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DLT Pilot Regime - a navigator

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“It is important to ensure that Union financial services legislation is fit for the digital age and contributes to a future-proof economy that works for citizens, including by enabling the use of innovative technologies. The Union has a policy interest in exploring, developing and promoting the uptake of transformative technologies in the financial sector, including the uptake of distributed ledger technology (**DLT**).” (DLT Pilot Regime, Recital 1)

Already in June 2022, [Regulation \(EU\) 2022/858](#) – dubbed **DLT Pilot Regime** - was published in the Official Journal of the European Union.

The DLT Pilot Regime is a European market infrastructure regulation that aims to overcome the limitations and regulatory gaps in existing regulation, in particular in the [Central Securities Depositories Regulation \(CSDR\)](#) and the [Markets in Financial Instruments Regulation \(MiFIR\)](#) and that prevents barriers for decentralised market infrastructure.

The European Union considers the DLT Pilot Regime a **regulatory sandbox**. It creates a controlled environment in which DLT market infrastructures can develop and test DLT based business models for a period of up to six years. Interested market participants need to apply for specific license under the DLT Pilot Regime to act as DLT market infrastructures. Subject to this license, market participants may be released from certain obligations in the existing EU market infrastructure regulation, while being required to comply with other requirements under the DLT Pilot Regime to mitigate any resulting risks. The DLT Pilot Regime is therefore not an unregulated space, as one would typically consider a regulatory sandbox, but rather a laboratory in which market participants can experiment with a new technology under the scrutiny of supervisory authorities.

On 23 March 2023, the DLT Pilot Regime entered into force. As of this date, national competent authorities accept license applications from market participants and are permitted to issue licenses under the DLT Pilot Regime.

02

DLT Market Infrastructure

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The DLT Pilot Regime provides for the introduction of new types of market participants: DLT multilateral trading facilities (**DLT MTF**), DLT settlement systems (**DLT SS**) and DLT trading and settlement systems (**DLT TSS**).

DLT MTF

A **DLT MTF** is a multilateral trading facility (*MTF*) that only admits to trading DLT financial instruments.

Multilateral trading facilities are multilateral systems that are operated by authorised investment firms or market operators, and which bring together third parties that are interested in buying and selling financial instruments.

Trading platforms for crypto-assets that operate on a multilateral basis already exist in the market. However, they usually do not trade crypto-assets that also qualify as DLT Financial Instruments but mainly cryptocurrencies. An MTF has to be distinguished from entities that offer a broker/dealer service in relation to crypto-assets. Those “exchanges” do not bring together third parties and would not qualify as DLT MTF.

DLT SS

A **DLT SS** is a settlement system that settles transactions in DLT Financial Instruments against payment or against delivery and that allows the initial recording of DLT Financial Instruments or allows the provision of safekeeping services in relation to DLT Financial Instruments.

Settlement systems are operated by central securities depositories (*CSD*) which are authorised under the CSDR. CSD contribute to a large degree to maintaining post-trade infrastructures that safeguard financial markets and give market participants confidence that securities transactions are executed properly and in a timely manner. As such, the CSDR provides for, among others, shorter settlement periods, settlement discipline measures and an obligation regarding the dematerialisation for most securities. The settlement of transactions in DLT Financial Instruments follows a different technological route (see Section 05 re. “disintermediation in settlement”)

DLT TSS

A **DLT TSS** takes account of the abovementioned potential merger between trading and post-trading (incl. settlement) functions. A **DLT TSS** is a **DLT MTF** or **DLT SS** that combines services performed by a **DLT MTF** and a **DLT SS**. This combination of trading and post-trading activities within a single entity is not envisaged by the existing rules, due to, according to the DLT Pilot Regime “*policy choices related to risk specialisation and unbundling for the purposes of encouraging competition*”. **DLT TSS** can be operated by investment firms, market operators, credit institutions or *CSDs*.

Custodians, CCPs, crypto-custodians and crypto registrars

The DLT Pilot Regime does not describe whether and how other intermediaries that are part of the “traditional” market infrastructure or may be required to operate a DLT market infrastructure, should be regulated, such as security custodians,

central counterparties (*CCP*), Custodians, *CCPs*, crypto-custodians and crypto registrars. Their role (to the extent relevant) would still be covered by national rules.

It is not excluded that certain roles may overlap. For instance, Germany has established the licensable activity as “crypto registrar” (*Kryptowertpapierregisterführer*). The activity as “crypto registrar” comprises keeping a register for German crypto securities (*Kryptowertpapierregister*). It is – at least according to the German legislator – not excluded that a crypto registrar also provides “core services” set out in Annex A of the CSDR that a *CSD* may provide and that could therefore also be part of the services that are subject to the DLT Pilot Regime. The interaction of those national regimes and the DLT Pilot Regime must be carefully considered when setting up a DLT market infrastructure.

