

The EU pilot regime for DLT market infrastructures

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On 2 June 2022 the Regulation 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") was published on the Official Journal of the European Union (the "DLT Pilot Regime Regulation").

The DLT Pilot Regime Regulation is one of the measures included in the "*Digital Finance Package*" presented by the European Commission on 24 September 2020, along with the Markets in Crypto-Assets Regulation ("MiCAR").

The purpose of the DLT Pilot Regime Regulation is to introduce certain temporary exemptions from the current EU framework in order to permit the setting-up of DLT market infrastructures. The temporary regime will last for 6 years starting from March 2023, but can be renewed or made permanent by EU institutions at the end of this period.



Under the current EU rules market participants must issue instruments traded on trading venues in book entry form. This is a limitation to the development of DLT market infrastructures in the EU.

Rationale of the DLT Pilot Regime Regulation

Crypto-assets are gaining momentum in the financial sector industry, although they are still at an early stage of adoption.

The DLT technology allows the creation of innovative trading platforms where crypto-assets representing bonds, equity instruments, units or shares of investment funds or other tokenised assets can be traded and exchanged with no need to use book entry securities.

However, the existing EU regulatory framework requires market participants to issue instruments that can be traded on trading venues in book entry form. This requirement constitutes a limitation to the development of DLT market infrastructures in the EU.

The DLT Pilot Regime Regulation was approved in order to overcome the existing regulatory restrictions. The Regulation provides a

comprehensive legal framework for the listing and trading of those crypto-assets that qualify as financial instruments.

Scope of the New Rules

The DLT Pilot Regime Regulation applies only to crypto-assets qualifying as financial instruments in accordance with the MiFID 2 (“**DLT Financial Instruments**”). The trading of other crypto-assets is excluded from the scope of the DLT Pilot Regime Regulation – but will be governed by the MiCAR.

The DLT Pilot Regime Regulation introduces a specific regulatory regime for DLT market infrastructures – which notion comprises:

- ▶ DLT multilateral trading facilities (“**DLT MTF**”), *i.e.* multilateral trading facilities (as defined in the MiFID 2) (“**MTF**”) which only admits to trading DLT Financial Instruments;
- ▶ DLT settlement systems (“**DLT SS**”), which are settlement systems that settle transactions in DLT Financial Instruments;
- ▶ DLT trading and settlement systems (“**DLT TSS**”) which are those entities that combine the services of DLT MTFs and DLT SSs.

Limitations on DLT Financial Instruments

According to the DLT Pilot Regime Regulation only the following types of DLT Financial Instruments can be admitted to trading on a DLT market infrastructure:

- ▶ shares of an issuer with a market capitalisation (or a tentative market capitalisation) of less than EUR 500 million;
- ▶ bonds and other forms of securitised debts, or money market instruments, with an issue size of less than EUR 1 billion (excluding those embedding a derivative component) – corporate bonds issued by issuers with a market capitalization lower than EUR 200 million are excluded from the calculation of the 1 billion threshold;
- ▶ units in collective investment undertakings subject to the UCITS Directive whose market value is less than EUR 500 million.

More importantly, the aggregate market value of all DLT Financial Instruments traded on a DLT market infrastructure cannot exceed EUR 9 billion. If this threshold is exceeded, the DLT market infrastructure must initiate a transition process to start operating as a “traditional market infrastructure”.

Permission to Operate

The DLT Pilot Regime Regulation essentially provides that DLT MTFs, DLT SSs and DLT TSSs must be subject to the same legal framework



The new rules apply to multilateral trading facilities and securities settlement systems based on DLT technology.



Only shares, bonds and units of UCITS funds can be listed and traded on DLT market infrastructures, subject to certain quantitative thresholds.



The operators of DLT market infrastructures will be subject to the same authorization requirements applying to traditional market infrastructures.

currently applying to MTFs and securities settlement systems, subject to certain limited exemptions.

As a result, for instance, only entities that hold a license to operate an MTF under the MiFID2 can operate a DLT MTF – although such license can also be granted for the exclusive purpose of operating a DLT MTF.

The permission granted by the competent authority is valid throughout the entire European Economic Area for a period of up to six years from the date of issuance.

