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European Commission Introduces Sandbox for DLT-Based Trading and Post-Trading Market Infrastructures

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As part of its digital finance package,[1] the European Commission published a draft regulation regarding a pilot regime for market structures based on distributed ledger technology (the "DLT Pilot Regime").

The DLT Pilot Regime is part of an EU-wide strategy to further enable and support the potential of digital finance in terms of both innovation and competition while mitigating related risks. The European Commission recognizes that the existing financial services regulatory framework is not fully adapted to the use of distributed ledger technology ("DLT") and therefore poses obstacles to the further development of innovative market infrastructures for financial instruments. The European Commission identifies these obstacles as one of the factors that had prevented the European security token market from thriving in past years.

The DLT Pilot Regime is designed as a sandbox that will enable eligible market participants to operate DLT-based multilateral trading facilities and securities settlement systems while being exempted from certain requirements under the regulatory framework that have hindered the application of DLT in the financial instruments markets. The DLT Pilot Regime will be supplemented by the proposed directive amending a number of existing financial instruments regulations and providing for additional exemptions from such regulations for DLT-based multilateral trading facilities and securities settlement systems[2] (the "DLT Amending Directive").

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1 The digital finance package was adopted by the European Commission in September 2020 and includes (i) a communication of the European Commission on a digital finance strategy for the European Union, (ii) a legislative proposal for a regulation on markets in crypto-assets (see for details our client update of November 3, 2020, available at https://www.debevoise.com/-/media/files/insights/publications/2020/11/20201103-european-commission-introduces-draft.pdf), (iii) the DLT Pilot Regime and (iv) a legislative proposal for an EU regulatory framework on digital operational resilience. The digital finance package aims at building a competitive EU financial sector that gives consumers access to innovative financial products while ensuring consumer protection and financial stability.

2 Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/43/EC, 2009/65/EC, 2009/138/EU, 2011/61/EU, EU/2013/36, 2014/65/EU, (EU) 2015/2366 and EU/2016/2341 (COM(2020)596).

Eligible Market Infrastructures

The DLT Pilot Regime will introduce two types of DLT-based market infrastructures ("DLT Market Infrastructures") that will be eligible for the sandbox:

- **DLT Multilateral Trading Facility**
  A DLT multilateral trading facility (the "DLT MTF") is a multilateral trading facility as defined under the Markets in Financial Instruments Directive[3] ("MiFID II") that is operated by a market operator or an investment firm authorized under MiFID II and only admits DLT Transferable Securities (as defined below).

- **DLT Securities Settlement System**
  A DLT securities settlement system ("DLT SSS") is a securities settlement system as defined under the Central Securities Depository Regulation[4] (the "CSDR") that is operated by a central securities depository[5] (the "CSD") and settles transactions in DLT Transferable Securities against payment.

Eligible Market Participants

Only the following market participants will be eligible under the DLT Pilot Regime to apply for permission to operate a DLT MTF or DLT SSS, respectively:

- DLT MTF: investment firms and market operators as defined, and authorized, under MiFID II; and
- DLT SSS: CSDs as defined, and authorized, under the CSDR.

The permission granted under the DLT Pilot Regime to operate a DLT Market Infrastructure will be given only to eligible market participants authorized under MiFID and CSDR, as appropriate.

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3 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

4 Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.

5 As defined in Article 2(1) of the CSDR.

Eligible DLT Transferable Securities

In order to preserve financial stability while allowing innovation and experimentation within the regulatory sandbox, the type of transferable securities admitted to trading on a DLT MTF or recorded in a CSD operating a DLT SSS will be limited to DLT Transferable Securities (such as shares and bonds) that are not liquid.

"DLT Transferable Securities" are securities that constitute "transferable securities" within the meaning of MiFID II[6] and are issued, recorded, transferred and stored using a DLT.

Under the DLT Pilot Regime, DLT Transferable Securities are considered not to be liquid and therefore eligible if:

- in the case of shares, the market capitalization or the tentative market capitalization of the issuer is less than EUR 200 million; and
- in the case of convertible bonds, covered bonds, corporate bonds or public bonds (other than sovereign bonds), the issuance size is less than EUR 500 million.

