale. It would be reasonable and justified to state that any DLT solution used should be able to accommodate i.e. GDPR and AMLD5 requirements, but it would not be reasonable or justified to decide in advance that no DLT solution except "proprietary" DLTs would not able to do so.

It should be noted that many different legitimate projects and development teams currently work on "permissionless" DLTs. An EU pilot regime that is not technology-neutral may have negative impacts on competition when it comes to technology and financial infrastructure developments, both internally in the EU and on an international level. Moreover, there are multiple regulated projects (e-money and the issuing of not-publicly traded financial instruments) under existing EU and USA financial services regulation using "permissionless" and public DLTs regarding tokenization and transactions settlement, that have managed to comply with other regulatory requirements such as KYC/AML or GDPR.

Taking all of this into account, if the *Pilot regime for DLT* would limit itself only to proprietary DLTs, the following risks may emerge:

- **It could make the EU regulatory framework even less technology-neutral and innovation-friendly, contrary to the goal of the proposal;**
- **It could halt or significantly slow down future technology innovation because the EU market may again fall into trap of tailoring legislation to a specific type of technology;**
- **It could have a negative impact on competition between EU entrepreneurs in the field of technology, financial infrastructures and product development; and**
- **It could make EU financial markets and developments in technology less globally competitive.**

An alternative proposal

A more innovation-friendly alternative, one that could keep all the necessary regulatory safeguards for this pilot regime, could be to introduce the concept of a "**proprietary DLT-based application**" instead of "proprietary DLT".

A DLT-based application or decentralized application (*DApp*) is a computer application that runs on a DLT. They are comparable to other conventional applications with same or similar functions, but the key difference is they are run on a distributed peer-to-peer network.

In other words, DLT-based applications have their backend code running on a DLT, as opposed to typical applications where the backend code is fully running on centralized servers. A DLT-based application can have frontend code and user interfaces written in any language that can make calls to its backend. Furthermore, its frontend can be hosted on centralized or decentralized storage.

Usually, key features of DLT- based application or decentralized application (*DApp*) are:

- Operate on its own without anyone entity controlling it;
- Its data and records must be public;
- Censorship-resistant - no single point of failure;
- No downtime -relying on a peer-to-peer system ensures the DApps continue to work even if individual computers or parts of the network go down;
- DLT based - they are composed of smart contracts;
- Open-source -This encourages the widespread development of the ecosystem and

It is reasonable to assume that some of those characteristics are <u>not compatible</u> with existing and necessary regulatory standards, especially lack of control and accountability.

However, most prominent decentralized finance (DeFi) projects and stablecoins, are under the control of a single entity holding the so-called *'God Mode'* admin keys. Meaning, the project owner keeps ownership of the DLT-based application to ensure that the protocol remains secure if any issues arise. Most used stablecoins are issued by legal entities under certain levels of regulatory scrutiny (e.g. **USDC**, **TUSD**, and **PAX**), and they are structured in a way that issuer holds admin power over multiple functions imbedded in the DLT token code. Still, they are issued on a public permissionless DLT.

Contrary to fully decentralized DLT-based applications, proprietary DLT-based applications have owners, as well as controls and liabilities necessary for regulated infrastructures such as MTP and CSD. In other words, this solution contribute to making the pilot regime more technology-neutral and well-balanced in creating an innovation-friendly environment for the DLT market infrastructures in the EU.

Hanfa also believes that EU`s core values should be integrated into principle based norms of this pilot regime, thereby actively stimulating the types of innovation that have the highest likelihood to create significant public value:

- A "proprietary DLT-based application" should be understandable, and not a black box solution,
- Most of the code implemented must be open source code,
- Every part of code must be audited before the application goes live,
- Interoperable and composable technology should have high priority, because the current financial system is comprised of "walled gardens" with limited transferability and any interoperability is controlled by rent-seekers.

Key issue to be addressed?

