



The EU DLT Pilot Regime: 11 things for firms to consider

23 March 2023

The EU's DLT Pilot Regime launches today, 23 March 2023. In this briefing we outline 11 things that firms should understand or consider before applying.

The DLT Pilot Regime allows operators of market infrastructure to test distributed ledger technology ('DLT') in the issuance, trading and settlement of tokenised financial instruments. Firms must apply to the scheme and, if successful, will receive a time-limited authorisation to operate a specific type of DLT market infrastructure ('DLT MI'). As part of their authorisation, firms may be granted exemptions from certain requirements under MiFID II, MiFIR, and/or CSDR¹. Those exemptions are critical, and allow firms to experiment with DLT in a manner that is otherwise prohibited or the subject of regulatory ambiguity.

This article outlines 11 issues that firms should understand or consider before applying to the DLT Pilot Regime. We refer to the provisions contained in the regulation establishing the DLT Pilot Regime (the 'DLT Regulation')² and the associated guidelines published by ESMA (the 'DLT Guidelines')³. We have not sought to provide a general overview of the DLT Pilot Regime, given the availability of summaries elsewhere.

11 things for firms to understand or consider:

- The DLT Pilot Regime is targeted in its scope
- Aggregate market value thresholds apply
- Firms may experiment with cash settlement options
- Operators must prepare to transition to traditional market infrastructure
- Regulatory exemptions present unique opportunities, but are subject to conditions
- The application process is prescriptive and requires careful consideration
- Material changes to a DLT MI's operations may necessitate a further application – and permissions can be withdrawn
- Operators will be held liable for certain losses
- Firms should expect to work closely with regulators throughout the life of the regime
- The DLT Pilot Regime is not a panacea for all legal and regulatory issues
- Authorisation is temporary in nature and the DLT Pilot Regime's longer-term role is uncertain

1 Directive 2014/65/EU of 15 May 2014 (MiFID II), Regulation (EU) No 600/2014 of 15 May 2014 (MiFIR) and Regulation (EU) No 909/2014 of 23 July 2014 (CSDR).

2 Regulation (EU) 2022/858 of 30 May 2022.

3 Guidelines on standard forms, formats and templates to apply for permission to operate a DLT Market Infrastructure, published by ESMA on 8 March 2023. In this note we have assumed the DLT Guidelines will be adopted by all NCAs, although NCAs are (at least technically) able to decide not to comply. Further technical guidance is set out in ESMA's Q&A document, published on 3 February 2023.

1 The DLT Pilot Regime is targeted in its scope

The scope of the DLT Pilot Regime is set by two parameters. First, by the categories of DLT MI contemplated by the regime. And second, by the types, and sizes, of DLT financial instruments that may be admitted to such DLT MI. The term ‘**DLT financial instrument**’ refers to a financial instrument, as defined in MiFID II, that is issued, recorded, transferred and stored using DLT.

The effect of these parameters is to limit the scope of the regime to platforms and products that are broadly analogous to regulated trading venues and traditional securities, save for their use of DLT.

DLT MI contemplated by the DLT Pilot Regime

The following three categories of DLT MI are contemplated by the DLT Pilot Regime:

- DLT multilateral trading facilities (**‘DLT MTFs’**), being MTFs that only admit DLT financial instruments to trading.
- DLT settlement systems (**‘DLT SS’**), being systems that facilitate the settlement of DLT financial instruments against payment or delivery and allow the initial recording of DLT financial instruments or the provision of safekeeping services in relation to DLT financial instruments.
- DLT trading and settlement systems (**‘DLT TSS’**), being DLT MTFs or DLT SSs that combine the services performed by a DLT MTF and DLT SS. This confers a new and unique regulatory status, enabling operators to offer services throughout the product lifecycle (in contrast to the traditional rules, which envisage trading and settlement activities being performed by separate market infrastructure (**‘MI’**)).

Generally, the DLT Pilot Regime envisages applicants being authorised as an investment firm or market operator under MiFID II or as a central securities depository (**‘CSD’**) under CSDR, depending on which

sort of DLT MI the applicant is seeking to operate. However, the regime is also open to unauthorised new entrants, provided they make a simultaneous application for authorisation under MiFID II and/or CSDR (as applicable) when applying to the DLT Pilot Regime.

A related point is that firms looking to participate in another capacity (e.g. as an investor or issuer of a DLT financial instrument) will need to partner with a DLT MI operator.

DLT financial instruments permitted by the DLT Pilot Regime

Only the DLT financial instruments specified in Article 3(1) of the DLT Regulation may be admitted to trading or recorded on a DLT MI. Other forms of financial instruments (such as derivatives and emissions allowances) are out of scope, as are cryptocurrencies and other cryptoassets that do not qualify as financial instruments under MiFID II.