In addition, sovereign bonds may not be admitted or recorded by a DLT Market Infrastructure, and the total market value of DLT Transferable Securities recorded by a DLT SSS (or by a DLT MTF if admitted for such service under the DLT Pilot Regime) must not exceed EUR 2.5 billion.

Permissions and Exemptions Available Under the Sandbox Framework

As a general rule, (i) a DLT MTF will be subject to all regulations applicable to multilateral trading facilities as defined and regulated under the MiFID and (ii) a CSD operating a DLT SSS will be subject to all regulations applicable to a CSD under the CSDR. Under the DLT Pilot Regime, DLT Market Infrastructures will be permitted to request exemptions from certain rules that are not compatible with the use of DLT in the trading and post-trading of DLT Transferable Securities. The aim of such exemptions is to expedite and condense trading and settlement to nearly real time and to enable the merger of trading and post-trading activities.

General Requirements for Permissions and Exemptions

A DLT Market Infrastructure will only be granted a permission or exemption under the DLT Pilot Regime if (i) it complies with specific conditions attached to each exemption

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6 Article 4(1)(44) (a) and (b) of MiFID II.

and additional conditions imposed by the national competent authorities ("NCA"), (ii) it demonstrates that the application of the exempted requirement is incompatible with the DLT use and (iii) the exemption is not extended to other multilateral trading facilities or settlement systems operated by the operator of the relevant DLT Market Infrastructure.

Permissions and Exemptions Available to DLT MTFs

The exemptions available to a DLT MTF under the DLT Pilot Regime are designed to enable a DLT MTF to perform activities that are currently performed by intermediaries, such as a CSD, including the initial recording of securities, settlement of transactions and safekeeping. In particular, a DLT MTF may request the following exemptions:

- **Recording, Settlement and Safekeeping of DLT Transferable Securities.** Under Article 3(2) of the CSDR, all transferable securities that are traded on a multilateral trading facility must be recorded in book-entry form in a CSD on or before the intended settlement date. By contrast, the DLT Pilot Regime will allow such recording to be performed by a DLT MTF on a DLT-based system. A DLT MTF that utilizes such exemption will also perform the activities of settlement of transactions and of safekeeping the DLT Transferable Securities, clients' funds and the related collateral.

  In order to obtain the exemption, a DLT MTF will need to comply with the conditions attached to it, including to:

  - ensure appropriate reconciliation of DLT Transferable Securities of an issuance admitted to trading and recorded on the DLT;
  - guarantee the safekeeping of DLT Transferable Securities and funds;
  - provide accurate and timely information on transactions, including finality of settlement;
  - settle transactions close to real time or intraday but no later than within two business days; and
  - ensure delivery versus payment.

- **Exemption from Intermediation Requirements—Direct Access for Retail Investors**
  Due to the applicable MiFID rules, traditional trading venues usually give access to retail investors through financial intermediaries such as investment firms or credit

institutions. The European Commission recognizes that trading platforms for crypto-assets generally give direct access to retail investors and thus finds that MiFID's intermediation requirements currently impose constraints on the development of financial market infrastructures for crypto-assets. Under the DLT Pilot Regime, a DLT MTF will thus be able to request an exemption from such intermediation obligation in order to give retail investors direct access to the trading venue.[7]

A DLT MTF that grants direct access to retail investors must ensure that each admitted retail investor meets certain criteria, such as showing sufficient good repute, being fit and proper and having sufficient level of ability, competence, experience and knowledge of the trading and functioning of DLT.

Permissions and Exemptions Available to DLT SSS

As for DLT MTFs, the exemptions available to a DLT SSS under the DLT Pilot Regime are designed to enable a DLT SSS to perform settlement activities using DLT and thereby reduce the need for intermediaries. In order to achieve such goals, the DLT Pilot Regime will provide for the following exemptions:

- **Exemption from Intermediation Requirements—Direct Access for Retail Investors**
  Access for retail investors to the settlement and delivery systems operated by a CSD under the CSDR is also limited by the requirement of intermediation through a credit institution or an investment firm.[8] Again, the European Commission recognizes that such intermediation requirement may create a regulatory obstacle to the development of alternative models of settlement based on DLT. Therefore, the DLT Pilot Regime will enable a CSD operating a DLT SSS to request an exemption from the intermediation requirement and to give direct access to retail investors.

