



Draft Report of the European Parliament on the European Commission proposal for a Regulation on a pilot regime for market infrastructures based on distributed ledger technology. International Bulletin of November 2021.

On 9 March, the Committee on Economic and Monetary Affairs (ECON) of the European Parliament published a **draft report** (prepared by Johan Van Overtveldt of the European Conservatives and Reformists Group) **on the European Commission proposal for a Regulation on a pilot regime for market infrastructures based on distributed ledger technology**. Following the submission of 500 amendments, the report was discussed and approved by the ECON on 13 July, and inter-institutional talks between the European Parliament, the European Commission and the Council to reach a binding agreement for the future regulation in the shortest possible time were also given the go ahead.

The European Commission's proposal for a Regulation on a pilot regime for market infrastructures based on distributed ledger technology (DLT) is part of the **digital finance package** published by the institution on 24 September 2020, which also includes the following initiatives: a) a regulatory proposal for the crypto-asset markets that regulates the issuance of and services relating to crypto-assets that fall outside the current legislation on financial services in the European Union; b) a new digital finance strategy to advance towards a European financial data area, promote new ways to channel finance to SMEs and bring about better financial products for consumers; c) a retail payments strategy to provide secure, fast, reliable and affordable payment services; and d) a legislative proposal on digital operational resilience of financial institutions to close the door to cyberattacks and improve the supervision of outsourced services (including cloud services).

1. Proposal for a European Commission Regulation on a pilot regime for market infrastructures based on DLT

The proposal aims to develop secondary markets for financial instruments in the form of crypto-assets by providing a mechanism that allows market infrastructures wishing to trade and settle transactions to experiment with a limited use of DLT and gain experience in new opportunities and problems arising, while at the same time safeguarding financial stability, investor protection and market integrity. It is based on a sandbox approach as the experience and knowledge acquired by authorities and market participants will help define the content of future European legislation in this area.

DLT market infrastructures will have special authorisation that affords them a temporary exemption from some of the requirements of the Markets in Financial Instruments Directive (MiFID II) and the Central Securities Depositories Regulation (CSD Regulation), provided that they can demonstrate that the application of the provision for which exemption is requested is incompatible with the use of DLT, propose compensatory measures to achieve the objectives pursued by the provisions with respect to which exemption is requested and comply with the specific conditions associated with these exemptions. The National Competent Authority (NCA) will provide details in the specific authorisation for each DLT-based market infrastructure of any additional

measures necessary to address the new types of risk deriving from the use of DLT.

There are two categories of DLT market infrastructures: DLT multilateral trading facilities (MTFs) and DLT securities settlement systems (SSSs).

A DLT MTF, operated by an Investment Firm (IF) or a market governing body, may request exemption from the application of Article 3.2 of the CSD Regulation so that securities can be registered with the MTF itself and not necessarily with the CSD. In this case, the MTF must establish robust procedures to guarantee the integrity of the issuance of the securities, custody, settlement and delivery versus payment, among others. Another proposal for a Directive, which accompanies the new proposals on digital finance, modifies several Directives to introduce changes that allow the legal fit of these proposals. In regard to the pilot DLT regime, a section 3 has been included in Article 19 of MIFID II to allow DLT MTFs to apply for temporary exemption (for up to four years) from the obligation of intermediation and to provide direct access to retail investors as members or participants of the MTF, provided that they are fit and proper for anti-money laundering and combating the financing of terrorism purpose.

A DLT SSS will be operated by a Central Securities Depository (CSD). The DLT SSS may request exemption from some of the provisions of the CSD Regulation, such as: (a) Article 2.4 on dematerialised form; (b) Article 2.9 on transfer orders; (c) Article 2.28 on securities accounts; (d) Article 3 on book-entry form; (e) Article 37 on the integrity of the issue (provided that the number of DLT transferable securities making up an issue or part of a securities issue submitted to a CSD, operating a DLT SSS is equal to the sum of securities registered in the distributed ledger); (f) Article 38 on the segregation of assets; (g) Article 2.19 on admission as participants; (h) Article 40 on cash settlement (provided that it guarantees delivery against payment) and Articles 50 and 53 on standard link access and access between a CSD and another market infrastructure (provided that it demonstrates that the use of the DLT is incompatible with legacy systems).

