



PILOT REGIME FOR USE OF DISTRIBUTED LEDGER TECHNOLOGY IN CAPITAL MARKET INFRASTRUCTURES

17 APRIL 2023

Introduction

As the globalization and digitalization of the financial sector continuously gain momentum on multiple fronts, new legal challenges arise with regulators seeking to balance encouragement of innovation with the desire to ensure adequate protection of persons and society. Distributed ledger technology (“DLT”) is a means of saving information through a distributed ledger, i.e. a repeated digital copy of data available at multiple locations which are built upon public-key cryptography, a cryptographic system that uses pairs of keys; public keys, which are publicly known and essential for identification, and private keys, which are kept secret and are used for authentication and encryption.¹ A well-known version of a DLT is blockchain technology.

¹ European Securities and Markets Authority: *Advice on Initial Coin Offerings and Crypto-Assets*, 9 January 2019.

On 24 September 2020, the European Commission (the “EC”) issued a Digital Finance Package with the aim to boost Europe’s competitiveness and innovation in the financial sector, paving the way for Europe to become a global standard-setter². Moreover, on 30 June 2022, the European Union issued Regulation (EU) 2022/858 of 30 May 2022 regarding a pilot regime for market infrastructures based on distributed ledger technology (the “DLTR”) with its main purpose being to promote innovation and allow for temporary derogations from current applicable law to gain experience in the use of DLT in market infrastructures (“DLT MI”) while mitigating risks for investors, market integrity, and financial stability. The DLTR entered into force on 23 March 2023. The DLTR essentially serves as a temporary “sandbox” for the eventual regulation of DLT financial instruments and provides regulatory authorities and the financial market with the opportunity to experience and identify opportunities and risks associated with DLT and to incorporate the results into a permanent legal framework³.

Lastly, in March 2023, ESMA issued both guidelines⁴ (“ESMA Guidelines”) and a Q&A⁵ on the DLTR (“ESMA Q&A”).

The DLTR will be applicable for a maximum of six years⁶. ESMA shall by 24 March 2026 present a report to the EC on, inter alia, the functioning of the DLT MI’s, the number and value of transactions traded or settled on DLT MI’s and an overall assessment of the costs and benefits of the pilot regime provided for in this Regulation and a recommendation of whether, and under which conditions, to continue the DLTR to assist the EC and the European Council in determining the future regulation of DLT financial instruments⁷.

Scope of the DLTR

The DLTR applies to what may be commonly referred to as crypto-assets, crypto-securities, or tokenised securities. The DLTR defines such as a “DLT financial instrument” being a financial instrument that is issued, recorded, transferred, and stored using DLT⁸. A DLT is an information repository that keeps records of transactions and that is shared across, and synchronised between, a set of DLT network nodes using a consensus mechanism⁹. The term financial instrument is derived from the definition in MiFID II¹⁰. However, the DLTR limits

² European Commission: *Digital Finance Package: Commission sets out new, ambitious approach to encourage responsible innovation to benefit consumers and businesses*, 24 September 2020. [Digital Finance Package \(europa.eu\)](https://ec.europa.eu/finance/digital-finance-package)

³ Preamble no. 6 of the DLTR.

⁴ ESMA Guidelines on standard forms, formats and templates to apply for permission to operate a DLT market infrastructure, last updated on 15 December 2022 (ESMA 70-460-206).

⁵ ESMA Q&A on the DLTR last updated on 31 March 2023 (ESMA70-460-189).

⁶ DLTR art. 14 (2).

⁷ DLTR art. 14.

⁸ DLTR art. 2(11).

⁹ DLTR art. 2 (2).

¹⁰ DLTR art. 2(12) and MiFID II art. 4(1)(15), cf. Section C of Annex 1. The definition of a “financial instrument” in MiFID II has accordingly been updated as of 23 March 2023 to “those instruments

the scope of the financial instruments which can be trading or recorded on a DLT MI to shares, bonds (and other securitised debt) and units in collective investment undertakings¹¹.

Consequently, a DLT financial instrument for the purpose of the DLTR is a share, bond or unit in a collective investment undertaking that is issued, recorded, transferred and stored using DLT. The ISIN of the DLT financial instruments should, as a general rule, be the same as the “traditional” financial instrument¹². Notwithstanding the definition of a DLT financial instrument, which seems to imply that only newly issued shares are covered by the definition (financial instruments that are “(...) issued”), the ESMA Q&A seems to imply that already existing “traditional” financial instruments can be digitally represented as a DLT financial instrument.

Provisions on market abuse, insider trading and public offerings and admittance to trading also apply to DLT financial instruments.

New Market Participants

The DLTR introduces three new types of market infrastructures: DLT multilateral trading facilities (“DLT MTF”), DLT settlement systems (“DLT SS”), and DLT trading and settlement systems (“DLT TSS”):

1. A DLT MTF is a multilateral trading facility authorised under MiFID II which has also received specific permission under the DLTR on which DLT financial instruments can be traded¹³;
2. A DLT SS is a settlement system operated by a central securities depository (“CSD”) authorised under Regulation (EU) 909/2014 (“CSDR”) that settles transactions in DLT financial instrument against payment or delivery and differs from the existing settlement system by being compatible with the technological basis of DLT financial instruments¹⁴; and
3. A DLT TSS is either a DLT MTF or a DLT SS that combines services performed by a DLT MTF and a DLT SS¹⁵.