The eligible DLT financial instruments listed in Article 3(1) of the DLT Regulation are:

- Shares, where the issuer has a market capitalisation or tentative market capitalisation of less than €500m. This effectively excludes large corporates’ or financial institutions’ shares from being admitted to DLT MIs, which has been criticised in some quarters⁴.
- Bonds and other forms of securitised debt (including depositary receipts in respect of such securities and money market funds), where the issuance size is less than €1bn. Instruments that embed a derivative (or which ‘incorporate a structure that makes it difficult for clients to understand the risks involved’) are excluded.
- Units in authorised UCITS, provided that market value of assets under management is less than €500m. Non-UCITS collective undertakings and structured UCITS⁵ are excluded.

The relevant national competent authority (**‘NCA’**) may set lower thresholds than those specified above. The financial instruments that

⁴ On the basis that SME issuers are less likely to have the inclination or resources to list their equity securities on DLT MI when compared to larger issuers.

⁵ As referred to in Article 36(1) of Regulation (EU) No 583/2010.

may be admitted to a DLT MI are also subject to aggregate market value thresholds, explained below.

2 Aggregate market value thresholds apply

The DLT Regulation specifies certain aggregate market value limits, in addition to the product thresholds specified above. Those limits apply on a per-DLT MI basis and serve to the limit, for financial stability reasons, the overall trading volumes of each DLT MI. The thresholds have proven to be somewhat controversial, due to the consequences of the thresholds being breached.

The thresholds, which may be lowered by NCAs, are set out in Article 3(2) and (3) of the DLT Regulation and provide that:

- The aggregate market value of all DLT financial instruments that are admitted to trading or are recorded on a DLT MI must not exceed €6bn. The market value of a DLT financial instrument is determined at the point in time that the DLT financial instrument is admitted to trading or initially recorded. If the limit is exceeded, no new DLT financial instruments may be admitted or recorded on the DLT MI.
- If the aggregate market value of all DLT financial instruments that are admitted to trading or are recorded on a DLT MI exceeds €9bn, the operator must activate its transition strategy (described in paragraph 4, below) and notify its NCA.

To assess their ongoing compliance with such requirements, firms must calculate the monthly average aggregate market value of DLT financial instruments traded or recorded on the DLT MI, by reference to the daily closing prices of each DLT financial instrument.

3 Firms may experiment with cash settlement options

Traditional CSDs are required, under CSDR, to settle transactions using central bank money where practical and available. The DLT Pilot Regime enables operators of DLT SS or DLT TSS to apply for an exemption from those requirements. If granted, operators may settle transactions using commercial bank money (including in tokenised form) or e-money, until tokenised central bank money (i.e. wholesale

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CBDC) becomes available.

The approach to cash settlement will be a key element to operators' system designs. Using an on-ledger solution is not mandatory under the DLT Pilot Regime, but operators will no doubt want to consider tokenised settlement options wherever possible, due to the greater efficiencies they are expected to bring.

4 Operators must prepare to transition to traditional market infrastructure

One of the key obligations for DLT MI operators under DLT Pilot Regime is the requirement to establish and maintain a 'transition strategy'. Amongst other things⁶, the transition strategy must set out the operator's plans for reducing the activity of the DLT MI or for transitioning out of, or ceasing to operate, the DLT MI, including the transition or reversion of its DLT operations to traditional MI.

An operator's transition strategy will be triggered in three situations:

- First, when the €9bn aggregate market value threshold described previously has been exceeded.
- Second, when a specific permission or exemption granted to the operator of the DLT MI is to be withdrawn or otherwise discontinued (including as a result of the DLT Pilot Regime itself being discontinued).
- Third, upon the voluntary or involuntary cessation of the business of the DLT MI.

New entrants that do not already operate traditional MI should take particular note of Articles 7(8) to (10) of the DLT Regulation. Those provisions require the new entrant to use best endeavours to conclude arrangements with third-party operators of traditional MI ('third-party arrangements'). In the event the transition strategy is triggered, the DLT financial instruments traded or recorded on the affected DLT MI would be transferred to the traditional MI pursuant to

those third-party arrangements.

Third-party arrangements do not necessarily need to be established at the time an application is made, as long as they are in place no later than five years from the permission being granted (unless where required earlier by the relevant NCA). Notably, Article 7(9) limits the circumstances in which CSDs can deny requests for third-party arrangements and sets certain general standards as regards the terms on which access may be given.

Preparing a transition strategy will require considerable thought, and will form a central component of a firm's application for application.

