coinbase

To:
Directorate-General for Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Bruxelles/Brussel
Belgium

1 November 2024

Re: European Commission request for views on the use of distributed ledger technology in capital markets and asset tokenization

Coinbase Global, Inc. (together with its subsidiaries, **Coinbase**) appreciates the opportunity to provide input into the European Commission's Directorate-General for Financial Stability, Financial Services and Capital Markets Union (the **Commission**) deliberations request for input on the use of Distributed Ledger Technology (DLT) in capital markets and associated asset tokenization.

Coinbase started in 2012 with the idea that anyone, anywhere, should be able to send and receive Bitcoin easily and securely. Today, we bring together the most trusted and secure technology stack at global scale allowing for the development and support of an entirely new market structure.

The use of permissionless systems as a foundational layer for financial market infrastructure and asset tokenization holds great potential to expand access to capital markets, improve their efficiency and support innovation.

Coinbase is committed to the EU, and we are actively seeking opportunities to bring new innovative products to market and contribute to the development of a Digital Capital Markets Union.

We stand ready to assist the European Commission in reviewing the EU DLT pilot regime and a more permanent policy framework that helps lead the development of DLT-based capital markets.

Yours sincerely,

Tom Duff Gordon

Tom Duff Gordon, Vice President, International Policy
Coinbase

Introduction

The trend towards tokenization and the use of distributed ledger technology in capital markets is accelerating. This promises to expand access to capital markets, improve their efficiency and promote innovation.

Coinbase is committed to the EU, and we are actively seeking opportunities to bring new innovative products to market and contribute to the development of a Digital Capital Markets Union.

Coinbase's platform brings together the most trusted and secure technology stack at global scale allowing for the development and support of an entirely new market structure, much of which will be needed by EU banks and partners. This includes a digital asset exchange, qualified custody, smart contract development, wallet infrastructure, trade execution and order algorithms, fiat on-off ramps, and importantly a fast and low cost blockchain, BASE.

Europe has a great opportunity to further develop a more permanent policy framework that helps Europe lead the development of DLT-based capital markets. We have set below our initial policy recommendations and stand ready to assist EU policymakers in the review of the EU DLT pilot regime and potential changes to the EU single rulebook.

Policy recommendations

Improve viability of participation in EU DLT pilot regime

Prospective participants in the DLT pilot regime currently face the challenge of balancing significant investment costs and high barriers of entry against the commercial viability of operating within restricted transaction volume caps and duration.

Based on our work with institutional clients, we expect the next major technological catalyst in capital markets to be the tokenization of funds with a strong focus on tokenized money market funds (MMFs), particularly for liquidity and collateral management, payments, and yield generation.

However, the issuance limit for tokenized money market funds is capped at €1 billion, while an aggregate market value threshold of €6 billion exists for financial instruments recorded on a DLT pilot regime authorized market infrastructure. The current caps unnecessarily limit the ability of institutional investors and asset managers to test and participate effectively in the EU DLT Pilot regime, as they will not be able to support the volume and size of transactions typically handled in traditional markets.

It is costly to develop new technology and products and low thresholds for permitted activity in instruments that are otherwise well established in markets will limit the economic incentive to participate. A significant increase of issuance limits (including for MMFs) and aggregate market value thresholds, with continued supervisory flexibility to adjust on a case-by-case basis, would help improve the attractiveness of the EU DLT pilot regime. This would also recognise market dynamics, as tokenization is projected to be a $16 trillion market by 2030 according to Boston Consulting Group, and ensure competitiveness towards other jurisdictions.

Leverage full potential of permissionless financial market infrastructure

The EU DLT Pilot Regime recognised that permissionless systems offer unique benefits over permissioned systems by enhancing transparency, decentralization and cost efficiency in capital markets.

A model with a permissionless base layer with requisite permissioning at the smart contract level would offer market participants the transparency, security and innovation potential of public blockchains, alongside the regulatory control commensurate with traditional financial markets.

At present, the adoption and commercial viability of permissionless base layer financial market infrastructure is being endangered by the prudential treatment of digital assets transacted on permissionless systems. The BCBS rules assign a punitive risk weight of 1250% to all DLT-based securities transactions on permissionless blockchains, even when such securities meet the classification conditions of tokenized traditional assets. This is due to a number of unique risks in the use of permissionless blockchains identified by the BCBS.