03

DLT Financial Instruments

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The DLT Pilot Regime aims to facilitate the trading and settlement of “financial instruments” that are issued, recorded, transferred and stored using DLT (*DLT Financial Instruments*).

Financial instruments

The term financial instruments, as defined in the DLT Pilot Regime by way of reference to the [Markets in Financial Instruments Directive \(MiFID II\)](#) is broad and includes, among others, transferable securities, units in UCITS and derivatives.

However, in order to preserve investor protection, market integrity and financial stability, the types of financial instruments that can be admitted to trading or recorded on a DLT market infrastructure, are limited by the DLT Pilot Regime as follows:

- shares, the issuer of which has a market capitalisation, or a tentative market capitalisation, of less than EUR 500 million (*DLT Shares*)
- bonds and other forms of securitised debt or money market instruments with an issue size of less than EUR 1 billion (*DLT Bonds*); and

- units in collective investment undertakings in transferable securities, i.e. UCITS, the market value of the assets under management of which is less than EUR 500 million (*DLT UCITS Units*).

The DLT Pilot Regime’s limitation to “financial instruments” also delineates the DLT Pilot Regime from crypto-assets that are regulated by MiCA. The trading and settlement of crypto-assets that are regulated by MiCA is not subject to the MiFIR and the CSDR but is largely unregulated under Union law until MiCA enters into force. Therefore, there is also no necessity for the DLT Pilot Regime to provide for exemptions from any rules that are perceived as barriers to a DLT market infrastructure.

Issued, recorded, transferred and stored using DLT

The DLT Pilot Regime applies to financial instruments that are issued by way of using distributed ledger technologies. As a market infrastructure regulation, the DLT Pilot Regime

leaves the civil law framework for the issuance and transfer of securities up to the member states, which may or may not permit the issuance of financial instruments on distributed ledgers.

In 2021, Germany adopted the German Electronic Securities Act (*Gesetz über elektronische Wertpapiere, eWpG*), which permits for the issuance of electronic securities that qualify as bearer bonds under section 793 of the German Civil Code (*Bürgerliches Gesetzbuch, BGB*), which is the typical way of issuing bonds that are governed by German civil law. The eWpG permits for two types of electronic securities, centrally registered securities and decentralised registered securities (so called “**Crypto Securities**”). While the eWpG does not explicitly refer to the term “distributed ledger”, issuing Crypto Securities on DLT is – so far - the norm. Most issuances so far rely on the Polygon network or the Ethereum blockchain and may qualify as DLT Bonds.

In 2022, and largely based upon the legal regime for Crypto Securities, Germany enabled the issuance of investment fund units that are registered on a distributed ledger (cf. the Ordinance on Crypto-Fund Units (*Verordnung über Kryptofondsanteile, KryptoFAV*)) and that may also be DLT UCITS Units.

Over the last years, a new type of DLT-based instrument, so called “Stock Tokens” emerged. Stock Tokens are traditional book-entry shares that are immobilised and represented by newly issued tokens. The DLT Pilot Regime does not specify whether trading and settlement of these tokens should be governed by the DLT Pilot Regime. In order for the “Stock Tokens” to be subject to the DLT Pilot Regime, however, they would presumably have to qualify as DLT Financial Instruments themselves.

04

License application and legal obligations

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License requirement

Operating a DLT MTF, DLT SS or DLT TSS requires a specific license under the DLT Pilot Regime.

Eligible applicants for such license are:

- **DLT MTF:** Authorised investment firms or operators of regulated markets (including credit institutions authorised as investment firm or operators of regulated markets).
- **DLT SS:** Legal persons authorised as a CSD.
- **DLT TSS:** Legal persons authorised as a CSD, authorised investment firms or operators of regulated markets (including credit institutions authorised as investment firm or operators of regulated markets).

Unregulated entities may apply for a specific license under the DLT Pilot Regime if they apply for a license as investment firm, operator of a regulated market or, as the case may be, CSD, in parallel.

A license is valid throughout the Union and does not have to be specifically passported. ESMA keeps a public register of licensed entities on its website.

License application

Applicants must apply for a license with a national competent authority, which in the case of Germany would be BaFin. The application is reviewed in parallel by ESMA which issues a non-binding opinion on the exemptions requested or on the adequacy of the type of distributed ledger technology used for the DLT Pilot Regime.

