*FINAL*
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# ECSDA RESPONSE TO THE CPMI-IOSCO CONSULTATION ON STABLECOIN ARRANGEMENTS

## Executive Summary

**ECSDA supports the approach taken by CPMI-IOSCO in considering the appropriateness of the current Principles for Financial Market Infrastructures (PFMIs) as a basis for the regulation of stablecoin arrangements (SAs).** Raising the regulation of SAs to the current levels foreseen for Financial Market Infrastructures (FMIs) will avoid duplication and fragmentation of the PFMIs while ensuring the *"same business, same risks, same rules"* principle. Regulations should be technology-neutral, the technology should be no justification for different treatment. Unfortunately, this fundamental principle is not being ensured by EU legislation (CSDR, MiCA, DLT Pilot Regime). In this vein, we are concerned that the PFMIs may not be applied coherently globally, with possible concerns related to systemic risk and level playing field, and urge CPMI-IOSCO to issue global guidance on how FMIs using DLT should comply with the PFMIs.

### *Main Concerns*

***In determining the viability of SAs as settlement assets for CCPs and CSDs, ECSDA would like to highlight the following three main points:***

- **Clarifying the liability regime and the rights associated with settlement assets is crucial.** We encourage CPMI-IOSCO to further consider 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.

- **Risks posed by 'probabilistic finality' must be removed - ensuring financial stability.** Considering the significant risks posed by forks, SAs should only be allowed to use DLT models that do not leave any ambiguity in regards to the settlement finality.

- **Enhancing money settlements by assessing:**
    a. Nature and sufficiency[1] of the SA's reserve assets,
    *b. Sufficiency[2] of the regulatory and supervisory framework,*
    ***c. Importance of depositing reserves in form of securities with regulated FMIs, i.e. CSDs, and***
    ***d. Clarity and enforceability of the legal claims, titles, interests and other rights and protections granted to holders of stablecoin.***

[1] CPMI & IOSCO, *Consultative report, Application of the PFMI to stablecoin arrangements*, p. 20, available at https://www.bis.org/cpmi/publ/d198.pdf
[2] Ibid.

**ECSDA Response to the Questions Posed in the Consultative Report**

*Applicability of the PFMI to SAs*

1. Is it clear when SAs are considered FMIs for the purposes of applying the PFMI?

We fully agree with the CPMI-IOSCO Consultative Report (Report), in that some functions performed by SAs may qualify as FMI functions. It is also mentioned that the "*transfer function is an FMI function*"[3]. The Report also mentions that "*To the extent to which an SA provides functions that more closely resemble those provided by other types of FMIs, the SA should consider the relevant principles and observe them accordingly*"[4].

From that perspective, we agree that some of the features of the SA may not only be close to payments, but may also closely resemble securities. In that sense, the function of the initial *recording* of securities is also an essential FMI function and can lead to systemic risks. Therefore, although we understand that the scope of this Report was not intended to cover these scenarios, we ask the policymakers to consider how the PFMIs relating to the *transfer and initial recording of securities* apply to SAs and to other solutions providing FMI services using DLT and having analogous features.

*Considerations for determining the systemic importance of an SA*

2. Are the suggested considerations for determining the systemic importance of SAs clear comprehensive and useful? Are there any risks or considerations missing?

ECSDA agrees with the relevant conditions in determining the systemic risk of SAs, highlighted by the Report. In ECSDA's previous response to the FSB consultation on Global Stablecoins, we echoed similar criteria, for example (i) size of the SA and (ii) the nature and risk profile of the SA activity. ECSDA would like to include the following additional criteria which may be relevant in determining the systemic importance of SAs:

1) **The transaction value,**
2) **Volume(s) of coins,**
3) **The number of participants (reach), and**
4) **The number of countries, as well as the geographical location, it is used in:** To address specific risks of systemic SAs, a temporary limitation on the geographical spread through underlying regional networks might be helpful.

*Governance*

3. Is the guidance provided on governance clear and actionable to inform how SAs will need to **ensure clear and direct lines of accountability and set up governance arrangements** to observe the PFMI?

A key point of consideration in relation to a systemic SA is the design of the accountability and liability framework for operators and participants. Clarity regarding the contractual relationships in the system between the different service providers and the nature of the rights associated with the stablecoin is critical. It would also be important to understand against whom the contractual

[3] CPMI & IOSCO, *Consultative report, Application of the PFMI to stablecoin arrangements*, p. 9, available at https://www.bis.org/cpmi/publ/d198.pdf
[4] Ibid.

rights can be exercised, and who can enforce them. Without that framework, many of the concerns outlined by the Report regarding the applicability of the PFMIs to SAs are exacerbated, for example, principle 8 on settlement finality.

