

CLIENT ALERT

The European DLT Pilot Regime – A Sandbox for Blockchain Technology in the Financial Industry

January 19, 2023

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ESMA published new Guidelines and updated Q&As on DLT Pilot Regime

Just recently, the European Securities and Markets Authority (**ESMA**) published new guidelines and updated Q&As regarding Regulation (EU) 2022/858 of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology (**DLT** and the **DLT Pilot Regime**). On 15 December 2022, ESMA published a “Final Report – draft Guidelines on standard forms, formats and templates to apply for permission to operate a DLT Market Infrastructure” and on 16 December 2022, ESMA published updated “Questions and Answers On the implementation of Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology”.

DLT Pilot Regime – The Legal Foundation for DLT Market Infrastructures

The DLT Pilot Regime is part of the Digital Finance Package which was introduced by the European Commission in 2020 and which aims to support the digital transition while mitigating associated potential risks and turn Europe into a global digital player. The DLT Pilot Regime was published in the Official Journal of the EU on 2 June 2022 and entered into force on 22 June 2022.

The regime is a regulatory sandbox and permits eligible firms to operate a DLT multilateral trading facility, DLT settlement system or a combination thereof for DLT financial instruments. DLT financial instruments are financial instruments within the meaning of Directive 2014/65/EU on markets in financial instruments (**MiFID II**) that are issued, recorded, transferred

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and stored using DLT. The idea of the DLT Pilot Regime is to facilitate the development of a secondary market infrastructure for digital securities and to help EU regulators gain experience regarding the use of DLT and, consequently, to assess which changes to the current regulatory framework may be needed or beneficial for the use of DLT.

The most prominent form of DLT is blockchain technology. Blockchains are currently under exploration for their potential use in various industries including the financial industry and its respective (technical) market infrastructures.

The DLT Pilot Regime provides the framework to apply for specific permissions and potential exemptions from existing regulation to operate three different kinds of DLT market infrastructures (**DLT MI**):

- **DLT MTF** – are multilateral trading facilities (**MTF**) operated by an investment firm or a regulated market operator that only admit DLT financial instruments to trading;
- **DLT SS** – are settlement systems operated by a central securities depository (**CSD**) as defined in Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories (**CSDR**) which, generally speaking, settle transactions in DLT financial instruments and which allow the initial recording of DLT financial instruments or allow the provision of safekeeping services in relation to DLT financial instruments; and
- **DLT TSS** – are trading and settlement systems which combine the services performed by a DLT MTF and a DLT SS and are operated either by an investment firm, a regulated market operator or a CSD.¹

Exemptions from Existing Regulation to enable DLT Market Infrastructures

When applying to operate one of the three DLT MIs, the eligible persons may apply for certain exemptions from existing regulation such as MiFID II, Regulation (EU) No 600/2014 of 15 May 2014 on markets in financial instruments (**MiFIR**) or the CSDR.

The existing regulation governing market infrastructures is based on a legislative understanding which is oriented towards traditional technical infrastructures and their respective implications. Since DLT or blockchain technology is based on a new and innovative technical approach compared to these traditional technical infrastructures, certain exemptions from

¹ Article 2 no. 5 DLT Pilot Regime.

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existing regulation may be granted to DLT MI operators in order to enable them to use this new technology in a regulated environment. The following exemptions may be granted:

- **Exemptions for DLT MTF** – possible exemptions from MiFID II and MiFIR address direct retail participation² and transaction reporting;³
- **Exemptions for DLT SS** – possible exemptions from CSDR address dematerialized form; transfer orders; securities accounts; recording of securities in book-entry form; integrity of issue; segregation of assets; measures to prevent settlement fails; measures to address settlement fails; outsourcing of a core service to a third party; admittance as participants of other natural and legal persons; requirements for participation; transparency; communication procedures with participants and other market infrastructures; settlement finality; cash settlement; standard link access; customized link access and access between a CSD and another market infrastructure;⁴ and
- **Exemptions for DLT TSS** – possible exemptions include the exemptions mentioned above for DLT MTF and DLT SS.⁵

