ashurst

EU DLT Pilot Regime

A guide to the application process for operating a DLT market infrastructure

February 2023

Contents

Key Contacts

Etay Katz
Partner
London

T +44 20 7859 3133
etay.katz@ashurst.com

Pilar Lluesma
Head of Finance Regulatory (Counsel)
Madrid

T +34 913 649 443
pilar.lluesma@ashurst.com

Detmar Loff
Partner
Frankfurt

T +49 69 97 11 26 41
detmar.loff@ashurst.com

Hubert Blanc-Jouvan
Partner - Avocat à la Cour
Paris

T +33 1 53 53 53 97
hubert.blanc-jouvan@ashurst.com

Jamie Jefferson Ng
Senior Associate
London

T +44 20 7859 3153
jamie.jefferson.ng@ashurst.com

Clara Yeo
Solicitor
London

T +44 20 7859 1641
clara.yeo@ashurst.com

Tim Cant
Partner
London

T +44 20 7859 3394
timothy.cant@ashurst.com

Sid Ulker
Counsel
London

T +44 20 7859 3049
sid.ulker@ashurst.com

Conrad Ruppel
Partner
Frankfurt

T +49 69 97 11 26 22
conrad.ruppel@ashurst.com

Daniel Franks
Partner
London

T +44 20 7859 2766
daniel.franks@ashurst.com

Sophie Skeet
Senior Associate
Frankfurt

T +49 69 97 11 26 71
sophie.skeet@ashurst.com

Background

The European Union DLT Pilot Regime (**DLT Pilot Regime**), which has an implementation date of 23 March 2023, represents a significant step forward in the use of distributed ledger technology (**DLT**) in the European financial services sector. When originally drafted, EU financial services legislation did not envisage DLT and/or digital assets and therefore contains provisions which may prevent or constrain the use of DLT in the issuance, trading and settlement of financial instruments.

The DLT Pilot Regime seeks to address this state of affairs by providing authorisation to Multilateral Trading Facilities (**MTFs**) and Central Securities Depositaries (**CSDs**) to operate DLT financial market infrastructure. As part of such authorisation, MTFs and CSDs can be granted temporary exemptions, for a period of up to six years, from certain existing requirements of EU financial services legislation in order to enable the use of DLT without contravening such legislation.

Following the publication by the European Securities and Markets Authority (**ESMA**) on 15 December 2022 of *Guidelines on standard forms, formats and templates to apply for permission to operate a DLT Market Infrastructure* (**Guidelines**), new market entrants and incumbent market participants can immediately start preparing their applications to operate DLT market infrastructures (**DLT MIs**) under the DLT Pilot Regime.

The purpose of this guide

We have prepared this guide in order to assist financial markets incumbents to enlarge their scope of activities, and new financial market entrants to offer new services, pursuant to the DLT Pilot Regime. This guide provides:

- an overview of the DLT Pilot Regime;
- information about the application process for the DLT Pilot Regime;
- our observations on the approach taken by ESMA in the Guidelines; and
- a summary of the current status of the proposed UK Financial Market Infrastructure Sandbox **(FMI Sandbox)** which is considered to be the UK equivalent of the DLT Pilot Regime.

The DLT Pilot Regime

An overview

The DLT Pilot Regime, which is created by the *Regulation (EU) 2022/858 on a pilot regime for market infrastructures based on distributed ledger technology* (**DLT Regulation**), allows market infrastructure providers to use DLT for the issuance, trading and settlement of digital assets that qualify as in-scope financial instruments and within limits on volume/quantum.

1. How will the DLT Pilot Regime be implemented?

The DLT Regulation will facilitate the grant of authorisation to successful applicants to operate DLT MIs, including by granting exemptions from certain existing requirements under the following financial services legislation where such legislation potentially constrains the use of DLT:

- Markets in Financial Instruments Regulation (**MiFIR**);
- Markets in Financial Instruments Directive II (**MiFID II**); and/or
- Central Securities Depositories Regulation (**CSDR**).