Furthermore, the proposal envisages that cash payments can be replaced by e-money tokens in both DLT infrastructures.

Only the following transferable securities in the form of crypto-assets, i.e. DLT securities, can be traded and settled under the pilot regime: a) shares of issuers with a (tentative) market capitalisation of less than €200 million, and b) bonds other than sovereign bonds with an issuance size of less than €500 million. Furthermore, the total market value of the transferable securities recorded on a DLT market infrastructure cannot exceed €2.5 billion.

Further to the specific conditions attached to exemptions and compensatory measures, in accordance with the proposed Regulation, all DLT market infrastructures must comply with a series of additional requirements, such as establishing a business plan to describe the technical aspects related to the use of DLT, ensuring that the information and cyber arrangements of the DLT market infrastructure are commensurate with the nature, scale and complexity of their business or establishing a strategy for transitioning out of or winding down a market infrastructure to be deployed in a timely manner (in the event that the authorisation or any of the exemptions are suspended or revoked, or in the event of voluntary cessation). In particular, DLT SSSs and DLT MTFs that are permitted to settle transactions must establish operating rules for access to the DLT, the rules for the participating nodes and the rules to address potential conflicts of interest, as well as risk management measures (including mitigation measures).

The specific permission granted to a DLT SSS or MTF will be valid throughout the European Union for up to six years, although it can be withdrawn if a failure in the operation of the DLT is detected, there is a lack of compliance with attached conditions or the transferable securities admitted/recorded in the DLT are not included in the scope.

ESMA has, among others, the following tasks: (a) to issue a non-binding opinion on the NCA responsible for

authorising the DLT market infrastructure that includes the requested exemptions; (b) publish on its website the list of DLT SSSs and MTFs; (c) fulfil a coordination role between competent authorities to build a common understanding of DLT; (d) build a common supervisory culture of DLT SSSs and MTFs; (e) submit an annual report to the European Commission on the application of exemptions, compensatory or corrective measures granted to DLT market infrastructures; and (f) no later than five years from the application of the pilot scheme submit a report on the functioning of DLT SSSs and MTFs, and the risks and benefits of using DLT.

The duration of the DLT pilot scheme will be five years, after which the Commission, on the basis of ESMA's advice, will have to assess the costs and benefits of extending the DLT market infrastructures scheme for a further period of time, whether to extend the regime to new types of financial instruments, make it permanent (with or without amendments) or terminate the regime. The European Commission may propose any appropriate modifications to the Union framework on financial services legislation or harmonisation of national laws that would facilitate the use of distributed ledger technology in the financial sector as well as any measures needed to bridge the transition of DLT market infrastructures out of the pilot regime.

2. Draft Report of the European Parliament on the European Commission proposal for a Regulation on a pilot regime for market infrastructures based on distributed ledger technology

The report approved by the ECON highlights a number of **potential benefits** in the Commission's proposal for the provision of financial services. These include reducing complexity, greater speed of end-to-end processing, more transparency and immutability in the recording of transactions, increased network resilience through distributed data management, and fewer operational and financial risks. It also considers that to develop successful DLT projects at European level requires the European Union to adopt an ambitious approach.

The report also mentions its **support for the general objectives** of the proposal, which are the following: (a) to provide legal certainty by setting uniform requirements to manage DLT market infrastructures; (b) support innovation by removing obstacles to the application of DLT, allowing the entire financial sector to gain experience in its use; (c) instil consumer and investor protection and market integrity through supervision and cooperation between ESMA and NCAs, and (d) ensure financial stability by creating proper safeguards, e.g. limiting the size of the pilot scheme and the types of financial instruments that can be traded or recorded.

However, it also contains a **series of amendments to the text of the European Commission proposal** that mainly affect the following aspects:

.- Scope of application

The proposed Regulation, as stated above, puts limits on the entities and transferable securities that are eligible for the pilot scheme and establishes certain financial thresholds to ensure investor protection, market integrity and financial stability.