5 Regulatory exemptions present unique opportunities, but are subject to conditions

The centrepiece of the DLT Pilot Regime is the availability of 20 different exemptions to specific regulatory requirements under MiFID II, MiFIR and/or CSDR. Those exemptions create a unique testing environment for DLT MI, in which firms can experiment under the auspices of the relevant NCA.

Exemptions must be requested individually as part of the application process. Applicants intending to operate a DLT MTF may apply for the MiFID II and MiFIR exemptions specified in Article 4(2) and (3) of the DLT Regulation, whereas applicants intending to operate a DLT SS may apply for the CSDR exemptions specified in Article 5(2) to (9) of the DLT Regulation. Applicants intending to operate a DLT TSS may apply for both sets of exemptions.

Before applying to the DLT Pilot Regime, then, potential applicants should first consider which exemptions are needed to achieve their objectives (and, in fact, whether the project could be tested on a privately placed basis rather than through a DLT MI, in which case participation in the DLT Pilot Regime may not be necessary at all).

⁶ Article 7(7) of the DLT Regulation also requires the transition strategy to (i) set out how members, participants, issuers and clients are to be treated in the event of a withdrawal or discontinuation of a specific permission or the cessation of the DLT MI's business (ii) set out how clients, in particular retail investors, are to be protected from any disproportionate impact from the withdrawal or discontinuation of a specific permission or the cessation of the DLT MI's business and (iii) specify what steps will be taken in the event the €9bn aggregate market value threshold is exceeded.

When applying for exemptions, firms should bear the following points in mind:

- First, the exemptions that may be granted under the DLT Regulation are targeted in nature, i.e. they only relate to the regulatory requirements that prevent firms from testing DLT-based solutions in an MI context. Accordingly, firms must comply with all other regulatory requirements in full, including those under MiFID II, MiFIR and CSDR. Firms will thus need to be cognisant of whether (and how) any DLT processes impact any non-exempted regulatory requirements.
- Second, certain conditions and compensatory measures apply to the exemptions granted under the DLT Pilot Regime. Those conditions and measures are intended to mitigate the risks associated with the granting relevant exemption, whether from an investor protection, market integrity or financial stability perspective. Firms must explain any proposed compensatory measures, and how the relevant conditions set out in the DLT Regulation are to be complied with, as part of their application.

A good illustrative example concerns the exemption to the MiFID II transaction reporting obligations. While exemptions could prove useful in theory, Article 4(3) of the DLT Regulation requires DLT MTFs to keep records of the transactions executed through its systems and to ensure that its NCA has direct and immediate access to those records. This is a particularly onerous condition and one that, arguably, calls the usefulness of the exemption into question.

- Third, applicants must demonstrate that each requested exemption is (i) proportionate to, and justified by, the use of DLT and (ii) limited to the DLT MI applied for, i.e. that the exemption does not extend to other MI operated by the applicant. Both aspects need to be explained and evidenced when applying to the DLT Pilot Regime.

6 The application process is prescriptive and requires careful consideration

To apply to the DLT Pilot Regime, firms must submit a completed application form, along with any supporting materials, to the relevant NCA⁷. Details of the application requirements, as well as standard forms, formats and templates, are set out in the DLT Guidelines. Although prescriptive, those standards are described as the minimum instructions that NCAs should provide to market participants, and NCAs may specify additional requirements in due course. ESMA is required to produce additional guidance⁸ as well, which may have a bearing on future applications.

Firms will need to submit different categories of information as part of their application. The requirements are set out in Articles 8(4), 9(4) and 10(4) of the DLT Regulation, but also more conveniently split out in separate tables in the annex to the DLT Guidelines. By way of summary:

- Table 1 covers basic information required by all applicants. For example, the name and LEI of the applicant, which type of DLT MI it is seeking to operate, and its existing MiFID II or CSDR authorisations (if any).
- Table 2 covers more detailed information required by all applicants. Examples include the business plan of how the applicant intends to carry out its services and activities, the rules of the proposed DLT MI, certain technical information concerning how the proposed DLT aspects will function, and details of the applicant's transition strategy.
- Table 3 must only be completed if the applicant is seeking to operate a DLT MTF or DLT TSS, and lists the two exemptions which potential DLT MTF or DLT TSS operators may apply for.
- Table 4 must only be completed if the applicant is seeking to operate a DLT SS or DLT TSS, and lists the 18 exemptions which potential DLT SS or DLT TSS operators may apply for.

⁷ The relevant NCA will generally be the NCA designated by the Member State in which the applicant entity is established or in which its registered office is situated. See Article 12 of the DLT Regulation.