  A DLT SSS that gives direct access to retail investors must also ensure that such retail investors meet certain criteria, similar to the criteria for retail investors admitted to a DLT MTF.

- **Exemption from Requirements on Cash Settlement**
  Article 40 of CSDR provides specific requirements regarding settlement of payments, including the requirement to settle payments in central bank money, if available and practicable, or otherwise in commercial bank money. The European Commission recognizes that such requirement may be difficult to apply for a CSD operating a

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7 This exemption will be implemented by an amendment to Article 19 of the MiFID as provided for in the DLT Amending Directive.

8 Articles 2(1)(19) of the CSDR Regulation and Article 2(f) of the Settlement Finality Directive (98/26/EC).

DLT SSS since the CSD would be required to effect movements in cash accounts at the same time as the delivery of securities on the DLT. The DLT Pilot Regime will allow a DLT SSS to request an exemption from such requirements and provides that settlement of payments can be carried out through commercial bank money, including in a token-based form, or in e-money tokens.

- **Derogation from Definitions and Other Requirements of CSDR**
  The CSDR further provides for a number of other definitions and requirements for traditional settlement systems that are not compatible with the intended use of DLT. The DLT Pilot Regime will allow a CSD operating a DLT SSS to request an exemption from certain definitions and requirements, including with respect to:
  - dematerialized form of securities;[9]
  - securities accounts;[10]
  - recording of securities;[11]
  - integrity of issue;[12]
  - segregation of assets;[13]
  - extension and outsourcing of activities and services;[14] and
  - standard link access between CSDs and to other market infrastructures.[15]

  In part, these exempted requirements are replaced by similar requirements under the DLT Pilot Regime that are better suited for DLT-based settlement infrastructures.

Provisional Permissions and Exemptions

The permissions and exemptions will be granted on a temporary basis for a period of up to six years.

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9 Article 2(1)(4) of the CSDR provides that dematerialized form requires that securities exist only as book entry records.

10 Article 2(1)(28) of the CSDR requires a securities account on which securities may be credited or debited.

11 Article 3 of the CSDR requires that securities must be represented in book-entry form or dematerialized form.

12 Article 37 of the CSDR requires certain reconciliation measures, including the obligation of a CSD, among others, to verify that the number of issued securities matches the number of securities on the relevant securities accounts.

13 Article 38 of the CSDR requires CSD to ensure that securities of a participant can be segregated from securities of other participants and the CSD's own assets.

14 Articles 19 and 30 of the CSDR require an authorization by the NCA for outsourcing of services and compliance with certain conditions. Such requirements would be difficult to comply with in the case of a distributed ledger that is operated by various participants.

15 Articles 50 and 53 of the CSDR. However, a CSD operating a DLT SSS that requests the exemption from the requirements on standard link access must in return give access to other CSDs operating a DLT SSS and to DLT MTFs.

Risk Mitigation and Ongoing Requirements

In order to ensure a level of consumer and investor protection, market integrity and financial stability that is comparable to the existing regulatory framework for financial instruments, the DLT Pilot Regime will put in place various safeguards and requirements for DLT Market Infrastructures that are granted an exemption from the existing rules. In addition, such DLT Market Infrastructures will be subject to certain ongoing obligations. This includes the provision of information about their business and the functionality of the DLT-based systems in order to enable regulators to gain experience on the impact of the use of DLT and on any adaptations to the existing financial services regulations that could be necessary to allow for the use of DLT on a greater scale.

