# PRR explained: Europe's DLT Pilot Regime

The proposed Pilot Regime Regulation for market infrastructures based on DLT

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# Introduction

On 24 September 2020, the European Commission published a proposal for a regulation on a **pilot regime for market infrastructures** based on **distributed ledger technology** (DLT). This proposed pilot regime is part of a broad **EU Digital Finance Package**, which comprises two strategies and four legislative proposals aimed at supporting consumer and investor protection, legal certainty, innovation, and financial stability. Two legislative measures are specifically directed at crypto-assets: this DLT Pilot Regime Regulation (PRR) and the Markets in Crypto-assets Regulation (MiCA)[1].

*Certain provisions in existing EU legislation prevent or restrict market infrastructures from using DLT*

Under current legislation, **market infrastructures** are **prevented** or **restricted** in their **use of DLT** for certain activities or are required to duplicate some record-keeping. The PRR provides a mechanism to **allow certain restricted use of DLT** and to avoid some duplicated transaction record-keeping. This will be achieved by allowing firms already authorised to operate **specific market infrastructures** to apply for **specific exemptions** from **certain restrictions and requirements**, therefore permitting them to restructure their activities making use of DLT.

The PRR enables a market infrastructure to apply for, and be granted, **temporary exemption** from certain EU legislative requirements applicable to crypto-assets that qualify as financial instruments. This discretionary flexibility is hoped to encourage market participants to develop systems for the trading and settlement of such crypto-assets and so boost innovation in the industry.

As an EU Regulation, directly applicable across the 30 EEA countries, there will be a uniform approach to these alternative requirements for DLT market infrastructures, providing both legal certainty and flexibility.

Further, the **supervision and cooperation** of the European Securities and Markets Authority (ESMA) and national competent authorities are intended to ensure a **level playing field** and to support **consumer and investor protection** as well as **financial stability.** The experience and understanding gained by these authorities regarding the application of current EU financial services legislation to DLT-based market infrastructures is expected to inform future legislative developments.

The PRR's purpose is to **allow authorised market infrastructures to experiment using DLT** in specific areas of their business for an **initial period of six years**. The planned timeframe for testing is significantly longer than that of other testing environments or *sandboxes* that have been established in various jurisdictions in the last few years. These early sandboxes have allowed unauthorised players with innovative business models to test products and services that would not fall under any specific regulatory framework, in a safe environment, typically for a period of six to twelve months.

[1] See XReg Consulting's *MiCA Explained*

*The DLT pilot regime differs from other sandboxes in that it allows longer-term experimentation by incumbents, to do what they currently do but with technology normally denied to them*

The main differences between typical financial sandboxes and the PRR are that the PRR **will only allow existing authorised entities to test their business models using DLT** (rather than allowing unauthorised newcomers to test their proposed business models) and that the **testing period will be significantly longer**.

The PRR favours incumbent market infrastructures in that, whilst it does not stop a newcomer from becoming a traditional market infrastructure and then applying to make use of the exemptions, it **does not cater for newcomers seeking to be authorised only in the context of the exemptions**. A comparable example would be a new mobile communications network operator being required to lay landlines as a traditional telecoms operator in order to apply for a 5G licence.

*Little or no utility for a newcomer*

Overall, the proposed pilot regime is a promising aspect of the Digital Finance Package which should **stimulate the growth and development of DLT market infrastructures** whose activities may have been prevented or restricted due to current EU legislation that was not designed with DLT in mind.

## Subject Matter, Scope and Definitions

The PRR outlines requirements for **multilateral trading facilities** (MTFs) and **securities settlement systems** using DLT which have specific permissions under the regime.

These specific permissions can be granted to authorised **investment firms or to firms authorised to operate a regulated market** under the 2nd Markets in Financial Instruments Directive (MiFID) and to **central securities depositories** (CSDs) authorised under the Central Securities Depositaries Regulation (CSDR).

The requirements and procedures for DLT market infrastructures set out in the PRR relate to specific permissions, related exemptions and attached conditions, compensatory or corrective measures, their operation and supervision, and cooperation between operators, regulators and ESMA.

Article 2 of the PRR presents several new terms and definitions, including the following:

**'DLT transferable securities'** means 'transferable securities' within the meaning of Article 4(1)(44) (a) and (b) of Directive 2014/65/EU that are issued, recorded, transferred and stored using DLT;

**'DLT multilateral trading facility'** or **'DLT MTF'** means a 'multilateral trading facility', operated by an investment firm or a market operator, that only admits to trading DLT transferable securities and that may be permitted, on the basis of transparent, non-discretionary, uniform rules and procedures, to:

a) ensure the initial recording of DLT transferable securities;

b) settle transactions in DLT transferable securities against payment; and

c) provide safekeeping services in relation to DLT transferable securities, or where applicable, to related payments and collateral, provided using the DLT MTF;

**'DLT securities settlement system'** means a securities settlement system, operated by a 'central securities depository', that settles transactions in DLT transferable securities against payment.

