

EU PILOT REGIME: ACCELERATING THE DEVELOPMENT OF A DIGITAL CAPITAL MARKET IN EUROPE

The EU Pilot Regime is expected to give rise to an increase in the volume of issuances of DLT Financial Instruments in Europe as operators of DLT Market infrastructures are given the opportunity to experiment with the use of DLT in issuance and post-trade processes, free from certain regulatory constraints.

INTRODUCTION

The European Union ("EU") is keen to develop a market (a "**Digital Capital Market**") for financial instruments that are issued, recorded, transferred and stored using DLT¹ ("**DLT Financial Instruments**").² A Digital Capital Market has the potential to offer an additional source of capital to issuers, with the use of distributed ledger technology and smart contracts commonly described as offering a range of potential advantages to market actors, including, among other things, a reduced settlement cycle (potentially even instant, 'atomic settlement'), the automation of payments of principal and interest, a simpler ownership and custody structure, greater security and transparency and the possibility of paying for DLT Financial Instruments using crypto-currencies such as Central Bank Digital Currency ("**CBDC**").

Notwithstanding the development of legal regimes that have sought to encourage the issuance of DLT Financial Instruments in certain EU member states such as France, Luxembourg and Germany, key activities in relation to the life-cycle of DLT Financial Instruments such as (i) facilitating the buying and selling of securities, (ii) facilitating the transfer of payments and (iii) providing settlement services, recording securities in a book-entry system or maintaining securities accounts, are regulated by European-level legislation that was drawn up long before DLT became mainstream.

Under the EU Pilot Regime,³ published on 2 June 2022, certain DLT Market Infrastructures (as defined below) will be able to apply to be temporarily

Key take-aways

- DLT has been identified by the EU as an innovative technology which could have a transformative effect on the financial sector.
- The EU has created a sandbox, the EU Pilot Regime, to allow regulated investment firms, market operators and central securities depositories to operate DLT -based market infrastructures.
- These DLT-based market infrastructures will be able to accommodate financial instruments that are issued, recorded, transferred and stored using DLT, potentially accelerating the development of a digital capital market in Europe.

¹ DLT refers to distributed ledger technology. DLT is a decentralised peer-to-peer data storage system where participating computers (known as nodes) hold and maintain identical copies of the ledger. Data integrity is achieved through public-private key cryptography, so that an individual node cannot tamper with information recorded in the ledger by rewriting the transaction.

² Article 2(11) of the EU Pilot Regime

³ Regulation (EU) 2022/858 of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology (the "**EU Pilot Regime**")

exempted, for a three year period starting on 23 March 2023,⁴ from some of the specific requirements of EU financial services legislation that the European Union feels could otherwise prevent operators from developing solutions for the trading and settlement of DLT Financial Instruments (see "*What EU Financial Services Regulation can be disapplied?*" below).

WHO CAN BENEFIT FROM THE EU PILOT REGIME?

The DLT market infrastructures ("**DLT Market Infrastructures**") that may be developed for the first time under the EU Pilot Regime are DLT multilateral trading facilities ("**DLT MTFs**"), DLT settlement systems ("**DLT SSs**") and DLT trading and settlement systems ("**DLT TSSs**"). Subject to approval from the relevant competent authority ("**NCA**") in accordance with the EU Pilot Regime, such DLT Market Infrastructures can be run by investment firms⁵, market operators⁶ and/or central securities depositories⁷ ("**CSDs**"). The EU Pilot Regime is open to new market entrants, but they will need to meet not only the requirements of the EU Pilot Regime, but also the more general requirements for investment firms, market operators or CSDs under MiFID II and Regulation (EU) No 909/2014 ("**CSDR**"), as applicable.

DLT MTFs

DLT MTFs may be operated by investment firms or market operators and will constitute DLT-based financial trading venues.

Article 3 of CSDR provides that where a transaction in transferable securities takes place on a trading venue, the relevant securities shall be recorded in book-entry form in a CSD. Given that the CSDs are not operationally set up to handle DLT Financial Instruments, and that the legislation governing them is not adapted to their dealing with DLT Financial Instruments either, issuers have not been able to list and admit to trading DLT Financial Instruments on a trading venue. The development of DLT MTFs should be seen firmly in the context of wider efforts to increase the liquidity of DLT Financial Instruments, in particular the use of bulletin boards⁸ and, for example, the possibility to register DLT Financial Instruments on the Securities Official List of the Luxembourg Stock Exchange which permits some transparency for investors with regards to the pricing of secondary market trades.⁹ To the extent that there has been secondary trading for DLT Financial Instruments thus far, it has been limited to over-the-counter (OTC) trading.