As part of the application process, DLT MIs can request limited exemptions from specific requirements in the legislation listed above, provided they comply with the conditions attached to those exemptions and compensatory measures requested by the relevant national competent authority (**NCA**). Such exemptions could be granted for up to six years from the date of grant.

2. Who does the DLT Pilot Regime apply to?

There are three categories of DLT MIs under the DLT Regulation:

1. DLT Multilateral Trading Facility (**DLT MTF**), which has trading functions.
    - A DLT MTF is an MTF that is operated by an investment firm or a market operator authorised under MiFID II with specific permission under the EU DLT Regulation.
    - DLT MTFs would be subject to all requirements that apply to MTFs under MIFID II and MiFIR (as well as any other applicable EU financial services legislation) except for requirements in respect of which an exemption has been granted in accordance with the DLT Regulation (see subheading 6 below for further information).
    - A credit institution authorised under the Capital Requirements Directive IV providing investment services and/or performing investment activities would only be allowed to operate a DLT MTF when authorised as an investment firm or market operator under MIFID II.
2. DLT Settlement System (**DLT SS**), which has settlement functions.
    - A DLT SS is a settlement system operated by a CSD authorised under CSDR with specific permission to operate a DLT SS under the EU DLT Regulation.
    - A DLT SS, and the CSD which operates it, would be subject to all relevant requirements under CSDR (as well as any other applicable EU financial services legislation) except for requirements in respect of which an exemption has been granted in accordance with the DLT Regulation (see subheading 7 below for further information).
3. DLT Trading and Settlement System (**DLT TSS**), which has both trading and settlement functions.
    - DLT TSS combines the activities normally performed by MTFs and securities settlement systems and can either be:

a) a DLT MTF that combines the services performed by a DLT MTF and a DLT SS, and be operated by an investment firm or market operator that has received a specific permission to operate a DLT TSS under the DLT Regulation; or

b) a DLT SS that combines the services performed by a DLT MTF and a DLT SS, and be operated by a CSD that has received a specific permission to operate a DLT TSS under the DLT Regulation.

- A DLT TSS will be subject to both the MTF requirements under MiFID II/MiFIR and the CSDR, subject to any exemptions under the DLT Regulation (see subheadings 6 and 7 below for further information).
- Where incumbents intend to operate a DLT TSS, it is therefore necessary to comply with requirements that apply to the market infrastructure function that the incumbent did not originally perform (subject to any exemptions granted). This means, for example, that an investment firm or market operator operating a DLT TSS would have to comply with some requirements under CSDR and a CSD would have to comply with some requirements under MiFID II and MiFIR.

3. Which financial instruments does the DLT Pilot Regime apply to?

The types of financial instruments in scope of the DLT Pilot Regime is limited and includes:

- ***Shares*** in respect of an issuer which has a market capitalisation (or a tentative market capitalisation) of less than EUR 500 million. 'Tentative' is not defined or explained but we interpret the reference to mean 'indicative' or 'intended' market capitalisation.
- ***Bonds*** with an issue size of less than EUR 1 billion. This includes bonds taking the form of securitised debt, money market instruments and depository receipts for bonds and securitised debt but excludes bonds that embed a derivative or which incorporate a structure that makes it difficult for clients to understand the risks involved.
- ***Units in collective investment undertakings*** where the market value of assets under management is less than EUR 500 million but excluding: (i) shares in undertakings that are not undertakings for collective investment in transferable securities (**UCITS**) (i.e. non-UCITS collective undertakings); and (ii) structured UCITS as referred to in Article 36(1) of *Commission Regulation (EU) No 583/2010 as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website*.

An NCA may set lower thresholds than those set out above.

4. What are the market value thresholds that apply?

The aggregate market value of all DLT financial instruments that are admitted to trading on a DLT MI, or that are recorded on a DLT MI, should not exceed EUR 6 billion at the moment of admission to trading, or initial recording, of a new DLT financial instrument. An NCA may set a lower threshold than EUR 6 billion.

