

## Regulatory News Alert

### DLT Pilot regime released: how EU is preparing for tomorrow's digital securities market

3 June 2022

#### A little bit of background...

On 2 June 2022, [Regulation 2022/858](#) of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology was published in the Official Journal of the European Union (**DLT Pilot Regime**).

The DLT Pilot Regime is part of a comprehensive package of measures ([Digital Finance Package](#)) introduced by the European Commission in 2020 to further enable and support the potential of digital finance in terms of innovation and competition, while mitigating associated potential risks. As reminder, the package also included a proposal on [Markets in Crypto Assets Regulation \(MiCA\)](#), a proposal for [Digital Operational Resilience Act \(DORA\)](#), and a proposal to clarify or amend certain related EU financial services rules, notably on retail payments; all portions of this package are on the verge of going into force.

**The Commission's stance on digital finance is clear:** giving it the highest priority in order to boost Europe's competitiveness and innovation in the financial sector and paving the way for Europe to become a global standard-setter. The EU's digital agenda is massive and should be delivered over the next 36 months with topics ranging AI, machine learning, data regulation, electronic identification schemes (eID), etc.

#### A new marketplace for crypto-assets that qualify as financial instruments

The so-called “tokenization,” or digital representation, of financial instruments on distributed ledgers or the issuance of traditional asset classes in tokenized form to enable crypto-assets to be issued, stored and transferred on a distributed ledger, is expected to open up opportunities for efficiency improvements in trading and post-trading processes.

However, union financial services legislation was not designed with such technology and crypto-assets in mind and contains provisions that could limit the use of blockchain technology. For these reasons, the DLT Pilot Regime was introduced to allow for such technology to flourish, while accounting for potential risks at the same time.

The DLT Pilot Regime establishes the conditions for:

- **permission to operate a DLT market infrastructure,**
- **limitations on the DLT financial instruments** that can be admitted to trading and settled on the DLT, and
- **cooperation** between the DLT market operators, competent authorities and the European Securities and Markets Authority (ESMA).

In terms of financial instruments that can be admitted to trading and settled on the DLT, and in order to allow innovation and experimentation, in principle, **only less liquid bonds, shares and fund units** will be allowed on the DLT. In addition, the **aggregate market capitalization shall not exceed EUR 6 billion** at the moment of admission to trading, or initial recording, of a new DLT financial instrument.

## Important distinction with MiCA

DLT Pilot Regime provides a legal framework for the trading and settlement of transactions in those **crypto-assets that qualify as financial instruments** within the meaning of [Directive 2014/65/EU \("MiFID II"\)](#), hence true digital securities.

For the **other crypto-assets** that do not qualify as financial instruments (such as stablecoins, e-money tokens and utility tokens), a dedicated regulatory framework at EU level (MiCA) is currently well underway. The overall objective of MiCA is to provide a harmonized EU framework for those crypto assets which are not currently captured by EU financial service legislation.

It is expected that, over time, ESMA will mandate specific criteria (by means of a Regulatory Technical Standards) discerning which crypto-assets should be treated as financial instruments (due to the specific rights they grant to the holder or issuer that are usually linked to financial instruments, such as profit, or governance rights – or a claim on a future cash flow).

## European regulators opted for a unique “sandbox” approach

In an out-of-character move for European lawmakers, with the DLT Pilot Regime, the Commission expressed a softer position and openness in embracing the uptake of transformative technologies in the financial sector, including the DLT.

The DLT Pilot Regime is specific in its nature due to the fact that it represents a **testing environment** which grants temporary but still **momentous derogations from existing rules**. The intent is to exempt DLT market infrastructures from several requirements of EU financial services legislation that could otherwise prevent them from developing solutions for the trading and settlement of transactions in crypto-assets by means of DLT.

## Temporary nature and an EU-wide passport

The permission to operate DLT market infrastructure in accordance with the Pilot Regime is temporary (limited to a period of **up to six years**) and will be periodically reviewed by supervisors. Such operators will be subject to strict requirements, so that those who fail to meet the relevant criteria can no longer run the pilot; this is what might be the biggest hurdle to overcome for the long run.

Importantly, the DLT permission will come with an “EU passport,” meaning that it shall be valid throughout the European Union.

## New financial institution welcomed

Authorized financial institutions (investment firms, market operators, central securities depositaries or CSDs) will still need **specific permission** to operate a DLT market infrastructure under the Pilot Regime.

