THE INTERNATIONAL DIMENSION OF DLT NETWORKS, LAW AND REGULATION

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BLOCKCHAIN FINANCIAL ASSETS AND BEYOND: LEGAL AND REGULATORY PERSPECTIVES
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OVERVIEW

• Introduction
• Securities custody, clearing and settlement – current and future state of play
• Applicable Law
• Regulation
• Conclusions
SECURITIES CUSTODY, CLEARING AND SETTLEMENT

MULTI-TIERED HOLDING SYSTEM
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DLT NETWORK (PERMISSIONED)
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INTERNATIONAL DIMENSION OF DLT NETWORKS

APPLICABLE LAW
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Instruments

- Hague Securities Convention
  - Finalized 2001; ratified by Switzerland, Mauritius (2009), US (2016)
  - Applied by Switzerland as domestic private international law since 2010
  - Entered into force on 1 April 2017

- European Union
  - Public consultation on the conflict of laws rules for third party effects of transactions in securities and claims (4 April 2017)

APPLICABLE LAW - HSC

Scope of HSC

- determines the law applicable to <<proprietary interests in>> securities held with an intermediary (2 I HSC)
  - Securities ... any shares, bonds or other financial instruments or financial assets (other than cash), or any interest therein (1 I a HSC)
  - Securities held with an intermediary ... rights of an account holder resulting from a credit of securities to a securities account (1 I b HSC)
  - Securities account ... account maintained by an intermediary to which securities may be credited or debited (1 I c HSC)
  - Intermediary ... maintains securities accounts for others or both for others and for its own account (1 I c HSC)
APPLICABLE LAW - HSC

Connecting factors – PRIMA (Place of Relevant Intermediary Approach)

- **Primary rule (4 HSC):**
  - law expressly agreed in account agreement +
  - Intermediary has a qualifying office in that state

- **Fall back rules (5 HSC):**
  - Office through which account agreement was entered into (5 I HSC)
  - State of incorporation of relevant intermediary (5 II HSC)
  - Place of business of relevant intermediary (5 III HSC)

- Applicable law has to be determined separately for each leg – conceptual difficulties for jurisdictions which apply the concept of a (single) disposition

APPLICABLE LAW – EU DIRECTIVES

EU directives also based on PRIMA, but different connecting factors:

- **SFD:** “register, account or centralised deposit system located in a Member State”

- **FCD:** “country in which the relevant account is maintained”
  - ‘relevant account’ is defined as “the register or account – which may be maintained by the collateral taker – in which the entries are made by which that book entry securities collateral is provided to the collateral taker”;
  - “book entry securities collateral” means “financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary”

- **Winding-up Directive:** “register, an account or a centralised deposit system held or located in a Member State”
APPLICABLE LAW – EU DIRECTIVES

EU directives – way forward (Cons. Doc. 4/7/17)

• Problems
  • Fragmented legal framework
  • Different instruments cover a different range of assets
  • Unclear how many laws apply in a holding chain and how they interact

• Alternative Solutions
  • Super-PRIMA
  • Law designated for the system (2(1)(a) SFD)
  • Law under which the financial instrument is constituted

APPLICABLE LAW - DLT

Application of HSC/EU Directives to DLT securities clearing and settlement networks

• Only permissioned DLT ("securities held with an intermediary")
• Problems with determining the location of an account unresolved
• HSC approach works better, but qualifying office-requirement difficult the reconcile with realities of a digital economy
• Determining applicable law for each leg of a transaction not compatible with blockchain-mechanism
• Chain of transactions = chain of jurisdictions?
  • Under PRIMA, different laws will govern perfection and priority of different transactions within one single blockchain
  • What happens if transaction 1 is not effective/perfected under law 1 to transactions 2 - n perfected under laws 2 – n?
APPLICABLE LAW - DLT

Better approach: Law designated by the system

- 2(a) SFD:
  - "governed by the law of a Member State chosen by the participants"
  - Minimum contact requirement, e.g. at least one participant must be established in that Member State
- One single law covering all transactions in a blockchain
- Full transparency for participants – Consumer participants – exception for financial instruments 6(4)(d) Rome I
- Full transparency for third parties acquiring interests in DLT-based securities
- May be identical with law governing issuance of financial instrument (if issued on DLT, if debt instrument)
- Different laws may apply if pools or portfolios of financial instruments are transferred

INTERNATIONAL DIMENSION OF DLT NETWORKS

REGULATION
REGULATION AND DLT

Issues

• How is existing regulatory regime applied to DLT networks?
  • Personal/substantive scope of regulations
• What is territorial scope of regulations?
• How is financial sector regulation enforced if financial services are provided in/through a DLT network?
  • Permissioned vs. unpermissioned DLT
  • ESMA: “…the DLT that is likely to be used in financial markets would be a permissioned system with authorized participants only.”

EU REGULATORY LANDSCAPE

Source: ESMA: The Distributed Ledger Technology Applied to Securities Markets (7 February 2017)
TERRITORIAL SCOPE

PRESENCE WITHIN TERRITORY

2.1 (2) CSDR: ‘third-country CSD’ means any legal entity established in a third country ...

2.1 (23) CSDR: ‘home Member State’ means the Member State in which a CSD is established;

4.1 a EMIR: … OTC derivatives contract (iv) between a financial counterparty or a non-financial counterparty … and an entity established in a third country …

EFFECT WITHIN TERRITORY

Competition law – US vs.
Alco, 148 F.2d 416 (1945);
ECJ, 27.9.1988 – 89/85 - wood pulp

4.1 a EMIR: … OTC derivatives contract (v) between two entities established in one or more third countries …, provided that the contract has a direct, substantial and foreseeable effect within the Union …;

TERRITORIAL SCOPE

DLT-network will be subject to EU regulation only if:

- all participants are established within Union
- If gatekeeper is established within Union, or
- if network has direct, substantial, foreseeable effect within Union

Presence of one or several, but not all participants alone not sufficient

Risk of fragmentation if regulation is enforced extraterritorially
CONCLUSIONS

1. DLT may reduce complexities of current tiered systems for the custody, clearing and settlement of securities – also reduction of complexities in cross-border situations

2. While PRIMA would work (with a few twists, only permissioned DLT) it is not the ideal connecting factor – law designated by the system

3. Territorial approach to regulation will not work either to determine regulation applicable to network – effects doctrine (direct, substantial, foreseeable)

4. “DLT could introduce new functions or roles” (and make existing roles less relevant) (ESMA)