Against the three issues raised by the Report, we support the guidance that SAs should be owned and operated by one or more identifiable and responsible entities. ECSDA agrees with the need to allow for clear and identifiable lines of responsibility and accountability as well as the creation of appropriate governance arrangements.

4. What are the challenges that SAs may face due to the use of **distributed and/or automated technology protocols and decentralisation**, when seeking to observe Principle 2 on governance, in particular when ensuring the **clear allocation of responsibility and accountability**?

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 condition 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, th e lack of a clear allocation of responsibility and accountability of certain DLT protocols may be solved by incorporating a permissioned private DLT environment. This will create an ecosystem where market infrastructures can accept and monitor participants to 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.

*Interdependencies*

5. Is the guidance on Principle 3 clear and actionable to inform **how SAs will need to comprehensively manage risks** from other SA functions and entities and their interdependencies?

Due to the interdependence of different actors and segments of financial markets, the risks posed by the interdependence of SAs to the overall stability of the financial markets, particularly in terms of credit and liquidity risks, should be monitored. As the Report outlines, SAs are characterised by multiple interdependencies with other entities, at a more pronounced level than FMIs. These interdependencies may carry credit and liquidity risk implications, depending on the entities within the SA and its functions, leading to diverse risk profiles in the market.

ECSDA agrees with the guidance of regular reviews of the FMI material risks as well as with the need to develop appropriate risk-management frameworks and tools. However, due to the difference in risk appetite of each SA (depending on its organisational structure), it may be prudent to create a baseline of risk management criteria that is applicable to all systemic SAs. On top of this, additional risk management requirements may be used, commensurate to the level of interdependence with other entities and the systemic importance of the SA. In order to mitigate fragmentation, clear, harmonised guidelines across jurisdictions are needed from the outset.

*Settlement finality*

6. Is the guidance on Principle 8 on settlement finality clear and actionable to inform how SAs will need to manage risks arising from a misalignment between technical and legal finality?

As outlined by the Report, one of the main issues linked to principle 8 is indeed the possibility to have a misalignment between technical and legal finality due to the "*probabilistic settlement*" feature of DLT. In this regard, we support the approach 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.

The guidance provided in the Report outlines the need to clearly define the moment of finality but also to "*make it transparent whether and to what extent there could be a misalignment between technical settlement and legal finality*", as well as how these should be reversed in case it occurs. While we understand the rationale behind such guidance, we believe it may be more appropriate for the PFMIs to prevent systemically important SAs from using DLT models that entail probabilistic settlement rather than requesting them to mitigate the uncertainties it creates.

In addition, with reference to the guidance provided requiring to have in place measures "*to address the potential losses that could be created in case of reversal stemming from the misalignment between technical settlement and legal finality*". ECSDA requests clarity regarding this intended guidance in the context of clearing and settlement services and also, whether such mechanisms are viable. 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, systemically important SAs 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.

*Money settlements*

7. Is the guidance on Principle 9 on money settlements clear and actionable to inform how SAs will need to manage risks associated with the use of a stablecoin as a settlement asset? In particular, is the guidance clear on the **considerations which an SA should take into account when choosing a stablecoin as a settlement asset** with little or no credit or liquidity risk as an appropriate alternative to central bank money?

ECSDA agrees that the settlement asset employed should have little or no liquidity risk. The Report outlines many relevant considerations which ECSDA would like to build on. As indicated above, ECSDA notes that the current proposals of EU legislation (CSDR, MiCA and DLT Pilot Regime) do not foresee the possibility for stablecoins being a settlement asset for CSDs.

**Nature and sufficiency of the SA's reserve assets:**

- 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, 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

**Clarity and enforceability of the legal claims, titles, interests and other rights and protections accorded to holders of the 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 ensues.

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

*General*

8. Are there other issues or principles of the PFMI where additional guidance for SAs would be useful? If so, what is the issue identified and how is it notable for SAs?

Please see our answer to question 1 above.

In addition, it is unclear which competent authority(ies) would be involved in case a SA would involve several legal entities located in different jurisdictions. This could give rise to considerable regulatory arbitrage risks.

9. Are there any terms used in this report for which further clarification would be useful for SAs when seeking to observe the PFMI?

As a generic comment, we would suggest changing the term 'reserve' to 'collateral'. This term would be more appropriate based on the mechanisms currently employed and the different types of assets which can potentially back the stablecoins (cash, securities and others).