However, access to the pilot regime will not be limited to incumbent financial institutions but will also be **open to new entrants**.

## Significant derogations to traditional marketplace will be allowed yet unknown

DLT operators will be subject to various **organizational requirements**, including robust IT and cyber arrangements, arrangements to safeguard clients' assets, record-keeping obligations, investor protection arrangements (including procedures for compensation or redress), KYC/AML requirements, etc.

Competent authorities may decide, on a case-by-case basis, to require **additional prudential safeguards** from the DLT operator in the form of their own funds or insurance policies.

In any case, DLT operators should demonstrate that the exemption requested is **proportionate and justified** by the use of DLT.

However, once given a permission to operate a DLT operators will be able to request **major exemptions** under the Pilot Regime, thus creating a complete carve out from the current financial regulatory and operational regime, provided that they comply with the conditions attached to the exemptions and with any compensatory measures required by the competent authorities.

Some of the most notable provisions of the Pilot Regime refer to exemptions from:

- **Intermediation**, including possibility to **offer direct access to natural persons** to deal with own account as DLT infrastructure participants
- **Transaction reporting**, as provided under the Article 26 of the [Regulation 600/2014 \(MiFIR\)](#)
- **Recording and settling DLT financial instruments with a CSD**: The current rules envisage the performance of trading and post-trading (settlement) activities by separate market infrastructures. Central Securities Depository Regulation requires that financial instruments admitted to trading on a trading venue are recorded with a CSD. Due to the capabilities of this technology, it will be allowed to **combine the activities normally performed by both Multilateral Trading Facilities (MTFs) and CSDs**.
- **Settlement discipline requirements**, if a DLT operator ensures, at the minimum, a clear, accurate and timely **confirmation of the details of transactions**, including; any payments made in respect thereof; plus the discharge of or calling for any collateral; and the prevention, or, if not possible, **addressing of settlement fails**.
- **CSDR settlement finality requirements**, under the condition that the DLT **settles transactions close to real time or intraday**, and no later than on the second business day, and after the conclusion of the trade, discloses the rules governing the settlement and mitigates any risk, particularly with regard to **insolvency proceedings**.

- **Rules on cash settlement**, including the possibility to use **innovative solutions, such as “settlement coins,”** or commercial bank money in a tokenised form or e-money tokens (as defined in the MiCA) instead of cash. However, **delivery versus payment (DvP)** still has to be ensured.

## Interaction with other sectoral legislation

In order to move closer to a level playing field for financial instruments admitted to trading on traditional trading venues or settled with traditional CSDs, and to ensure high levels of investor protection, market integrity, and financial stability, **a full set of Union financial services legislation**, including Market Abuse Regulation, CSDR, Prospectus Regulation, a Transparency Directive, and a Directive on Settlement Finality **will apply** to issuers of such crypto-assets and to firms conducting activities related to such crypto-assets.

However, some potential gaps have been identified in the existing EU financial services rules regarding their application to crypto-assets. In particular, certain RTS under MiFIR relative to pre- and post-trade transparency requirements will apply in adapted manner.

## The future is here, and it's digital

Most of the provisions of the Pilot Regime shall apply **from 23 March 2023**.

Aside the DLT Pilot European Policy makers are finalizing the MiCA regulation that will complete the regulatory framework regarding digital assets and tokens. It will potentially come to effect **in the second half of 2024**.

In 2026, ESMA and the Commission will come-up with **a report assessing the pilot regime** and how well it worked in practice. The report should contain a proposition on what's concretely best going forward, if the regime should be extended for a further period or extended to new types of financial instruments, made permanent by modifications to EU financial services legislation, or terminated altogether. The potential for digital securities should then follow an exponential path once launched on the right track.

Be that as it may, there is a clear consensus among European lawmakers that it is not ultimately desirable to have two parallel regimes, for DLT-based and non-DLT-based market infrastructures, in place. Ergo, if the pilot regime turns out to be a success, **it should be made permanent** by amending relevant European Union financial services legislation **to establish a single coherent framework**.

## How Deloitte can help

Deloitte can help you navigate this new environment, understand and define your digital strategy, identify how these new instruments and tools might impact your environment and organization, and even accompany you on the path of asset tokenization for financial or other purposes.

Deloitte helps you stay ahead of the regulatory curve with its regulatory watch service.

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