General Risk-Mitigation Requirements

The general requirements of the DLT Pilot Regime designed to mitigate the risks associated with the use of DLT include the obligations of the DLT Market Infrastructures to:

- establish a clear and detailed business plan;
- provide clear and publically available written documentation defining the rules under which the DLT Market Infrastructure will operate, including applicable legal terms;
- provide all members, participants, clients and investors with clear and unambiguous information on how they carry out their functions, services and activities and how these are different from a traditional multilateral trading facility or CSD;
- ensure that overall IT and cyber security arrangements related to the use of DLT are adequate, taking into account the nature, scale and complexity of the business;
- have adequate arrangements to safeguard DLT Transferable Securities, clients' funds and collateral where the business model of a DLT Market Infrastructure involves the safekeeping of, or the means to access, these assets; and
- establish a clear, detailed and publicly available exit strategy for transitioning out of, or winding down, the DLT Market Infrastructure.

Ongoing Information Requirements

The DLT Pilot Regime will also provide for significant information obligations towards NCAs and the European Securities and Markets Authority (the "ESMA"). Each DLT Market Infrastructure must inform authorities of proposed material changes to its business plan, the rules of the DLT Market Infrastructure and its legal terms at least four months before such a change is implemented. It must further report any evidence of unauthorized access, cyber-attacks, material malfunctions, fraud, theft or other serious malpractice, material changes in the information provided to the NCA and technical or operational difficulties in delivering activities or services covered under the permission, as well as any risks to investor protection, market integrity or financial stability that may have arisen and were not anticipated in the initial application for permission. In turn, the NCA will be granted comprehensive powers to obtain information, including audit rights, and to take appropriate measures (e.g., corrective measures regarding the business plan of a DLT Market Infrastructure).

An operator of a DLT Market Infrastructure will also be required to provide, on a bi-annual basis, a report to the respective NCA and ESMA incorporating the above-mentioned information as well as information about the number and value of DLT Transferable Securities admitted to trading on the relevant DLT MTF or recorded by the relevant CSD (or on the DLT MTF if permitted under the DLT Pilot Regime), the number and value of transactions traded and settled on a DLT Market Infrastructure and an assessment of difficulties in applying the existing EU financial services regulations or national laws.

Role of Supervisory Authorities

In order to ensure supervisory convergence, each DLT Market Infrastructure will be generally supervised by the NCA of its home Member State. The NCA will act in close coordination with ESMA in order to ensure supervisory convergence.

The NCA will be in charge of granting permissions under the DLT Pilot Regime and will have the power to impose additional conditions when granting a permission. The NCA will also be entitled to refuse a permission to operate a DLT Market Infrastructure if there are objective grounds for believing that there are significant risks to investor protection, market integrity or financial stability or that the permission is sought to circumvent existing legal or regulatory requirements. Similarly, an NCA may also withdraw a permission under specific circumstances.

Before granting permission to a DLT Market Infrastructure, the NCA will consult ESMA, which will issue a non-binding opinion and make recommendations. Such opinion and recommendations are aimed at ensuring financial stability, market integrity and investor protection, as well as consistency and proportionality of the exemptions granted by the NCAs in order to establish a level playing field and fair competition across the European market.

After a five-year period (at the latest), ESMA will produce a detailed report on the pilot regime to the European Commission. On the basis of this assessment, the European Commission will present a report, including a cost-benefit analysis, to the European Council and the European Parliament on whether the pilot regime should be maintained as is, extended to new categories of financial instruments, otherwise amended or terminated.

Outlook

The draft is now subject to a review by the European Parliament and the European Council. The European Commission plans to have the final regime implemented by 2024.

The DLT Pilot Regime is just a first step on a long path ahead to make the benefits of DLT available to the markets for financial instruments. The European Commission expressly points out that, given the limited experience as regards the trading and post-trading of transactions in crypto-assets that qualify as financial instruments, it would currently be premature to bring significant modifications to the EU financial services regulations to enable the full deployment of such crypto-assets and their underlying technology. The DLT Pilot Regime is designed to enable the European lawmakers and regulators to gain such experience and to assess whether such technology is worth implementing into the EU financial markets regulations.

The DLT Pilot Regime will certainly help understand whether the key benefits of DLT, such as an expedited settlement processes, a reduced need for intermediaries, mitigation of cyber risks and reduction of costs can materialize. If this is the case, the DLT Pilot Regime could have a positive impact on a wider adoption and acceptance of DLT and crypto-assets in the financial markets sector.

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Please do not hesitate to contact us with any questions.

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