We have not seen a convincing argument to conclude that MiFID II, CSDR, or SFD provisions preclude or limit the use of different models of DLT in the issuance, trading, and settlement of crypto-assets which qualify as financial instruments. „Proprietary DLT" is not in itself incompatible with MiFID II, CSDR, or SFD provisions (with the modifications that would be introduced in the DLT Pilot regime).

There are many obvious points where public and permissionless DLT may not fit neatly in the existing EU regulatory framework, but this does not mean that they should be excluded ex-ante, which is why we proposed to include the concept of a "**proprietary DLT-based application".**

2. Licence to operate a DLT MTF or DLT securities settlement system

The pilot regime requires market infrastructures to go through an application process in which they have to request the relevant exemptions and explain how they will comply with the specific requirements. **Still, this pilot regime might further stifle competitive technological developments in the EU financial markets as it allows the use of the pilot regime only for the existing market infrastructures** (market operators/investment firms and CSDs).

The pilot project could be enhanced by exploring the possibility for allowing new entrants into the regime, by specifying a limited license for them, with bespoke requirements. One option would be to do this now, another is to do this in a review process. E.g, by year three of the regime. Hanfa believes that it could be worthwhile to explore this option, with the appropriate safeguards.

Hanfa also believes that this could be a good staging ground to explore **entities with a unified license** for trading and settlement services. Meaning, to introduce a new stand-alone license type for ***DLT (Post-Trading Facilities*** that would include both; DLT CSD and DLT MTF in one unified and stand-alone license. That approach would create new possibilities for innovation that are not sufficiently addressed by the existing EU regulatory framework. Under appropriate safeguards, the Pilot regime could allow MTFs to provide certain post-trade services normally reserved for other financial market infrastructures, and vice versa. There is significant potential for cost reduction that could be achieved by use of DLT, which could be stifled if this option is not explored.

By limiting the Pilot regime to existing market infrastructures and imposing obligations for separate licenses to operate an integrated service under the Pilot regime, this legislative initiative could end up replicating the limitations of the regulatory regime it is trying to improve.

3. Settlement finality Directive - provisions concerning insolvency proceedings

According to the EC proposal for the pilot regime, Directive 98/26/EC (SFD) shall not apply to the DLT CSDs (settlement systems). While we understand the constraints, this may leave a gap for settlement finality protections and insolvency proceedings that may be detrimental to the development of a pilot regime for CSDs. For the pilot regime to be functional and to provide legal certainty, bespoke provisions concerning settlement finality and insolvency proceedings should considered, including when a DLT MTF provides settlement services. While the pilot enables CSDs to operate 'DLT securities settlement systems' outside the scope of the SFD, it does not preclude CSDs from operating 'DLT securities settlement systems' within the SFD. This may well be possible for permissioned DLTs and for the "proprietary DLT-based application", where the system operator could design the system and its rules to be SFD compliant. However, this would likely only be possible with parallel specifications or clarifications in the SFD itself, to enhance legal certainty.

4. Limitations on the type of instruments that can be admitted to trading on or settled by a DLT market infrastructure

There may be room to include other MiFID II financial instruments in the Pilot regime, without disturbing the balance between innovation and investor protection, for example:

- 'exchange-traded fund' with the same limit as the shares (< Eur 200 million);
- Sovereign bonds with a market capitalization < Eur 1 billion.

UCITS ETFs are a widespread retail instrument, well-known to investors, and with well established safeguards regarding issuance and trading. Including ETFs in the scope of the Pilot regime should be discussed further.

There are good arguments that sovereign bonds should be included in the Pilot regime:

- Some countries already tested or used DLTs for issuing or managing sovereign instruments;
- Using the Pilot regime for sovereign bonds can help in offering sovereign instruments directly to a wider investment audience/citizens.

The Commission proposal did not fully explain why sovereign bonds should be entirely excluded from the pilot regime (please note that, in any case, this would only be possible if the sovereign issuer agrees to include an issuance of sovereign bonds on a DLT based solution in the pilot regime) . As an additional safeguard, the inclusion of sovereign bonds could only be possible for already licensed entities, and an expansion of this to the newcomers in the regime could be foreseen in a review clause (mid-duration of the pilot regime).