



24 March 2020

European Commission
DG FISMA
Rue de Spa 2
1000 Bruxelles

Via online submission: https://ec.europa.eu/info/publications/finance-consultations-2019-crypto-assets_en

RE: EU Commission Consultation Paper on an EU framework for markets in crypto assets

State Street Corporation (“State Street”) appreciates the opportunity to respond to the European Commission’s consultation paper on an EU framework for markets in crypto-assets. In the paper, the EU Commission seeks feedback and direction on how the European regulatory framework should evolve to apply to crypto-assets. In particular, feedback is requested regarding areas where guidance is required to apply the regulatory framework to crypto-assets as well as identifying necessary changes to develop a regulatory framework build around crypto asset functionalities.

Headquartered in Boston, Massachusetts, State Street is a global custodian bank which specializes in the provision of financial services to institutional investor clients. This includes the provision of investment servicing, investment management, data and analytics, and investment research and trading. With \$34.36 trillion in assets under custody and administration and \$3.12 trillion in assets under management, State Street operates in more than 100 geographic markets globally.¹

As one of the world’s largest global custodian banks, State Street is actively working to understand the way in which crypto-assets may change the traditional custody function. As such, we strongly support efforts to ensure an appropriate regulatory framework for crypto-assets, aimed at promoting fair, efficient and transparent financial markets, and ensuring a high level of investor protection.

The development of a fit for purpose regulatory framework for crypto-assets will encourage financial innovation and market developments, which will contribute to furthering the objectives of the Capital Markets Union (CMU) and Digital Single Market (DSM). In that context, and to ensure the free development of innovation, it is important that the regulatory framework remains technology agnostic, outcomes driven and future proof.

Key Features of Crypto-assets

As an initial matter, it is important to clearly distinguish between various types of crypto-assets when considering an appropriate regulatory framework. This includes a careful consideration of the intended function and characteristics of the asset. We believe that a common taxonomy that conveys these important distinctions in the features and risk profile of various types of digital assets is necessary in

¹ Assets under management as of December 31, 2019 includes approximately \$45 billion of assets with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

order to ensure that digital assets can meet the promise of greater efficiency and reduced risk in the provision of post-trade financial services. As a starting point, such a taxonomy should take into account several factors such as

1. the economic function of the digital asset
2. specific traits or characteristics of such an asset and
3. key structural features of the digital asset's protocol.

While it would be desirable to ensure that any taxonomy builds on existing initiatives on global level in this regard, e.g. G7/G20, Financial Stability Board (BIS), Bank for International Settlements (BIS), International Organisation of Securities Commissions (IOSCO), yet to be agreed definitions need to provide greater clarity to the market in terms of how existing regulations (e.g. securities or custody law) relate to digital assets and whether more flexibility will be needed to allow for the issuance of digital assets outside traditional market infrastructures. For instance, native security tokens (i.e. those financial instruments that are directly issued on the blockchain without further need to register those assets outside the distributed ledger) could drive market efficiencies, and therefore should also be taken into consideration when designing a taxonomy and a regulatory framework for digital assets.

The taxonomy should consider important characteristics and structural features such as the governance of the distributed ledger protocol on which the crypto asset exists, features of the crypto asset itself, and the capabilities available to participants in the case of loss or theft of the crypto asset. This would typically require a clearly identifiable issuer and enforceable rights belonging to the investor. Clearly, crypto-assets, such as bitcoin, do not have these features and therefore present a very different risk profile compared to other digital assets. Specifically, the governance of the distributed ledger protocol on which the digital asset exists (and/or the smart contracts used to create digital assets on this protocol) strongly impacts the legal and regulatory frameworks that would apply to the digital asset. Matters such as who has access to the distributed ledger, who has visibility of the underlying data, how decisions are made e.g. in terms of updates to the database, and what responsibilities participants have will influence the robustness and therefore risk profile of the governance structure.

Regulatory Treatment of Crypto-assets that are Similar to Traditional Assets

State Street strongly supports the core principle of “same risk, same activity, same treatment”. However, the risk inherent to digital assets may differ from risks in traditional assets leveraging centralised market infrastructures. Indeed, we strongly believe that the applicable regulatory framework should not disadvantage the use of digital assets that are the functional equivalent of traditional assets solely because of the technology which underlines such assets.