ESMA has so far issued the following:

- [Template for general information of the applicant;](#)
- [Template for information that should be included in an application for permission to operate a DLT MTF, a DLT SS or a DLT TSS;](#)
- [Application for a permission to operate a DLT MTF or DLT TSS: Exemption\(s\) to Directive 2014/65/EU and Regulation \(EU\) No 600/2014;](#)
- [Application for permission to operate a DLT SS or DLT TSS: Exemption\(s\) to Regulation \(EU\) No 909/2014.](#)

Exemptions and obligations

Save for exemptions under the DLT Pilot Regime, DLT market infrastructures and their operators are

subject to all requirements that apply to traditional MTF and CSDs, in particular under MiFIR, MiFID II and CSDR.

Together with their licensing applications, DLT MTF, DLT SS and DLT TSS can request exemptions from the application of certain requirements that traditionally apply to MTF and CSDs. In each case, competent authorities can only grant such exemptions if the applicant fulfils requirements specific to each exemption. Once granted, the exemption only applies to the DLT market infrastructure bit of firms' activities and not to the remainder of their regulated business activities.

The key exemptions are:

- **Open access:** Traditionally, only certain types of institutional investors can participate in MTF or settlement systems. On the other hand, trading platforms for crypto-assets usually provide direct access to trading for a broader group of clients, potentially including retail clients. This waives the requirement for broker/dealer intermediaries. In light of these developments, natural and legal persons that are of sufficiently good repute and have sufficient levels of knowledge and abilities (which may include

retail clients) may be permitted to directly participate in DLT MTF, DLT SS and DLT TSS.

- **No MiFIR transaction reporting:** A DLT MTF can request to be released from the obligation to report transactions to the competent authorities (cf. Art. 26 MiFIR). However, a DLT MTF must still keep records of all transactions executed through its systems itself and the same set of information, as required under Art. 26(3) MiFIR must be recorded and be made directly and immediately accessible to the competent authority. This also requires granting the competent authority an “regulatory observer participant” status on the DLT MTF. Accordingly, the value of this “exemption” may be limited.
- **No book-entry form:** Traditionally, any issuer of securities which are admitted to trading or traded on trading venues (such as MTF) must arrange for such securities to be represented in book-entry form as immobilisation or subsequent to a direct issuance in dematerialised form. Transactions in such securities must be recorded in book-entry form in a CSD. This traditional “book-entry” may be obsolete for DLT Financial Instruments, and its existence may

04 License application and legal obligations

hinder the registration with a CSD, and, as a result, their trading on trading venues. An exemption may therefore be claimed.

- **No CSDR requirements regarding settlement discipline:** CSD are traditionally subject to strict requirements to prevent and address settlement failures. Such failures can arise as a result of the failure to deliver securities on time or at all, as well as the failure to deliver the owed payment. The risk of settlement failures may, however, not arise in DLT-based settlement systems, which can allow for an almost instant settlement process and a true ‘delivery versus payment system’ (for details see at Section 05).
- **No cash settlement via central bank money required:** CSD are generally held to settle the cash payments of its securities settlement system through accounts opened with a central bank of issue of the relevant currency. Traditional “delivery versus payment” would require effectuating payment simultaneously to the settlement of the security, which may not be achievable for a transfer of the security on the distributed ledger. As long as central bank money on a distributed ledger (e.g. a Digital Euro) is not available, commercial money on DLT basis (such

as “e-money tokens”) may be used, which, however, requires an exemption from the CSDR requirement.

- **No CSDR settlement finality requirements:** Settlement finality guarantees that transfer orders which enter into such systems are also finally settled, regardless of whether the sending participant has become insolvent or transfer orders have been revoked in the meantime. This is traditionally achieved by designating and notifying securities settlement systems under Directive 98/26/EC (*Settlement Finality Directive*). However, it may be difficult for a DLT SS to be eligible for Directive 98/26/EC. Therefore, the DLT Pilot Regime permits to operate DLT SS that are not eligible, provided certain measures to mitigate risks arising from insolvency are complied with.

Claiming an exemption does not mean that the relevant activity is not subject to ongoing requirements. The DLT Pilot Regime subjects DLT market infrastructure providers to additional requirements that compensate for the exempted duties or address the additional risks potentially associated with the use of distributed ledger technologies.

05

Benefits and limitations of the DLT Pilot Regime

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For European Union financial services legislation, the DLT Pilot Regime’s “regulatory sandbox” approach is quite unique. A sandbox has benefits and limitations that should be considered before applying for a license as DLT Market Infrastructure or issuing or investing in DLT Financial Instruments.

Benefits

The ‘tokenisation’ of financial instruments, i.e. the digital representation of financial instruments on distributed ledgers or the issuance of traditional asset classes in tokenised form to enable them to be issued, stored and transferred on a distributed ledger, is expected to open up opportunities for **efficiency improvements** in the trading and post-trading process.

In particular, the DLT Pilot Regime may foster **disintermediation in trading**. Opening up the direct trading access to a larger group of traders, including, potentially, retail investors, removes the need for broker/dealer (and therefore cost-savings).