The PRR also relies on other definitions in MiFID and CSDR.

## Limitations on transferable securities

Under Article 3, various limitations apply to the DLT transferable securities which may be admitted to trading on, or settled by, a DLT market infrastructure. Notably, only the following types of DLT transferable securities can be admitted to trading on, or recorded by, DLT market infrastructures:

a) shares where the issuer's market capitalisation is below €200m;

b) bonds with an issuance size below €500m (except sovereign bonds which must not be admitted to trading on, or recorded by, a DLT market infrastructure).

The total market value of DLT transferable securities recorded by DLT market infrastructures must not exceed €2.5bn.

*From the eleven financial instruments defined in MiFID, only transferable securities will benefit from the DLT pilot regime*

## Exemptions

<table>
<tr><th>DLT MTF</th><th>DLT securities settlement system</th></tr>
<tr><td>An investment firm or market operator operating a DLT MTF will be subject to all the requirements applicable to MTFs under MiFID II, except for the exemptions applied for and granted.</td><td>A CSD operating a DLT securities settlement system will be subject to all the requirements applicable to CSDs under CSDR, except for the exemptions applied for and granted.</td></tr>
<tr><td colspan="2">In both cases, a DLT MTF and a CSD operating a DLT securities settlement system will have to comply with the obligations set out in Article 6 of the Regulation<br>(see Additional Requirements below) and other conditions and compensatory measures.</td></tr>
<tr><td colspan="2">Applicable exemptions include:</td></tr>
<tr><td rowspan="5">Exemption from Article 3(2) of CSDR to allow the admission to trading of DLT transferable securities that are not recorded in a CSD but instead are recorded in the MTF's distributed ledger.</td><td>Exemption from Articles 2(4), 2(9), 2(28), 3, 37 and 38 of CSDR on dematerialised form, transfer of orders, securities accounts, recording of securities, integrity of issue and segregation of assets so that it can record DLT transferable securities on its distributed ledger.</td></tr>
<tr><td>Exemption from Articles 19 and 30 of CSDR so that it can outsource more than one core activity, allowing it to share responsibility of running its DLT with participants.</td></tr>
<tr><td>Exemption from Article 2(19) in order to allow it to admit as participants natural and legal persons without an intermediary.</td></tr>
<tr><td>Exemption from Article 40 of CSDR on cash settlement to allow the CSD to settle payments using central bank money, commercial bank money or e-money tokens.</td></tr>
<tr><td>Exemption from Articles 50 and/or 53 of CSDR on standard link access and access between a CSD and another market infrastructure so that the CSD is not required to grant access to its settlement system when it would be incompatible or too costly to do so.</td></tr>
<tr><td colspan="2">To request an exemption under the PRR, DLT MTFs and CSDs operating securities settlement systems will have to demonstrate that the exemption is proportionate and limited to the use of DLT and is not extended to any other MTF or securities settlement system operated by the same investment firm, market operator, or CSD.</td></tr>
</table>

## Additional requirements

Under Article 6 of the PRR, operators of DLT market infrastructures need to comply with additional requirements which seek to address the novel risks that arise from the use of DLT.

*In addition to existing requirements, DLT market infrastructures will need to comply with additional requirements in relation to their use of DLT*

These include requirements to:

a) prepare a business plan describing how the operator intends to carry out their services and activities, including a description of critical staff, technical aspects and the use of DLT;

b) have up-to-date, clear and detailed publicly available documents which provide clear information on how the firm will carry out their functions, services and activities, how they differ from traditional operators and the legal basis under which they will operate;

c) establish policies, procedures and controls regarding the access of the DLT, the participation of validating nodes, conflicts of interest and risk management;

d) implement adequate IT and cyber arrangements;

e) comply with customer asset safeguarding requirements; and

f) have a 'transition strategy' in place should the firm lose permissions or exemptions granted.

Additionally, regulators are given the ability to impose an independent audit of the IT and cyber arrangements of the provider, with the provider bearing the costs of the audit.