Where the aggregate market value of all DLT financial instruments that are admitted to trading on a DLT MI, or that are recorded on a DLT MI, has reached EUR 9 billion, the operator of the DLT MI must activate a "transition strategy", which is a strategy for reducing the activity of, transitioning out of, or ceasing to operate, a particular DLT MI, including the transition or reversion of its DLT operations to traditional market infrastructure (see subheading 5 below for further information).

In the event that an NCA sets a lower aggregate market value threshold than EUR 6 billion as referenced above, the EUR 9 billion aggregate market threshold amount must be commensurately lowered.

5. Are there any notable obligations on, or notable requirements applicable to, operators of DLT MIs?

Transition Strategy

Operators of DLT MIs should have in place, at the time when a specific permission is granted, a clear, credible and detailed exit strategy for reducing the activity of, transitioning out of, or ceasing to operate, a particular DLT MI (including the transition or reversion of its DLT operations to traditional market infrastructure) in case the following scenarios arise:

- the EUR 9 billion threshold set out under subheading 4 above is exceeded;
- a specific permission or exemption granted is to be withdrawn or otherwise discontinued (including in consequence of the DLT Pilot Regime being discontinued); or
- any voluntary or involuntary cessation of the business of the DLT MI occurs.

The transition strategy must be made publicly available and be ready to be deployed in a timely manner.

The transition strategy should:

- 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 business;
- 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 business;
- set out what is to be done in the event that the EUR 9 billion threshold is exceeded; and
- be updated on an ongoing basis subject to the prior approval of the relevant NCA.

New entrants or operators of DLT TSS that do not operate a traditional market infrastructure to which they could transfer DLT financial instruments should seek to conclude arrangements with operators of traditional market infrastructures.

Liability

Operators of DLT MIs shall be liable in the event of a loss of funds, collateral or a DLT financial instrument. The liability is limited to the market value of the asset lost as of the time when the loss was incurred. Operators of DLT MIs shall not be liable for loss where it proves that the loss is not attributable to the operator, in particular due to any event that the operator demonstrates occurred independently of its operations (including problems arising as a result of an external event beyond its reasonable control), the consequences of which were unavoidable despite all reasonable efforts to the contrary.

General

Other notable requirements applicable to operators of DLT MIs include:

- documenting rules on the functioning of the DLT used, including rules on accessing the distributed ledger, on the participation of validating nodes and on addressing potential conflicts of interests;
- website disclosures detailing how operations and services differ from an MTF or securities settlement system that are not based on DLT; and
- specific operational risk management procedures for the risks posed by the use of DLT and digital securities more broadly.

6. What exemptions from MiFID II are potentially available for DLT MTFs and DLT TSSs?

For applicants intending to operate a DLT MTF or DLT TSS, there are two exemptions that applicants may request regarding trading venue aspects:

1. **Direct retail participation:** An NCA may permit an operator to enable a wider range of participants (including individuals) to deal directly provided they fulfil certain requirements (e.g. they are of sufficient good repute and have a sufficient level of trading ability, competence and experience, including knowledge of the functioning of DLT).

By comparison, under MiFID II, the participants that are admitted by traditional MTFs are restricted to investment firms, credit institutions and other persons with sufficient trading ability and competence to maintain adequate organisational arrangements and resources.

2. **Transaction reporting:** An NCA may exempt an operator (and its participants) from the transaction reporting obligations under MiFID II provided that: (i) the operator keeps records of all transactions executed through its systems; and (ii) the relevant NCA has direct and immediate access to such transaction reporting records.

7. What exemptions from CSDR are potentially available for DLT SSs and DLT TSSs?

For applicants intending to operate a DLT SS or DLT TSS, there are 18 exemptions regarding settlement system aspects that applicants may request, including the following:

- **Dematerialised form; transfer orders; securities accounts; recording of securities in book-entry form; integrity of issue; and segregation of assets**

  An NCA may exempt an applicant from such requirements (each considered individually) if the applicant demonstrates that the use of a securities account and/or the book-entry form is incompatible with its DLT use and it proposes compensatory measures to safeguard, record and segregate DLT financial instruments.