DLT Market Infrastructure also contributes to **disintermediation in settlement**. A “settlement” of transactions in financial instruments issued on distributed ledger, however, does not follow the classical trading, clearing and settlement cycle. Those elements can merge into one. In particular,

the actual exchange of the financial instrument and the compensation (“payment”) for the instrument can be effectuated by way of smart contracts in nearly real time. This requires that also the payment is effectuated by an instrument that is issued on distributed ledger. Such instrument may be a Central Bank Digital Currency (CBDC) or a payment token that has been issued by a private issuer. The DLT Pilot Regime suggests the use of ‘e-money tokens,’ which is a specific form of stablecoin regulated under the Markets in Crypto-Assets Regulation (MiCA).

Settlement of an instrument or “payment” in a distributed ledger is carried out by way of creating a new register entry that attributes the instrument to its owners account (“public key”). In the process of settling a transaction in financial instruments issued on distributed ledger, two different unconnected distributed ledgers may be involved, i.e. the ledger that registers the financial

instrument and the ledger that registers the “payment” instrument. Certain smart contracts, so called “Hashed Timelock Contracts” (HTLC), provide for an option that both registrations are dependent on each other, i.e. that none of the instruments is re-registered without the other being re-registered on the other ledger. HTLC enable cross-chain settlements that are usually referred to as “atomic swaps.” This mechanism permits a true “**delivery versus payment**” (DVP) without requiring a trusted intermediary. DVP (as defined in the CSDR) refers to securities settlement mechanisms which link a transfer of securities with a transfer of cash in a way that the delivery of securities occurs if and only if the corresponding transfer of cash occurs and vice versa. Ensuring DVP is traditionally one of the key obligations of CSDs.

The DLT Pilot Regime does not waive the requirement for market infrastructure that settles DLT Financial Instruments to be operated by a licensed entity entirely, but still requires a DLT SS or DLT TSS. However, with the combination of trading and settlement, it permits **new business models** and potentially, **new entrants** into this market segment.

Furthermore, it enables a **secondary market** for DLT Financial Instruments.

05 Benefits and limitations of the DLT Pilot Regime

Limitations

While the DLT Pilot Regime in theory enables to set the foundations for a DLT-based market infrastructure, there are certain limitations that should be carefully considered as well: As with the change of all infrastructure, the establishment of DLT-based market infrastructure faces a **collective action problem** even if it is permissible from a regulatory perspective. Its establishment requires a common shift by investors, issuers and market infrastructure provider onto the new system in order to become a liquid market. Therefore, a more or less close cooperation of market participants will still be required to create a thriving DLT ecosystem.

The most notable limitation of attractiveness are the size limits at the moment of admission to trading:

- **DLT Shares:** shares, the issuer of which has a market capitalisation of less than EUR 500m
- **DLT Bonds:** with an issue size of less than EUR 1bn (disregarding corporate bonds issued by issuers whose market capitalisation did not exceed EUR 200 million at their initial issuance)

- **DLT UCITS Units:** the market value of the assets under management of which is less than EUR 500m.

Size limit per DLT Market Infrastructure: The aggregate market value of all DLT Financial Instruments admitted to trading/recorded on a DLT market infrastructure must not exceed EUR 6bn at the moment of admission to trading of additional DLT Financial Instruments. If a threshold of EUR 9bn is reached, then the operator of the DLT market infrastructure must undertake a transition of its distributed ledger technology operations to traditional market infrastructures or cease respective operations. Those size limits significantly **limit the attractiveness** of the DLT Pilot Regime and may result in **liquidity fragmentation** for market participants.

Permissions under the DLT Pilot Regimes are valid for up to six years. It is uncertain whether and how DLT Market Infrastructure may be operated after the planned end of the “regulatory sandbox”.

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Legal Sources

06 Legal Sources

Title	Content	Link
Regulation (EU) 2022/858	DLT Pilot Regime	https://eur-lex.europa.eu/legal-content/DE/TXT/?uri=CELEX%3A32022R0858
Guidelines on standard forms	Guidelines on standard forms, formats and templates to apply for permission to operate a DLT Market Infrastructure	https://www.esma.europa.eu/sites/default/files/library/esma_70-460-206_final_report_on_dltr_gl_on_application_for_permission.pdf
Q&A	Q&A on the on DLT Pilot Regime	https://www.esma.europa.eu/sites/default/files/library/esma70-460-189_qas_dlt_pilot_regulation.pdf
Report on the DLT Pilot Regime	Report on the DLT Pilot Regime and compensatory measures on supervisory data	https://www.esma.europa.eu/sites/default/files/library/esma70-460-111_report_on_the_dlt_pilot_regime.pdf

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