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How to steer the DLT pilot regime? Navigating between potential and challenges

Technological change is the driving force of our times – and COVID-19 has further accelerated the pace of change. Digital technologies are advancing in all segments of finance: contactless payments have boomed during the pandemic, robo-advisors offer fully automated investment tools to customers, and distributed ledger technology (DLT) looks set to play a much more important role in securities settlement in the future.

A crucial factor for all new technologies is the regulatory environment – without a stable and predictable set of rules, innovations face strong headwinds that may prevent them from taking off. At the same time, regulators need to ensure that consumers do not board vessels that are too risky for them and the market as a whole. In other words, regulating emerging technologies is about striking a balance between potential and challenges. The EU has developed a pilot regime to steer and stabilise the development of DLT for trading and securities settlement.

In essence, the initiative is about creating a kind of "regulatory sandbox" in the EU for the development and operation of market infrastructures based on DLT. Having a ring-fenced sandbox means that newcomers are able to play and experiment in a safe and supervised environment. The regulation takes the form of a pilot regime and has four main objectives: first, to create legal certainty for DLT market infrastructures within the EU; second, to support innovation in the EU by removing barriers to the application of new technologies in the financial sector; third, to safeguard consumer and investor protection and market integrity; and fourth, to guarantee financial stability.

Creating a pilot regime for DLT market infrastructures is the right approach. However, we need to keep two key issues in mind. First, when we enable this pilot to gain speed and take off we need to be able to call it back and force a safe landing at any time if its objectives are not met. There are, of course, reasonable limits incorporated into the pilot regime, concerning both the duration and certain value thresholds to limit the size and risk of the regulatory sandbox. Nevertheless, we need to communicate to the market that winding down the regime will be a viable option if significant risks are identified that cannot be addressed in any other way.

The second key issue is that we need to prevent fragmentation of the European settlement landscape. New solutions based on DLT promise to increase the efficiency of securities settlement but this depends on the specific design and development of the market. Creating many different non-interoperable DLT sandbanks or islands each with its own settlement asset will not enhance overall settlement efficiency in Europe. The sandbox concept is good but there would have to be a common one without major barriers to transactions, meaning that DLT infrastructure providers would need to ensure a high level of interoperability with existing legacy systems.

DLT offers significant efficiency gains for the European settlement landscape. However, we can only achieve these gains if we find the right balance between enabling potential and mitigating challenges. **Avoiding fragmentation will be key to reaping the benefits of the pilot regime.**