- **Measures to prevent settlement fails; and measures to address settlement fails**

  An NCA may exempt an applicant from such requirements (each considered individually) if the applicant ensures the DLT SS has robust procedures and arrangements that allow for clear, accurate and timely confirmation of the details of transactions, and that prevent or address settlement fails.

- **Requirements for participation; transparency; and communication procedures with participants and other market infrastructures**

  An NCA may exempt an applicant from such requirements (each considered individually) if the applicant proposes compensatory measures to meet the objectives of those requirements. The applicant would also need to ensure that the DLT SS publicly discloses criteria for participation that allows fair and open access and that those criteria are transparent, objective and non-discriminatory, and that the DLT SS publicly discloses prices and fees.

- **Settlement finality**

  An NCA may exempt an applicant from such requirement if the applicant proposes compensatory measures to meet the objectives of the requirement and ensures, by means of robust procedures and arrangements, that the DLT SS settles transactions in DLT financial instruments at close to real time or intraday, publicly discloses the rules governing the settlement system and mitigates any risk arising from the non-designation of the DLT SS as a system for the purposes of *Directive 98/26/EC on settlement finality in payment and securities settlement systems* (**Settlement Finality Directive**), in particular with regard to insolvency proceedings.

8. How does a new entrant or an incumbent apply to operate a DLT MI under the DLT Pilot Regime?

As at the publication date of this guide, the details for applying to operate a DLT MI are set out in the Guidelines and apply from 23 March 2023. The Guidelines contain standard forms, formats and templates for applicants to provide information to NCAs in order to apply to become an operator of a DLT MI and to seek specific exemptions under MiFIR, MiFID II and/or CSDR.

The standard forms, formats and templates constitute the minimum instructions that NCAs should provide to market participants which means that NCAs may in due course go beyond such minimum instructions. Once NCAs have determined the exact form/format/template they intend to use, NCAs should publish such instructions on their website.

In addition to following the application form/format/template provided by the relevant NCA, applicants should bear in mind that a permission issued under the DLT Regulation relates only to the operation of a DLT MI and does not replace an authorisation under MiFID II or CSDR. This means that new entrants who do not have authorisation under MiFID II or CSDR need to also apply for the relevant authorisation.

In order to promote consistency and proportionality, ESMA is required by the DLT Regulation to produce additional guidance in relation to:

a) exemptions granted to DLT MTF operators and CSD DLT SS operators, including in the context of evaluating the adequacy of different types of DLT used by operators;
b) compensatory measures for DLT MTFs and DLT SSs; and
c) the setting of lower thresholds by NCAs of the values set out in subheading 4 above.

Applicants should therefore be mindful that further information of relevance to the application process will be published in due course.

9. What general information does an applicant need to provide?

The Guidelines specify that there is certain information that applicants need to submit irrespective of whether they are intending to operate a DLT MTF, DLT SS or DLT TSS.

The information to be submitted is set out in tables in the Annex to the Guidelines and includes the following:

- General information on the applicant including corporate name, registered address, contact details, nature of the application (i.e. initial permission to operate a DLT MI or a change to a permission to operate a DLT MI because of a material change to the DLT functioning, services or activities), the trading venue or securities settlement system the applicant operates or intends to operate (where applicable), articles of association and other constitutional and statutory documentation;
- A business plan describing how the applicant intends to carry out their services and activities;
- A description of the critical staff and types of clients targeted;
- A description of the technical aspects (including technical implementation) of the DLT, supporting infrastructure, third party arrangements and, if there are any cloud-based aspects, information in line with ESMA's *Guidelines on outsourcing to cloud service providers*;
- A description of the use of the DLT, including details of the operation on the user's side and the operator's side;
- Rules defining the rights, obligations, responsibilities and liabilities of the operator of the DLT MI;
- Information relating to criteria for participation, governing law and jurisdiction of the DLT MI, pre-litigation dispute settlement mechanism and any insolvency protection measures under the Settlement Finality Directive;
- The type of DLT financial instruments to be traded and/or settled;
- The type/main characteristics of the DLT used (i.e. permissioned, permissionless, private, public and/or other characteristics - see below for clarification of each of these terms);
- A description of how the operators carry out their functions, services and activities (including a description of outsourcing arrangements, if any);
- A description of services provided to clients and how the performance of functions and services deviates from a non-DLT MTF or securities settlement system;
- Information on the functioning of the DLT used, including information on the rules on: accessing the distributed ledger; the participation of validating nodes; the validation process of transactions; addressing or detecting potential conflicts of interests; risk management and mitigation measures;