Applications for permission must include the exemptions being applied for. Prior to granting authorisation to a DLT market infrastructure, **competent authorities must consult ESMA**, who will then give a non-binding opinion aimed at **ensuring consistency and proportionality** of the exemptions granted by different competent authorities across the Union.

Permissions will be valid across the Union and ESMA will be required to publish the list of DLT market infrastructures with permissions as well as the list of exemptions granted to each of them.

## Specific permissions to operate a DLT market infrastructure

The application processes for specific permission to operate a DLT MTF or DLT securities settlement system are set out in the Regulation. In both cases, applications must include:

a) the information required under either Article 7(4) of MiFID which includes a programme of operations, the types of business envisaged, the operational structure and requirements applicable to shareholders and members of the qualifying body, or Article 7(9) of CSDR which requires CSDs to have adequate procedures to suspend any participant that consistently and systematically fails to deliver financial instruments on the intended settlement date;

b) the business plan, rules and legal arrangements, as well as the functioning, services and activities of the market infrastructure;

c) information relating to the functioning of its proprietary DLT;

d) IT and cyber arrangements;

e) safeguarding arrangements;

f) transition strategy;

g) the exemptions requested and justification for them, any proposed compensatory measures, and the proposed means to comply with conditions attached to exemptions.

Specific permissions shall be refused by the competent authority where there are grounds for believing that:

a) significant risks to investor protection, market integrity or financial stability are not properly addressed and mitigated by the applicant; or

b) the permission and exemptions have been requested in order to bypass legal and/or regulatory requirements.

Additionally, the competent authority may withdraw any permission or exemptions granted if:

- there is a flaw in the functioning of the DLT or the performance of the services and activities that give rise to considerable risks;
- there is a failure to comply with the relevant requirements or conditions under the PRR; or
- they were obtained on the basis of misleading information.

## Cooperation between operators, competent authorities and ESMA

Operators of DLT market infrastructures are required to cooperate with competent authorities and ESMA, and notify them of any of the following matters:

a) proposed material change to their business plan;

b) evidence of unauthorised access, material malfunctioning or serious malpractice suffered by the DLT market infrastructure;

c) material change in the information provided in the application for a specific permission;

d) difficulties in delivering the activities or services subject to the specific permission;

e) any unanticipated risk to investor protection, market integrity or financial stability.

Operators may also need to provide competent authorities and ESMA with other relevant information, and to implement corrective measures to the business plan or to the rules of the DLT market infrastructure and associated legal arrangements.

Further, every six months from when a permission is granted, operators must submit a report to ESMA and their regulator with information including the number and value of DLT transferable securities admitted to trading or recorded by the market infrastructure.

## Report, review, and timeline

The PRR will enter into force 20 days after being published in the Official Journal of the European Union and will apply 12 months later. Within 5 years after the Regulation's entry into force, ESMA

must present a comprehensive report to the Commission covering a range of information including the functioning, size, benefits and risks of DLT market infrastructures and the application of the PRR to these infrastructures.

On the basis of ESMA's report, the Commission must complete a report including a cost-benefit analysis on whether the regime should be extended, amended, made permanent, or terminated. Further, the report may include proposals for modifications to the EU's legislative framework governing financial services or harmonisation of national laws to facilitate the use of DLT in the financial sector.

*The PRR is hoped to have a positive impact in the development and wider adoption of DLT, however, it may be short-lived*

The impact of this Regulation is potentially significant. The DLT pilot regime may be made permanent and even accompanied by further regulatory developments, yet it could equally be terminated within 5 years from its commencement.

## Conclusion

Permission to operate and benefit from exemptions will only be granted upon satisfaction of a wide range of informational and regulatory requirements. Although the PRR will not apply until a year after coming into force, DLT market infrastructures hoping to benefit from this regime should begin to prepare soon if it wants to apply for any of the exemptions.

By exempting DLT market infrastructures from restrictive or prohibitive requirements under EU financial services law, the PRR is intended to have a positive impact on the development and use of DLT in financial markets.

The regime will allow policymakers and regulators to assess whether risks that are currently addressed by provisions in existing regulatory frameworks could also be mitigated through systems built around the use of DLT. If this experiment proves successful, it is likely that tokenised financial instruments will become more widely adopted, and further legislative developments will emerge to facilitate their use.

***XReg is a team of policy and regulatory experts based in Gibraltar, Brussels and London, dedicated to assisting governments, regulators, public bodies and the private sector in dealing with the challenges of continuously evolving crypto-asset Regulation. If you would like to discuss anything mentioned in this document or otherwise related to the PRR or MiCA, feel free to contact Siân Jones, Ernest Lima, or Ana James.***


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