⁸ The ESMA guidance required under Articles 8(8) and 9(8) is of the DLT Regulation is intended to promote the consistency and proportionality of (i) the exemptions granted to DLT MTF operators and CSD DLT SS operators and (ii) the imposition by the NCAs of any product or aggregate market value thresholds lower than those set out in Article 3 of the DLT Regulation. Separate guidance is required under Articles 4(6) and 5(12) in relation to the compensatory measures that may be required by the relevant NCA in relation to authorisation as a DLT MTF or DLT SS.

Firms should ensure applications are complete on initial submission to avoid delays. NCAs have 30 working days from receipt of the application to assess whether an application is complete. The decision to grant a specific permission or not must then be made by the relevant NCA within 90 working days of its receipt of a complete application.

NCAs must refuse to grant permission if there are grounds for believing that:

- There are significant risks to investor protection, market integrity or financial stability that are not properly addressed and mitigated by the applicant;
- The specific permission to operate the DLT MI and the exemptions requested are being sought for the purpose of circumventing legal or regulatory requirements; or
- The operator of the DLT MI will not be able to comply, or will not allow its users to comply, with applicable provisions of EU law or provisions of national law falling outside the scope of EU law.

For these reasons, firms should take great care in preparing their applications and ensure that each response is sufficiently detailed (and backed by supporting documentation where appropriate). We expect that NCAs will focus on operational risk mitigation, and use the standards applicable to traditional MTFs or CSDs as a benchmark (which implicitly favours operators with experience in operating those traditional authorised trading venues). That said, it is possible that certain NCAs will adopt a more flexible line, in light of the evolving technology and the nature of the pilot regime itself.

7 Material changes to a DLT MI's operations may necessitate a further application – and permissions can be withdrawn

Operators should be aware that further permission(s) may be required in certain circumstances, in addition to those granted in response to the initial application. Further permissions must be applied for where the operator intends to introduce a material change to the functioning of the DLT used, or to the services or activities of that operator, and that material change requires a new specific permission, a new exemption, or the modification of one or more of the operator's existing exemptions or of any conditions attached to an exemption.

An operator's permissions may also be withdrawn by the relevant NCA in the circumstances set out in Articles 8(12), 9(12) or 10(12) of the DLT Regulation. For example, authorisation may be withdrawn if a flaw has been discovered in relation to the DLT being used or if the operator has breached one of the applicable exemption conditions or thresholds. Firms will therefore need robust compliance procedures in place.

8 Operators will be held liable for certain losses

Article 7(6) of the DLT Regulation provides that an operator of DLT MI will be held liable for any loss of funds, collateral or DLT financial instruments attributable to that operator, subject to a cap of the market value of the asset lost. A carve-out applies where the operator can prove that the loss arose as a result of an external event beyond the



reasonable control over the DLT MI, provided the consequences were 'unavoidable despite all reasonable efforts to the contrary'.

Participants may well have grounds to make claims against the DLT MI operator for losses in the absence of this provision. Nonetheless, its existence will bolster investors' legal position as regards any losses they suffer.

9 Firms should expect to work closely with regulators throughout the life of the regime

A firm's application will be the main hurdle to overcome when seeking authorisation under the DLT Pilot Regime. However, firms should expect to work closely with their NCA throughout the life of the DLT Pilot Regime, too. Article 11 of the DLT Regulation sets out certain requirements as regards co-operating with regulators, including requirements to:

- Notify the NCA, without delay, upon the occurrence of one or more specified

matters: for example, any material changes to the operator's business plan and any technical or operational difficulties it has experienced.

- Provide the NCA with any information it requests.
- Implement any corrective measures required by the NCA with respect to an operator's business plan or the rules and legal terms of the DLT MI.
- Submit a report to the NCA every six months, containing, amongst other things, the number of DLT financial instruments traded or recorded on the DLT MI, a reasoned assessment of any difficulties in applying EU financial services legislation or national law, and any actions taken to implement the conditions attached to any exemptions or any compensatory or corrective measures.

Substantive ongoing discourse with regulators should therefore be anticipated (and costed) at the outset of a firm's participation in the pilot regime.



10 The DLT Pilot Regime is not a panacea for all legal and regulatory issues

As explained previously, firms authorised under the DLT Pilot Regime may be exempted from certain regulatory requirements. Potential applicants should be aware, however, that the requirements contained in MiFID II, MiFIR and CSDR (against which exemptions may be sought) are not the only legal or regulatory issues to consider. For example, applicants may also need to consider:

- Whether the legal frameworks in the jurisdictions in which the DLT MI operates provide sufficient legal certainty in respect of participants' property rights in the relevant DLT financial instruments. Certain jurisdictions have enacted specific legislation to address these sorts of concerns (e.g. Luxembourg, Germany and France) but this is not yet the case in all EU jurisdictions, and conflict of laws issues persist in some cases.
- Whether additional rules or regulations exist at a national level that may prevent or inhibit the DLT MI's plans, given exemptions from those rules or regulations are not available under the DLT Pilot Regime.