- IT and cyber arrangements including a description of controls and arrangements in place related to the use of DLT and DLT financial instruments and covering such matters as governance and strategy, IT and information security risk management, business continuity management and third party risk management;
- Arrangements to record and protect funds, collateral or DLT financial instruments;
- Investor protection measures; and
- A transition strategy for reducing the activity of, transitioning out of or ceasing to operate a DLT MI (see subheading 5 above for further information).

In relation to characteristics of the DLT, ESMA is reluctant to provide definitions that are too narrow and which may lose relevance as technology develops. For now, ESMA has provided the following clarifications, which apply for the purposes of the Guidelines:

- "**Permissioned**" means a DLT network in which only certain participants can perform certain functions (e.g. validation).
- "**Permissionless**" means a DLT network where any participant can carry out any function.
- "**Private**" means a DLT network that can be joined only by selected participants.
- "**Public**" means a DLT network which anyone can join.

10. What information does an applicant need to provide when seeking an exemption under MiFIR, MiFID II and/or CSDR?

For each exemption requested under MiFIR, MiFID II and/or CSDR, applicants must provide:

- justification;
- any compensatory measures proposed (in order to meet the objectives of the provision in respect of which an exemption is requested or in order to ensure investor protection, market integrity and financial stability); and
- the means by which the applicant intends to comply with the conditions attached to each exemption (as stipulated in the DLT Regulation).

Applicants must demonstrate that each exemption requested is:

- proportionate to, and justified by, the use of DLT; and
- limited to the DLT MI applied for and does not extend to other MTFs or securities settlement systems operated by that applicant.

11. What should a DLT MI operator do in the event of material changes post-application?

If there is any material change to the functioning of the DLT used, or to the services or activities of the DLT MI, that requires a new specific permission, a new exemption, the modification of an existing exemption or of any condition attached to an exemption, the DLT MI operator would need to make a new request for a specific permission, exemption or modification.

If there is any proposed material change to the DLT MI operator's business plan, including changes relating to critical staff, the rules of the DLT MI or legal terms, the DLT MI operator would need to notify the relevant NCA without delay and at least 4 months prior to planned implementation, regardless of whether the proposed material change requires a change to the specific permission or related exemptions or conditions attached to the exemptions.

In addition, DLT MIs must notify the relevant NCA without delay of any material change to information already provided by the DLT MI to the NCA.

ESMA tends to exclude from "material changes" information which is of a purely minor or technical nature that would not be relevant to an assessment of the operator compliance with the DLT Regulation, MIFID II or CSDR.

12. Is there anything else that applicants should be aware of?

Applicants should bear in mind the following in respect of applications for, and operation of, DLT MIs:

- As mentioned above: (i) ESMA is required by the DLT Regulation to produce additional guidance; and (ii) NCAs may in due course go beyond the minimum instructions for applications as included in the Guidelines. Applicants should therefore keep up-to-date with any further guidance and instructions that are issued.
- The DLT Regulation is a stand-alone regime and will prevail over Member State laws pertaining to the same objectives and subject matter. ESMA notes that applicants making references to other applications required by local law may cause the process to become unwieldy so this should be avoided.
- ESMA encourages operators to engage with NCAs to share their insights into DLT, particularly where there are any changes they consider are necessary to better comply with MiFIR, MiFID II and/or CSDR.
- ESMA has clarified that the phrase 'crypto-assets' (which was included in previous ESMA papers) is not relevant and has been removed from the Guidelines. DLT MIs shall therefore admit to trading and settle transactions in 'DLT financial instruments' only.
- EU legislation on financial services is intended to be neutral in respect of the use of any particular technology.

