Memorandum of Understanding

1st Smart Contract Conference, Hamburg, January 17th-19th 2020.

About

As distributed ledger technologies (DLT) such as blockchains evolve, it becomes evident that an intensive dialogue between regulators, attorneys and coders is needed. To bridge the gap between the different worlds, DLC Distributed Ledger Consulting together with Eversheds Sutherland and the Hamburg Chamber of Commerce hosted the 1st invite only Smart Contract Conference from January 17th-19th in Hamburg, which explicitly focused on Smart-Contracts in a regulated environment and the specific challenges that arise when dealing with those in financial transactions.

The following Memorandum of Understanding is the derivative of this intense 3-day-conference.

MoU

1. The DLT-community present at the conference saw a general demand for regulation of security transactions using smart contracts, as it would strengthen the blockchain ecosystem as a whole to have reasonable rules and standardization in place. It was strongly emphasized this regulatory approach should be taken on an EU-, if not better even broader level to avoid regulatory arbitrage, whilst taking local differences into consideration.

MoU

2. Nevertheless, it was also pointed out that regulation of the financial services sector using smart contracts is challenging. While the software engineers understand the technology, but are often not aware of the highly regulated legal framework, the regulators understand the legal environment but are often not aware of the complexities and possible positive impact the technology can bring. The lack of understanding bears the risk of inadequate regulations (lack of regulation, overregulation) which is detrimental to a still developing industry as well as for an adequate regulation of financial markets. Therefore, dialogue between different stakeholders has to be enhanced.

MoU

3. Distributed ledgers can be used as a security registry. The use of registries to record securities transactions is a widespread practice in mature financial markets. With differences in detail, under the concept of registration, securities only come into existence and can only be transferred when registered in the registry. It was seen as desirable that countries like Germany, which currently still have different concepts of transferring securities in place, also adopt a register-based system, including a distributed ledger based registry.

MoU

4. In order to avoid conflicts of interest and to enhance interoperability, anytime an issuer wishes to deploy or perform substantial administrative actions with a registry, the review and approval of a qualified third party should have to be obtained. It has to be explored further whether it should be a trusted or a regulated third party. Also, it has to be taken into account if parties who benefit from a slow change/no change of the current system are the right parties to play that role. It was stated that a new framework has to be developed, taking all the new challenges into account.

   As in the EU currently not the issuers but the issued financial instruments are subject to regulation, some participants suggested alternatively to only refer to civil liability instead of implementing a qualified third party.

MoU

5. It was supported that registrar functions (qualified third parties as in 4 and/or the issuer) should be responsible for AML and KYC checks for the issuing process as well as for following transfers.

6. An efficient settlement (payment versus delivery) on chain is only possible when using digital currencies. Therefore, it was the joint opinion that security transactions on chain might benefit from stable coins (e. g. CBDC). It was broadly explored to use digital fiat currency running on distributed ledgers issued by central banks for that purpose.

MoU

7. Certain security issuances require a prospectus. It was commonly agreed that in case the code of a smart contract used to facilitate a transaction in securities deviates from the prospectus, the prospectus should always prevail. If a security is issued using DLT, there should be an obligation to reference the underlying natural language prospectus in the smart contract. This could fulfil the requirement of a "durable medium" ("Dauerhafter Datenträger") within the meaning of § 126b BGB.

MoU

8. The interfaces facilitating securities transactions should be technically standardized by a standardization organisation in order to increase stability, safety and security of the code. For harmonization purposes, it was strongly supported that the European Commission should coordinate that standardization efforts. In addition to that, it was also emphasised to standardize coding terminology and to work on best practice principles.

MoU

9. Furthermore, reference implementations of smart contracts should be provided for specific individual functions which are typically needed in a specific securities issuance or transaction. Individual amendments to the standard smart contracts should remain possible.

10. Standard reference implementations of smart contracts in terms of no. 9 should be clearly identifiable (for example by number/hash) in order to enable parties of a natural language agreement to refer to the smart contract. This would decrease the risk of misinterpretations and contradictions between the natural language agreement and the smart contract code, thus improving the efficiency of negotiations and drafting.

MoU

11. In order to allow reference to a standard smart contract as described under no. 10, the parties to the natural language agreement have to understand the code of the smart contract. Therefore, translations and/or detailed explanations of the functionality of the respective smart contract should be provided by liable, qualified third parties, or the issuer, in order to enable the contractual partners to understand what a reference to the smart contract means.

MoU

12. However, a deviation of the content of the natural languages agreement and the actual will of the parties can even happen if a smart contract is referred to in the natural language agreement. This can in particular happen if the translation or explanation the parties relied on was wrong. This raises the question of liability for such wrong translations or explanations. One could think about the entity deploying the smart contract on the DLT as being liable.

MoU

13. A general understanding was reached that best principles for auditing smart contracts needs to be worked on, in order to determine liability and insurability of the respective providers.

If you want to get in touch, please drop us an E-Mail at s.hildebrandt@distributed-ledger-consulting.de