The punitive prudential treatment is expected to restrict banks' investment and participation in capital market transactions on permissionless systems, given the outsize balance sheet impact such participation would have. The use of prudential rules to resolve perceived risks should be avoided, not at least given that the BCBS identified legal and operational mitigants in relation to those risks. For example, counterparty participation can be limited through whitelisting at the smart contract level and like with transfer agents today the smart contract can reverse transactions through embedded compliance engines. Moreover, the use of technologies such as zero knowledge proofs aim to preserve privacy at the transaction level.

Therefore, the prudential treatment for DLT-based securities traded on permissionless systems should in principle be the same as for traditional securities. A change in the prudential treatment of DLT-based securities traded on permissionless systems is needed to ensure a level playing field with permission-based systems, at least for the duration of the EU DLT pilot regime.

At the same time, the EU should urge the BCBS to reassess whether banks can treat exposures to DLT-based security transactions on permissionless ledgers with the same prudential standards as traditional securities. This review should consider essential criteria such as strong governance, effective controls and risk mitigation measures.

Make use of MiCA authorized stablecoins as on-chain cash settlement assets

In DLT-based capital markets, on-chain cash settlement assets enable transaction programmability and atomic settlement, which are both central to realizing the efficiency and security benefits of DLT.

We believe a mix of on-chain cash settlement assets - such as wholesale CBDCs, tokenized commercial bank money, and stablecoins - is essential for DLT-based capital markets because it provides the flexibility, stability, and interoperability needed to support a wide range of transactions and participants. While wholesale CBDCs would be limited to interbank uses within certain jurisdictions, stablecoins and tokenized bank money can facilitate cross-border transactions, enhancing global interoperability.

In the EU, MiCA-authorized stablecoins have reached a production-grade level suitable for broad use within DLT-based capital markets, and while the EU DLT pilot regime allows for their use of, by providing an exemption from the requirement to settle in central bank money (as per Article 40 of the CSDR), there is an explicit preference for wholesale CBDC.

We strongly recommend that this exemption be extended to the cash settlement of DLT-based security transactions outside of the EU DLT pilot regime, and for continued use on decentralized settlement systems after the conclusion of the EU DLT pilot regime.

The success of EU DLT-based capital markets rests on making effective use of MiCA authorized stablecoins as on-chain cash settlement assets, while making progress on a EU wholesale CBDC and tokenized commercial bank money in parallel.

Establish an EU regulatory framework for custody of DLT-based securities

Custody rules for DLT-based securities remain fragmented and underdeveloped across EU Member States. This hampers the development of (cross-border) custodial services for DLT-based securities, and therefore also impacts investor access to DLT-based securities.

The EU Central Securities Depositories Regulation (CSDR) governs custody of traditional financial instruments but has not been updated to include DLT-based securities. Without explicit CSDR standards, certain Member States have developed security protocols for custody of DLT-based securities, including requirement for multi-signature wallets or offline storage, whilst others have not.

With the lack of harmonized rules across the EU, market participants still face uncertainty regarding the enforceability of regulations governing the transfer and disposition of digital asset rights, as well as the effectiveness of insolvency protection measures. This regulatory ambiguity complicates the provision of custody services at scale, as custodians and investors are left unsure about legal protections and procedural standards in cross-border scenarios.

Therefore the EU should establish a harmonized regulatory framework for DLT-based securities. Meanwhile, we welcome greater flexibility by allowing custody service providers to operate and innovate in the EU DLT pilot regime with the benefit of certain regulatory derogations, subject to appropriate oversight. This would be in anticipation of an EU regulatory framework that caters for the specificities of custody of DLT-based securities as is already the case in certain EU Member States.

Update the EU capital markets rulebook

The trend toward tokenization and the use of DLT in capital markets is accelerating. The EU should therefore not wait until the end of the DLT pilot regime before evaluating the need for changes to the EU capital markets rulebook. Waiting until the end of the pilot regime risks hindering the growth of DLT-based markets and innovation.

The EU could already consult on a permanent regime for decentralized settlement, making CSD security record keeping requirements compatible with the use of DLT, how to enable settlement finality on public blockchains and achieving collateral eligibility of DLT-based securities for monetary policy purposes.

As the use of DLT in capital markets moves from experimentation to more widespread adoption, the EU should seize the opportunity to establish a more robust policy framework that can drive the development of DLT-based capital markets. This framework should emphasize the importance of utilizing permissionless systems as a foundational layer for financial market infrastructure.