11 Authorisation is temporary in nature and the DLT Pilot Regime's longer-term role is uncertain

The DLT Pilot Regime is designed as a regulatory testing environment, not as a mechanism to implement a permanent set of legislative changes. Operators' permissions and exemptions are therefore granted on a temporary basis, for a period up to six years. As there is no guarantee that permanent legislative changes will be made, there remains a risk (at least in theory) that DLT MIs will need to be wound down when the DLT Pilot Regime and any

authorisations/exemptions granted thereunder are terminated or expire.

The European Commission is required to give a view on the longer-term role of the DLT Pilot Regime in 2026⁹. This will take the form of a report to the European Parliament and Council, containing a cost-benefit analysis of whether the DLT Pilot Regime should be:

- Extended for a further period of up to three years;
- Extended to other types of financial instrument that can be issued, recorded, transferred or stored using a distributed ledger technology;
- Amended;
- Made permanent through appropriate amendments of the relevant EU financial services legislation; or
- Terminated, including all permissions granted under the DLT Regulation.

Accordingly, the European Commission's report is expected to be a significant milestone and could lead to the DLT Pilot Regime (and the exemptions granted thereunder) being transposed into a permanent framework. We believe a transposition of sorts is more likely than not.

Note that the European Commission's report will be based on a report by ESMA, due no later than 24 March 2026. This must cover the issues listed in Article 14(1) of the DLT Regulation, which includes objective data requirements relating to the operation of the DLT Pilot Regime (such as the number of DLT MIs) as well as qualitative analysis in respect of certain specified issues.

Conclusion

The DLT Pilot Regime represents a unique opportunity for forward thinking market infrastructure providers. Although applications will require significant effort, the prospect of being able to experiment with the blessing of regulators – and make tangible steps towards the broader adoption of DLT solutions – should serve as ample incentive.

⁹ The specific deadline for the European Commission report is three months of its receipt of the ESMA report referred to above. As the ESMA report is due no later than 24 March 2026, the European Commission's report should be presented to the European Parliament and the Council no later than 24 June 2026.

There are several important issues that firms should weigh up before applying, however. One issue is whether the project in question can be adequately tested outside the DLT Pilot Regime (i.e. without needing regulatory exemptions). Another is whether the applicant has the resources and knowhow to navigate the application process and to discharge the ongoing risk management, monitoring and reporting obligations that accompany authorisation.

Firms should also consider whether there are advantages in participating in the UK's forthcoming financial markets infrastructure sandbox, expected to launch later in 2023. Few concrete details are known about the design of the FMI sandbox as yet, but this could offer a more beneficial alternative to the EU DLT Pilot Regime in due course (depending on the design of the scheme and firms' operating models).

Author



Oliver Ward
Senior Practice Development Lawyer,
Financial Markets (London)
T +44 20 7825 4703
E oliver.ward@simmons-simmons.com

Key Contacts



Rosali Pretorius
Partner, Financial Markets (London)
T +44 20 7825 4187
E rosali.pretorius@simmons-simmons.com



Felix Biedermann
Partner, Financial Markets (Frankfurt)
T +49 69 907454 71
E felix.biedermann@simmons-simmons.com



Cathrine Foldberg Møller
Partner, Financial Markets (Luxembourg)
T +352 26 21 16 19
E cathrine.foldberg-moller@simmons-simmons.com



Derek Lawlor
Partner, Financial Markets (Dublin)
T +353 1266 1158
E derek.lawlor@simmons-simmons.com

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This article should not be construed as legal advice. Readers are advised to speak to their legal counsel before taking action in relation to any of the matters described above.



Angus McLean
Partner & Head of FinTech (London)
T + 44 20 7825 4142
E angus.mclean@simmons-simmons.com



Alfredo de Lorenzo
Partner, Financial Markets (Madrid)
T +3491 426 2643
E alfredo.delorenzo@simmons-simmons.com



Emilien Bernard-Alzias
Partner, Financial Markets (Paris)
T +331 5329 1652
E emilien.bernard-alzias@simmons-simmons.com



Paola Leocani
Partner, Financial Markets (Milan)
T +3902 7250 5570
E paola.leocani@simmons-simmons.com

[simmons-simmons.com](https://www.simmons-simmons.com)

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