While offering the possibility of exemptions from existing regulation, the DLT Pilot Regime also contains general requirements addressed to DLT MI operators. Among others, the requirements address the proper documentation of the rules of operation, rules on the functioning of the DLT used, IT and cyber arrangement measures, protection of client funds as well as liability of the DLT MI operators for the loss of funds, collateral or DLT financial instruments.⁶

Formal Process to become an Operator of DLT Market Infrastructures

When requesting specific permission to operate a DLT MI and any exemption to existing regulation, the operator must demonstrate, *inter alia*, that the exemption requested is proportionate to, and justified by, the use of DLT.⁷ Furthermore, the national competent authority (**NCA**) may request any compensatory measures that it deems appropriate in order to meet the objectives of the provisions in respect of which an exemption has been requested or in order to ensure investor protection, market integrity or financial stability.⁸

² Article 4 para. 1, 2 DLT Pilot Regime.

³ Article 4 para. 1, 3 DLT Pilot Regime.

⁴ Article 5 para. 2 - 9 DLT Pilot Regime.

⁵ Article 6 para. 1, 2 DLT Pilot Regime.

⁶ Article 7 DLT Pilot Regime.

⁷ Article 4 para. 4; article 5 para. 10; article 6 para. 1, 2 DLT Pilot Regime.

⁸ Article 4 para. 1; article 5 para. 1; article 6 para. 1, 2 DLT Pilot Regime.

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Specific permission to operate a DLT MI may come in addition to an authorization as an investment firm, an operator of a regulated market or a CSD, or can be granted to new entrants that will have to meet the relevant MiFIR, MiFID II and CSDR requirements, except for those for which the applicant requested and was granted an exemption.

As soon as the NCA considers an application to operate a DLT MI to be complete, it sends a copy of that application to ESMA. Where necessary to promote consistency and proportionality of exemptions, or where necessary to ensure investor protection, market integrity and financial stability, ESMA is expected to provide the NCA with a non-binding opinion on the exemptions requested or on the adequacy of the type of DLT used. Where ESMA issues such a non-binding opinion, the NCA shall give that opinion due consideration and shall provide ESMA with a statement regarding any significant deviations from that opinion if requested by ESMA.⁹

The specific permission to operate a DLT MI given by the NCA shall specify *inter alia* the exemptions granted as well as any compensatory measures that the NCA deems appropriate. ESMA shall publish a list on its website containing the respective names of DLT MIs and *inter alia* the information regarding the start and end dates of their specific permissions as well as the list of exemptions granted to each of them.¹⁰

A granted specific permission is valid throughout the EU and permissions may be given for periods of up to six years from the date of issuance.¹¹

New Guidelines regarding Application Process and updated Q&As

The recently published guidelines and updated Q&As give further guidance on the process of becoming a DLT MI operator. While the new guidelines focus on the application process with the NCA, the updated Q&As focus on Transaction Reporting, Financial Instruments Reference Data and Order Record Keeping.

- **Guideline 1 addresses the NCAs** and requires them *inter alia* to provide instructions on their websites on how to submit an application for a specific permission to operate a DLT MI as well as clarifications if applications should be submitted on paper, electronically, or both and an indication regarding the language to be used during the application process.
- **Guideline 2 addresses the applicants** and provides various forms to be completed as part of the application process to become a DLT MI operator.

⁹ Article 8 para. 6, 7; article 9 para. 6, 7; article 10 para. 7, 8 DLT Pilot Regime.

¹⁰ Article 8 para. 11; article 9 para. 11, article 10 para. 11 DLT Pilot Regime.

¹¹ Article 8 para. 11; article 9 para. 11; article 10 para. 11 DLT Pilot Regime.

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Table 1 requests general information on the applicant such as corporate name, registered address or which authorizations under MiFID II or the CSDR were already obtained.

