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The DLT pilot regime – a path to Europe's 'next-gen' market infrastructures?

Distributed ledger technology (DLT) is a foundational technological innovation that could bring long-term benefits to create more efficient markets. The European Commission's proposed DLT pilot regime aims to support the digital transformation of financial markets. If adopted, it would allow the operation of market infrastructures based on DLT.

The pilot regime adopts a sandbox approach to creates certain exemptions from specific requirements embedded in EU legislation such as MiFID or CSDR. At present, there are over 50 countries which have implemented comparable 'sandboxes' that allow for temporary relief from certain regulatory obligations in order to promote experimentation particularly in the field of emerging technologies.

Previous consultations from the EU Commission concerning new technologies showed that many respondents, aside from some of the current infrastructure providers, believe that the existing EU framework is insufficiently technology neutral. This could undermine the successful deployment of new technologies such as DLT. The pilot regime is a way to address this issue:

- it recognises the potential need for regulatory change in light of new technologies,
- identifies areas that may be insufficiently innovation friendly,
- requires those seeking to create a DLT market infrastructures to prove that existing EU rules are incompatible with DLT.

Consequently, the barometer of success for the pilot regime is not necessarily its widespread adoption, since the regime should only be used if existing regulation would not allow for it. The real success is the engagement model created between the private and public sector and the transparency around such engagement. Nevertheless, the scope of the pilot regime is limited, i.e. restricted to illiquid securities, subject to a sunset clause and participation is only foreseen for CSDs and MTFs (multilateral trading facilities). This could create unintended outcomes:

Participation is limited to central infrastructures only: DLT-based networks are decentralised networks by design. This implies the redistribution of roles and activities that currently reside across existing market infrastructure and their users. The pilot regime does not fully allow for this level of experimentation to happen.There is continued uncertainty about the exit strategy: there is insufficient clarity on how a successful business model, developed as part of the pilot, can achieve a general stay once the pilot regime expires. This may increase the risk for investors to engage in building such models.National regulators are creating potentially more attractive alternatives: various Member States are in the process of amending their national securities law to allow for the creation of securities that are issued in digital form using DLT.This may be more attractive than the pilot regime

The pilot regime is a welcomed example of how EU regulators can flank technological innovation with regulatory flexibility. However, additional effort will be needed to allow for greater levels of decentralised market structures to evolve, which will be beneficial to financial markets in Europe and contribute to the efforts of creating a deep and innovative capital markets union.