The ECON report recommends limiting the DLT pilot scheme to certain market infrastructures, specifically DLT MTFs and DLT SSSs, but at the same time advocates the creation of a new type of market infrastructure for operators wishing to combine pre- and post-trade functions.

In regard to DLT transferable securities eligible for the pilot scheme, the ECON report proposes to broaden the scope of application by not excluding sovereign bonds and including units of exchange-traded funds. The report argues that public bonds should not be left out, causing a transfer of funds from sovereign bonds to corporate bonds while holdings in DLT ETFs could attract institutional investors.

In regard to financial thresholds, the ECON report considers that while the aggregate threshold for the total market value of DLT transferable securities proposed by the Commission appears to strike an appropriate balance between respect for innovation and protection from risks, the proposed individual financial thresholds would cover most shares and bonds currently traded on the stock markets. Therefore, the report proposes a

more prudent approach with significantly lower individual thresholds to only include in the pilot scheme DLT securities (shares and bonds) whose issuers have a (tentative) market capitalisation of less than €50 million. In this way, the DLT pilot scheme could be considered a useful tool for financing SMEs.

The ECON report also highlights the need for technology-neutral wording to describe the use of different types of DLT by the different market infrastructures compared to the Commission's proposal that seems to impose the exclusive use of specific DLTs by specific market infrastructures (e.g. proprietary DLT).

.- Level playing field for market infrastructures and proportionality of exemptions granted by the NCAs

The Commission proposal provides for the possibility of DLT MTFs carrying out CSD-specific activities under the pilot scheme but does not offer DLT SSSs the same opportunity to carry out MTF-specific activities. This means that DLT market infrastructures may follow different rules when they perform the same activity.

The ECON report considers that there is room to improve some provisions of the Commission proposal so as to ensure a genuine level playing field between DLT market infrastructures competing inside the Pilot Regime, keeping in mind the fundamental principle of "same activity, same risks, same rules". To preserve a level playing field for the two types of DLT market infrastructures, it proposes a **symmetric approach**, which means that a DLT MTF that provides settlement services must comply with the same requirements as a DLT SSS, and a DLT SSS must be allowed to perform the functions of a DLT MTF and also comply with the requirements of a DLT MTF. At the same time, in line with the ECON's proposal to create **a new type of market infrastructure** that performs trading and post-trading services mentioned in the previous section, it is recommended that whenever a DLT MTF is allowed to provide the services of a DLT SSS, and vice versa, these infrastructures must be considered "**a DLT Trading and Settlement System (TSS)**" subject to both MiFID II (for trading services) and the CSD regulation (for registry, settlement and custody services).

In regard to the proportionality of the exemptions, the ECON report suggests that as an alternative to the non-binding opinion proposed by the Commission, ESMA should issue a recommendation before the NCA is able to grant permission to a potential DLT market infrastructure to ensure a level playing field, consistency and proportionality in the exemptions awarded by the different NCAs throughout the European Union. Unlike a non-binding opinion, an ESMA recommendation is subject to the "*comply or explain*" approach for NCAs, in accordance with Article 16 of the ESMA Regulation.

.- Early-exit assessment

The ECON report considers that given the fast pace of technological innovation, a period of five years for the assessment to be made by the Commission of the functioning of the pilot scheme is too long and proposes to reduce it to three years. If, after this first three-year period, the pilot scheme has not been terminated, the Commission must present a final report after five years, as currently envisaged in the proposal. The ECON report also proposes that the Commission be given, on the basis of ESMA's advice, the competence to adjust certain thresholds through a delegated act as it is to be expected that, the longer the pilot regime continues, the more likely financial thresholds will be exceeded, and the bigger any potential transition efforts to a more permanent regime will be.

Useful links:

[Draft report of the European Parliament \(ECON\) on the proposal for a regulation of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology](#)

[Proposal for a European Commission Regulation on a pilot regime for market infrastructures based on](#)

distributed ledger technology

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