Table 2 requires more specific information, in particular:

- a **business plan** describing how the applicant intends to carry out its services and activities (including a description of the technical aspects, e.g. a detailed description of the DLT technical implementation);
- **rules defining the rights, obligations, responsibilities and liabilities** of the operator of the DLT MI, as well as that of the members, participants, issuers and/or clients using the concerned DLT MI (including governing law of the DLT MI and criteria for participation);
- information regarding the **functioning, services and activities of the DLT MI** (including type of DLT financial instruments traded and/or settled and type of DLT used);
- information on the **functioning of the DLT used** (including information on the validation process of transactions);
- overall **IT and cyber arrangements**;
- **arrangements to record and protect** members', participants', issuers' or clients' funds, collateral or DLT financial instruments;
- **investor protection** measures; as well as
- information on a **transition strategy** (i.e. a description of the transition strategy for reducing the activity of or transitioning out of, or ceasing to operate, a DLT MI).

Tables 3 and 4 provide for the waiver applications regarding the existing regulation in MiFID II, MiFIR or the CSDR. These forms require the applicant to provide, among others, a statement that the exemptions requested are proportionate and justified by the use of DLT.

For example, if an applicant aims to operate a DLT TSS (i.e. a combination of services provided by a DLT MTF and a DLT SS), Tables 1 through 4 must be provided to the NCA. Tables 1 and 2 for general information on the applicant and the specifics around the envisaged DLT MI operation, Table 3 for exemptions from MiFID II and MiFIR and Table 4 for exemptions from CSDR. We note that the requirements pursuant to MiFID II, MiFIR and CSDR must still be observed when operating a DLT MTF, DLT SS or DLT TSS, unless a waiver has been granted.

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- The **Updated Q&As** provide new guidance on Transaction Reporting, Financial Instruments Reference Data and Order Record Keeping. *Inter alia*, guidance with respect to the following is given.

With regard to reporting obligations under Article 26 MiFIR (unless a waiver from such obligation is requested and granted), such reporting obligations along with RTS 22 apply in full to DLT MTFs or DLT TSSs as soon as the permission to operate such a DLT MI is granted and, according to ESMA, there is no implementation lead-time provided to comply with these reporting obligations. Furthermore, ESMA clarifies that exemptions granted in accordance with Article 4 DLT Pilot Regime only apply to the DLT MTF or DLT TSS and their respective members and, therefore, reporting obligations will continue to apply to investment firms that are not members of the relevant DLT MTF or DLT TSS.

Regarding the correct reflection of cancellations and corrections, ESMA clarifies that the reporting exemptions only apply to the extent transactions are executed on the distributed ledger (i.e. on-DLT) and DLT MTFs and DLT TSSs operating multilateral trading systems which, partially or exclusively, execute transactions outside the distributed ledger (i.e. off-DLT) must ensure the correct sequencing under RTS 22 for such transactions. DLT MTFs/TSSs that benefit from reporting exemptions should explore with their NCA the possibility of providing only the definitive version of the transactions after validation and recording on the ledger.

Further guidance is given on how to populate certain fields of the forms in RTS 22, 23 and 24. For example, the Q&As provide guidance on how to populate field 33 “Price” or field 41 “Instrument identification code” of RTS 22. Transaction fees may not be treated as commissions and therefore field 33 should reflect only the traded price of the transaction and not include DLT transaction fees. With regard to field 41, if DLT financial instruments are the digital representation of a previously issued financial instrument, the ISIN of the previously issued financial instrument may also be used for the DLT financial instrument if the characteristics of both instruments are the same and both instruments are fully “fungible” with one another.

Conclusion

The DLT Pilot Regime aims at rethinking traditional market infrastructures and takes a first step towards their further (or different) digitalization. It will be interesting to see which market participants will make use of the DLT Pilot Regime and which waivers are applied for most frequently. At the same time, the potential compensatory measures required by the NCAs in exchange for such waivers will be a main focus. These compensatory measures and their feasibility are likely to determine how much of the innovative potential of DLT solutions will be explored by market participants. At the same time, NCAs may develop differently nuanced approaches to such compensatory measures and the development of such approaches may create divergent circumstances for market participants.

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