However, we recognize that the application of distributed ledger technologies within the financial markets is new and will result in important questions about the appropriate legal and regulatory treatment of various asset types. In our view, resolving these open questions would further facilitate the application of the “same risk, same activity, same treatment” principle and enable the markets, over time, to benefit from the efficiency and flexibility inherent in digital assets. This requires close collaboration among market participants and regulators, including cooperation between prudential and securities regulators.

Level Playing Field

State Street believes that any regulatory framework for crypto-assets must strive to maintain a level playing field across both existing and future service providers for digital assets in order to avoid the

potential erosion of existing mechanisms for the protection of the investor. This includes the proper safekeeping of assets, which we view as of utmost importance for the future development and acceptance of distributed ledger technology (DLT) and its functionality. In our view, this requires both the development of industry best practices and supervisory guidelines, especially in relation to regulated funds which are intended for use by non-institutional investors.

In the case of certain crypto-assets, the safeguarding of assets currently involves a combination of hot and cold storage, potentially including third-party control of the underlying keys or third-party involvement for shared keys. This model has materialised in the context of Bitcoin and similar crypto-assets, and fundamentally differs from the market structure which currently supports securities issued into a central securities depository (CSD). In the current environment, a number of control and governance processes must be performed to ensure proper safeguarding of assets held in custody. Bank custodians, such as State Street, currently operate on the basis of industry best practices which were designed for traditional assets and traditional infrastructures.

DLT offers the potential for transformational change in the conduct of existing financial services and processes. For example, by offering one shared source of truth, DLT will sharply narrow, if not eliminate, the need to reconcile financial assets across systems and among market participants. Additionally, the one shared source of truth may also change the need for, or modify the role of, CSDs. As such, DLT systems will require a form of consensus mechanism that ensures agreed upon updates to the common ledger, and any provider of DLT will need to ensure that validators are always available during operating hours to ensure settlement. Presently, there is no requirement for a distributed ledger provider to provide this validation and the market is using alternative means (e.g. economic incentives, private contracts, etc.). Furthermore, DLT offers the promise of smart contract functionality where various events, such as the payment of income, are embedded in the token created through the smart contract, thereby negating the need for separate asset administration functionality.

The key challenge for effective regulation that supports the development of a DLT service offering for EU capital markets will require to consider the unique features of digital assets. For instance, regulators should decide whether the regulatory framework for CSDs and Securities Settlement Systems fits with the blockchain ecosystem or to what extent the principles designed for the traditional infrastructures can help designing a new framework that takes full account of the specificities of the new technology.

Additionally, DLT offers the promise of smart contract functionality where various events, such as the payment of income, are embedded in the platform itself, thereby negating the need for a separate asset administration functionality. Notwithstanding these important innovations, what remains essential to the future of crypto-assets is the ability to protect the investor from the potential misappropriation of their assets. A robust digital asset custody framework supporting the protection of investor assets will be defined in line with advances in cryptography and distributed ledger technology, the unique characteristics of digital assets stemming from the decentralized market structure, as well as new consideration being given to cybersecurity and business continuity obligations. We believe that bank custodians are uniquely well-positioned to continue to play this role for security tokens, including through the development of digital capabilities which support custody and post-trade services, digital money, issuance and trading, research and analysis.

Regulatory flexibility in existing legislation

The design of crypto-assets can vary with regards to important features. For example, the rights and obligations of identifiable parties vary depending on whether a crypto asset is issued without an issuer (e.g. bitcoin) or via an issuer (e.g. security token) or other parties that have specific privileges (e.g. a smart contract making the transfer of a token subject to the respective wallet being whitelisted in a

databases or other central policing rights e.g. burn and re-issue assets). The different design choices will create different exposures to parties (beyond validators) maintaining a link of the DLT network with other networks or acting as a gatekeeper towards other markets. This should be an important factor when considering risk factors.

It is important that relevant regulations consider these different exposures but also retain the flexibility to adjust in an efficient and agile way to accommodate the different and emerging risks.

Thank you once again for the opportunity to respond to the consultation paper. We appreciate the European Commission's engagement on this matter and stand ready to serve as a trusted and experienced resource as the regulatory framework for crypto-assets is developed.

Sincerely,

A handwritten signature in dark ink, appearing to read 'Dr. S. Kasper', with a long horizontal flourish extending to the right.

Dr. Sven S. Kasper
International Head
Regulatory, Industry & Government Affairs