The specific requirements for operating a DLT MTF, a DLT SS and a DLT TSS are set out in Articles 4-6 and 8-10 of the DLTR. As stated above, to operate a DLT MTF and DLT SS, the operator must already hold a license as an MTF or CSD, respectively, and the pilot regime is consequently only available to entities already licensed under existing regulations.

specified in Section C of Annex I, including such instruments issued by means of distributed ledger technology” (our emphasis).

¹¹ DLTR art. 3(1). The DLTR also limits the market cap of issuers of shares and the AUM of the collective investment undertaking to EUR 500 million and the size of the debt to EUR 1 billion. The DLTR sets out further limits to the size of the DLT MI.

¹² ESMA Q&A, Section 4, Q1/A1.

¹³ DLTR art. 2(6).

¹⁴ DLTR art. 2(7).

¹⁵ DLTR art. 2(10).

Importantly, however, the DLTR allows MTF's and CSD's to apply for exemptions applicable to MTF's and CSD's pertaining to the operation of the DLT MI to the extent it is proportionate to, and justified by, the use of distributed ledger technology. These include:

1. DLT MTFs to be exempt from the obligation to report transactions on a daily basis¹⁶;
2. DLT SSs to be exempt from various requirements relating to CSDs, importantly the requirement for transferable listed securities to be issued and recorded in book-entry form in the CSD¹⁷, the requirements regarding settlement finality¹⁸; and
3. the option for a DLT SS to settle securities transactions in cash payments through accounts opened with a central bank of issue of the relevant currency where practical and available¹⁹ (this means that DvP settlement of securities transactions on DLT SSs may be done with tokenised cash instead of central bank money, i.e., settlement may occur with a digital currency referencing a single fiat currency instead of with central bank money).

The status of DLT MIs is optional and does not prevent financial market infrastructures, such as trading venues, CSDs and central counterparties from developing trading and post-trading services and activities for DLT financial instruments that qualify as financial instruments or are based on DLT.²⁰

An operator of a DLT MI must additionally fulfill the requirements listed in the DLTR Article 7 and 8, which includes high-level requirements for the operator's business plan, description of how the DLT functions, overall IT and cyber arrangements, safekeeping arrangements for clients' DLT financial instruments, arrangement for ensuring investor protection, and mechanisms for handling client complaints and redress, and evidence of sufficient prudential safeguards to meet its liabilities and to compensate its clients.

¹⁶ DLTR art. 4(3).

¹⁷ DLTR art. 5(2).

¹⁸ DLTR art. 5(7).

¹⁹ DLTR art. 5(8).

²⁰ Preamble no. 7 of the DLTR.

Outlook

Some market participants have already issued DLT securities in the EU in “sandbox”-testing environments, such as EIB²¹ and Santander²². The technology is, however, still in its nascent state with respect to the issuance and settlement of trades in financial instruments and certain barriers to scale the technology still exist, such as the potential large power consumption required to operate DLT networks. The Pilot Regime is an important step on the way to creating more efficient securities trading and settlement systems by providing market participants with better regulatory frames for innovating. It opens the possibility for incumbent and new market participants to develop and offer solutions that will contribute to, among other, reducing the settlement time lag, such as the Project Ion does in the US²³.

Link to the DLTR can be accessed [here](#), the ESMA Guidelines [here](#), and the ESMA Q&A [here](#).

²¹ <https://www.eib.org/en/press/all/2023-030-eib-issues-its-first-ever-digital-bond-in-british-pounds>

²² <https://www.santander.com/en/press-room/press-releases/santander-launches-the-first-end-to-end-blockchain-bond>

²³ [DTCC Project Ion White Paper](#). Project Ion is one of the largest DLT initiatives in equities settlement across the financial services industry with the goal to “provide a resilient, secure and scalable service to clients, with the option to leverage DLT for those firms who wish to take advantage of the emerging technology”.

If you have any questions or require further information regarding any of the above, please do not hesitate to contact us.



Kristoffer Lund Poulsen
Partner

Kristoffer.poulsen@moalemweitemeyer.com



Joachim Buznicki Nørlem
Senior Associate

Joachim.noerlem@moalemweitemeyer.com



Kadir Kurt
Associate

Kadir.kurt@moalemweitemeyer.com

The above does not constitute legal counselling and Moalem Weitemeyer does not warrant the accuracy of the information. With the above text, Moalem Weitemeyer has not assumed responsibility of any kind as a consequence of any reader's use of the above as a basis for decisions or considerations.

This news piece has been produced in the English language only. Are you a client or a prospective client, and should you require a Danish version, please email us at news@moalemweitemeyer.com with a link to the article that you would like to request to receive in Danish, and we will attend to your request without undue delay.