It should also be noted that, in certain circumstances, it may be possible to operate DLT financial market infrastructure without such operation needing to fall under and be governed by the DLT Pilot Regime. Furthermore, the UK will be introducing the FMI Sandbox so this may serve as a potential alternative and/or parallel route to the DLT Pilot Regime.

If you have any questions relating to the differing options available to you to provide financial market infrastructure based on DLT or other new technologies in the UK and/or Europe (pursuant to the DLT Pilot Regime, the FMI Sandbox or otherwise) please feel free to contact us.

13. How will the DLT Pilot Regime inform longer-term plans for the use of DLT in the European financial services sector?

By 24 March 2026, ESMA will present a comprehensive report to the European Commission containing its assessment of the DLT Pilot Regime. The report shall include, for example:

- details of the number of DLT MIs;
- the types of exemptions requested and granted;
- the number and value of DLT financial instruments admitted to trading and recorded on DLT MIs;
- the types of DLT used; and
- technical issues related to the use of DLT.

On the basis of ESMA's report, the European Commission will (within 3 months of receipt of ESMA's report) present a report to the European Parliament and the Council of the European Union which shall include a cost-benefit analysis on 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 DLT;
- amended;
- made permanent through appropriate amendments of the relevant EU financial services legislation; or
- terminated, including all specific permissions granted under the DLT Regulation.

Therefore, if the DLT Pilot Regime is successful, it could be made permanent by amending relevant EU financial services legislation to establish a single coherent framework.

Observations on the approach taken by ESMA in the Guidelines

Key considerations when deciding whether or not to apply for the DLT Pilot Regime

The DLT Pilot regime is a voluntary regime which is open to both incumbent authorised financial institutions and new entrants but it is not the only option that may be available to certain market infrastructure providers seeking to operate DLT-based financial market infrastructure. Indeed, the recitals to the DLT Regulation emphasise this point by explaining that DLT MI is optional and should not prevent financial market infrastructures, such as trading venues and CSDs, from developing trading and post-trading services and activities for crypto-assets that qualify as financial instruments, or are based on DLT, under existing EU financial services legislation (i.e. outside the DLT Pilot Regime).

Although market participants may currently be able to operate DLT-based financial market infrastructure under existing EU financial services legislation, there may be advantages to utilising the DLT Pilot Regime. For example, some financial market infrastructures may want to benefit from the exemptions available under the DLT Pilot Regime, especially in respect of exemptions which relate to areas where there is otherwise uncertainty as to how the obligations would apply to DLT-based financial instruments and/or where (without the exemption applying) there would be other significant barriers to DLT-based financial instruments.

Perhaps the most novel aspect of the DLT Pilot Regime is in respect of DLT TSSs as it provides a means for a wider range of market infrastructures to provide services which are typically carried out by CSDs (i.e. registration and settlement of securities). This could be of benefit, for example, to MTFs wanting to create efficiencies in the registration and settlement lifecycle of securities by removing the need for clearing intermediaries and their associated costs and difficulties. The DLT Pilot Regime also enables CSDs to operate MTFs and thereby expand their functionality beyond post-trade.

However, there are some drawbacks to utilising the DLT Pilot Regime. For example, the MiFID II exemptions are limited and the transaction reporting exemption is of questionable benefit given that transaction reporting records will still need to be prepared and must be made available to NCAs in a way that is not applicable under existing EU financial services legislation (i.e. NCAs must have direct and immediate access to the transaction reporting records).