DLT MTFs may be particularly interesting to (i) issuers who want to benefit from the liquidity and greater visibility of admitting their DLT financial instruments to trading on an established trading venue in Europe, as well as (ii) investors who regularly invest in securities admitted to trading on MTFs and wish to diversify their portfolios with DLT Financial Instruments.

⁴ This may be extended until 23 March 2026. See Article 14(2)(a) of the EU Pilot Regime

⁵ As defined in Article 4(1), point (1) of Directive 2015/65/EU ("**MiFID II**")

⁶ As defined in Article 4(1), point (18) of MiFID II

⁷ As defined in Article 2(1), point (1) of Regulation (EU) 909/2014

⁸ Bulletin Boards allow for the display of bid and offer interests, without matching orders, and do not require authorisation as a trading venue within the meaning of MiFID II. They facilitate OTC trading between parties.

⁹ See <https://www.cliffordchance.com/insights/resources/blogs/talking-tech/en/articles/2022/05/native-issuances-of-dlt-securities-in-luxembourg-france-and-ger.html>.

DLT SSs

DLT SSs may be operated by CSDs authorised under CSDR to run settlement systems that can (a) settle transactions in DLT Financial Instruments against payment or against delivery and (b) allow the initial recording of DLT Financial Instruments and/or the provision of safekeeping services in relation thereto.

CSDs play a key role in the trade and post-trade process, providing a central point for depositing financial instruments, enabling the processing and settlement of transactions, and providing custodial services (e.g. the administration of corporate actions and redemptions). If these processes can be carried out using DLT, whilst applying the protections of the CSDR that are so important to minimising risks to the financial system, there is general hope that the chances of developing a Digital Capital Market in Europe will be greatly increased.

DLT TSSs

DLT TSSs may be operated by investment firms, market operators or CSDs that want to combine into a single entity the services performed by a DLT MTF and a DLT SS. There is a precedent for such an approach in Switzerland where the Six Digital Exchange has obtained a licence from FINMA to operate a stock exchange and a central securities depository for digital assets in Switzerland and has successfully hosted the issuance of a range of DLT Financial Instruments. However, it appears that the EU do not necessarily want to encourage the combination of trading and post-trading activities within a single entity in the long-term, making clear that any such set-up shall be temporary and that the separation of activities is a policy choice that will not be abandoned, relating to risk specialisation and unbundling for the purposes of encouraging competition.¹⁰

WHAT EU FINANCIAL SERVICES LEGISLATION CAN BE DISAPPLIED?

Applicants will be able to obtain exemptions from certain provisions of CSDR and MiFID II identified in the EU Pilot Regime. The provisions that can be disapplied depend on the type of Market Infrastructure¹¹ but the general aim is to allow the applicants to (a) carry out activities which they are not currently authorised to do under the current legislation and (b) refrain from carrying out activities that are imposed by legislation but are ultimately burdensome or irrelevant in the DLT context.

Different legislation will be disapplied according to the type of DLT Market Infrastructure. For example, operators of DLT MTFs can apply to their NCA to grant an exemption from the obligation of intermediation under MiFID II so that retail investors can gain direct access to their digital platform and deal on their own account, as many investors are accustomed to doing on crypto-asset trading platforms. In order to ensure continued market integrity and financial stability, any retail investor granted direct access to DLT MTFs must nonetheless satisfy various requirements detailed in the EU Pilot Regime.¹²

¹⁰ Recital 14 of the EU Pilot Regime

¹¹ Note that DLT TSSs can apply to disapply the same legislation as both DLT MTFs and DLT SSs. See Article 6(1) of the EU Pilot Regime

¹² Article 4(2) of the EU Pilot Regime

DLT MTFs can also apply for exemptions from transaction reporting requirements under Regulation (EU) 600/2014 (MiFID).¹³

The list of legislation that can be disapplied by operators of DLT SSs is much longer than for DLT MTFs on account of the systemic importance of settlement and clearing activity. One of the most noteworthy rules that can be disapplied is Article 3 of CSDR, mentioned above, in relation to the requirement for transferable securities admitted to trading on a trading venue to be recorded in book-entry form in a CSD. Equally important is the possibility for CSDs operating DLT SSs to move away from the currently required cash settlement in favour of more innovative payment solutions such as CBDC or e-money tokens, provided that the settlement is done on a delivery versus payment basis.