Exemptions

DLT MTFs, DLT SSs and DLT TSSs that have been granted the permission to operate as such can apply for certain exemptions from the rules laid down in the existing EU financial framework.

One of the most notable exemptions is related to the category of customers that can become members or participants of a DLT MTF. While under the MiFID2 this possibility is restricted to institutional investors, under the DLT Pilot Regime Regulation a DLT MTF may admit natural and legal persons to deal on own account as members or participants, provided that they fulfil the following:

- ▶ they must be of sufficient good repute;
- ▶ they must have a sufficient level of trading ability, competence and experience, including knowledge of the functioning of the DLT;
- ▶ they are not market makers on the DLT MTF;
- ▶ they do not use a high-frequency algorithmic trading technique on the DLT MTF;
- ▶ they do not provide other persons with direct electronic access to the DLT MTF;
- ▶ they do not deal on their own account with executing client orders on the DLT market infrastructure; and
- ▶ they have given informed consent to trading on the DLT MTF as members or participants and have been informed by the DLT MTF of the potential risks of using its systems to trade DLT financial instruments.

Market Abuse

An important requirement introduced by the Pilot Regime regulation relates to the application of the “Market Abuse” Regulation (EU) No. 596/2014 (“**MAR**”) to all DLT Financial Instruments traded on a DLT MTF or on a DLT SS.

The issuers of instruments listed on “traditional” or DLT market infrastructures will accordingly be subject to the same rules in terms of



Natural or legal persons will have direct access to DLT market infrastructures provided that the conditions specified in the DLT Pilot Regime Regulation are satisfied.

market transparency and information that are provided for under the MAR.



The DLT Pilot Regime Regulation will enter into force in March 2023 and will apply for a 6-year period.

Entry Into Force and Temporary Nature of the New Rules

The DLT Pilot Regime Regulation will enter into force on 23 March 2023, but will apply only for a 6-year period on a temporary basis.

By 24 March 2026 ESMA must present a report to the European Commission on the application of the regime throughout the European Union. On the basis of this report, the European Commission may propose to terminate the regime, extend it for an additional period of up to three years (or to additional financial instruments), amend it or made it permanent.

Will the DLT Pilot Regime Regulation Promote or Limit the Growth of DLT Market Infrastructures in the EU?

The DLT Pilot Regime Regulation introduces a comprehensive framework for all operators wishing to establish and operate trading platforms based on DLT / blockchain in the EU.

However, the Regulation probably lacks ambition and can hardly be seen as a change of the approach followed by EU institutions on the regulation of market infrastructures.



Although the DLT Pilot Regime introduces a comprehensive framework for market operators, it probably lacks ambition and could limit the development of the EU market for DLT market infrastructures.

The outcome of the DLT Pilot Regime Regulation is to apply to DLT market infrastructures essentially the same rules to which traditional market infrastructures are subject. This approach appears to be inconsistent with the idea that DLT market infrastructures are meant to innovate the technology and processes underlying traditional markets.

It is also difficult to find a clear rationale in the limitations imposed on the DLT Financial Instruments that can be traded on DLT market infrastructures. For instance, units of alternative investment funds ("AIFs") are excluded from the scope of the new rules, while units of UCITS funds are included – although UCITS funds are already liquid due to the redemption rights of the investors.

The DLT Pilot Regime Regulation follows a one-size-fits-all approach which does not take into account the material differences among various DLT trading platforms – e.g. peer-to-peer / DeFi platforms, matching orders systems, liquidity pools, etc. This will likely limit the innovation in the trading mechanisms and systems that can be implemented through the DLT technology.

The imposition of the same licensing obligations applying to existing market operators – in particular, as regards the management of securities settlement systems – could restrict the access to such market by new players and facilitates a limited number of incumbents. The new market barriers could limit the competition in the industry, and induce some EU operators to establish their trading platforms outside the EU.



Finally, the DLT Pilot Regime Regulation does not provide for a third country regime applying to platforms established outside the EU. This could limit the access by EU investors and companies to the liquidity offered by DLT trading platforms that already operate (or will start operating) in third countries, such as Switzerland, the United Kingdom or the United States. This limitation could have material implications considering how fictitious the territorial boundaries are in the field of the blockchain technology.

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