Furthermore, the market value thresholds of DLT financial instruments that can be admitted to trading on a DLT MI under the DLT Pilot Regime are not a feature of the regimes under existing EU financial services legislation. We consider the thresholds to be a controversial aspect of the DLT Pilot Regime as they potentially limit the scale of DLT MI that is capable of being tested under the DLT Pilot Regime, especially as NCAs are able to lower them. It is also not clear (notwithstanding the need for a transition strategy) what exactly would happen in scenarios where DLT MIs are close to breaching the market value thresholds, and whether they would serve as a true cliff edge (which we would not expect to be the case). In practice, we expect NCAs to be receptive to constructive proposals on how to manage such scenarios.

The DLT Pilot Regime application process

The details that applicants need to provide, especially regarding the type of DLT used, are extensive and indicate an emphasis on DLT operational risk mitigation. This may demonstrate the EU and ESMA's cautious and controlled approach to introducing this nascent technology into scaled securities markets.

Given the information and justifications required by the Guidelines, NCAs are more likely to look favourably upon well-reasoned, well-considered applications. It would be unsurprising if (at least initially) NCAs err on the side of caution in terms of the exemptions they grant in this emerging field. We also anticipate that NCAs will adopt different approaches to, and have different expectations of, DLT

MIs. In particular, some NCAs may view the DLT Pilot Regime application process as akin to a sandbox style application (i.e. a work in progress to be developed with time) whereas other NCAs may view DLT Pilot Regime applications as requiring a high standard at the outset.

We expect existing firms with track records in building and operating DLT platforms for registering, settling and/or trading DLT financial instruments to have a significant advantage over other prospective applicants given the process they will already have undertaken to achieve operational status.

Concluding thoughts

The EU and ESMA signalling their openness to DLT and emerging technologies via the DLT Pilot Regime and the Guidelines represents their hedge against being left high and dry in the wake of the current wave of technological innovation but it could also indicate an already present realisation by each of the benefits that DLT and other new technologies are capable of providing (such as greater transparency, security and efficiencies in financial markets).

The Guidelines expect applicants and NCAs to dive deep into the details of DLT, including by NCAs learning through dialogue with market operators. These deep dives may provide insights which eventually benefit the market as a whole, especially in the event that the market for DLT financial instruments becomes, as we expect, permanent following the DLT Pilot Regime.

The FMI Sandbox

The UK Government is planning to establish, via the UK Financial Services and Markets Bill 2022 (which is currently being scrutinised by both houses of Parliament), a FMI Sandbox to enable firms to experiment and innovate in providing financial market infrastructure (**FMI**) services that underpin financial markets (e.g. trading and settlement), in particular by adopting DLT. The FMI Sandbox will be developed by HM Treasury, the Financial Conduct Authority and the Bank of England.

Similarly to the situation under EU financial services legislation, the UK legislative framework has not been designed to support the use of DLT in FMI and it is therefore necessary to reassess the UK legislative framework to enable the use of DLT and to realise its potential benefits whilst ensuring regulatory objectives are met. At present, it is not clear what legislative and regulatory changes will be needed and how they should be made.

The FMI Sandbox will operate in a similar way to the DLT Pilot Regime in that pre-existing legislation would be temporarily disapplied or modified to enable the use of DLT by market participants, including MTFs and CSDs. Participants would also have to meet existing regulatory standards applicable to FMIs and different requirements may be imposed on different FMI entities. Other than where legislation has been modified or disapplied to accommodate new technology and new practices, participants in the FMI Sandbox would otherwise be required to comply with all other existing, relevant legislation and regulator rules that apply to the activity they are undertaking.

While similar to the DLT Pilot Regime, at present the perimeter of the FMI Sandbox is unclear so there is potential for it to provide a broader scope than the DLT Pilot Regime in order to enable greater innovation by financial market participants and infrastructures. The scope of the FMI Sandbox is intended to be sufficiently flexible to enable different FMI sandboxes to be established to test different technologies and practices for different entities and activities.

ashurst

www.ashurst.com