WHAT ARE THE CONDITIONS ATTACHED TO PARTICIPATION IN THE EU PILOT REGIME?

Thresholds

DLT Financial Instruments may only be admitted to trading on a DLT Market Infrastructure, or recorded on a DLT Market Infrastructure, if at the moment of admission to trading or the moment of recording on a distributed ledger, the DLT Financial Instruments are:

- shares issued by issuers with a market capitalisation of less than EUR 500 million;
- bonds or securitised debt (including depositary receipts or money market instruments but excluding those which embed a derivative or have a complicated structure) with an issue size of below EUR 1 billion; or
- units in certain collective investment undertakings with less than EUR 500 million of assets under management.¹⁴

In addition, new DLT Financial Instruments will only be allowed to be recorded or admitted to trading on a DLT Market Infrastructure if it does not result in the aggregate amount of DLT Financial Instruments recorded or admitted to trading on such DLT Market Infrastructure exceeding EUR 6 billion.¹⁵

The thresholds have been criticised as being too low. However, the highest-profile DLT Financial Instrument issuances in Europe to date have had relatively small issuance amounts (for example, the EIB digital bond issuance in April 2021 was for EUR 100 million) and the immediate purpose of the EU Pilot Regime is not to facilitate access to capital, even if that is a longer-term ambition, but rather to experiment with DLT in the capital markets context and identify whether and which changes need to be made to European financial services legislation to allow a Digital Capital Market to develop.

Additional requirements

DLT Market Infrastructures and their operators are also subject to various additional requirements under the EU Pilot Regime, including the need to draw up (i) a detailed business plan that details how the DLT would be used and the applicable legal terms, (ii) specific and robust IT and cyber arrangements relating to the use of DLT, (iii) appropriate measures for the safeguarding of

¹³ Article 4(3) of the EU Pilot Regime

¹⁴ Article 3 of the EU Pilot Regime

¹⁵ Article 3(2) of the EU Pilot Regime

clients' funds and even (iv) an exit plan in the event that the EU Pilot Regime is discontinued.¹⁶

These additional requirements reflect an acknowledgement by the European Union that, as DLT is a new technology, there remains a need to preserve a high level of investor protection, market integrity, financial stability and transparency.

WHAT ARE THE NEXT STEPS?

The EU Pilot Regime will be in effect from 23 March 2023. At the conclusion of the EU Pilot Regime three years later, ESMA will provide the European Commission with its assessment of the success of the experiment.¹⁷

The European Commission will then have a number of options, including:

- extending the EU Pilot Regime for another three years;
- in addition to extending the EU Pilot Regime, opening it up to other types of financial instruments or otherwise amending it;
- making the EU Pilot Regime permanent by amending existing European legislation (in particular MiFID II and CSDR);
- introducing a new, specific regulation or directive for the issuance, registration and transfer of DLT Financial Instruments; or
- terminating the EU Pilot Regime.¹⁸

CONCLUSION

If the EU Pilot Regime is a success and the European Commission decides to modify or create legislation to make its provisions permanent, it is difficult to see how issuers and investors will fail to be attracted to the European Digital Capital Market. A permanent regime would allow for the full life-cycle of DLT Financial Instruments to be carried out in a fully regulated environment, using DLT Market Infrastructures that, at least initially, are likely to have been road-tested under the EU Pilot Regime.

The future of the Digital Capital Market in Europe is not solely dependent on the decision that the European Commission will take in 2026 and it is possible that issuers will continue to issue unlisted and uncleared DLT Financial Instruments pursuant to local member state law. Such laws may well continue to evolve and gain sophistication over the coming years, independently of the EU Pilot Regime. There are many other factors that could accelerate or slow down the development of the market, with the key one being efforts to develop a wholesale CBDC in Europe that would allow the cash leg of transactions involving DLT Financial Instruments to be processed via a risk-free medium which is programmable through the use of smart contracts.

¹⁶ Article 7 of the EU Pilot Regime

¹⁷ Article 14(1) of the EU Pilot Regime

¹⁸ Article 14(2) of the EU Pilot Regime

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