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PILOT REGIME

Updated in May 2023

The Pilot Regime, the Crypto-Asset Markets Regulation (MiCA) and the Digital Operational Resilience Regulation (DORA) are key elements of the EU's Digital Finance Package published on 24 September 2020. The Pilot Regime forms with MiCA the two major legislative proposals on digital assets proposed by the European Commission. The Commission's objective, through these proposals, is to encourage innovation based on the technology underlying this device, namely the "Distributed Ledger Technology" (DLT) while preserving financial stability, market integrity and investor protection.

1. Overview

Pilote Regime is an European regulation on market infrastructures (trading platforms) and post-trade infrastructures (settlement/delivery systems) which also makes it possible to authorise infrastructures that integrate both market and post-trade activities for the first time.

The European legislator's intention is to review the regulations applicable to them so that they can maximise the benefits of the new "distributed ledger technology" (DLT). In any case, given the principle of technological neutrality in EU legislation, the goal is for new infrastructures based on this new technology not to be penalised by existing regulations.

As the legislator wishes to allow market players to test this technology, the Pilot Regime is presented as a **temporary regulatory framework** based on a predefined list of potential exemptions from existing regulations, mainly MiFID¹ and CSDR². These exemptions are expected to last for three years but could possibly be extended by another three years. At the end of this trial period, the legislator, on the basis of an opinion from ESMA, will decide either to perpetuate, amend or repeal these temporary provisions.

a. Key aspects of the Regulation

The 23 March 2023, Europe officially launched a major experiment to test the blockchain and distributed ledger technology (DLT) on the financial markets, a technology that was born with the now famous and sometimes controversial Bitcoin.

¹ MiFID: Markets in Financial Instruments Directive

² CSD: Central Securities Depository Regulation

This experiment, called the Pilot Regime, should last at least 3 years (renewable once) and allow the European authorities in charge of market regulations to better understand the supposed benefits of this new technology, but also and more importantly the potential challenges to existing regulations and infrastructures.

- **Assets in scope**

While MICA is a proposal relating to new digital assets, i.e. not yet covered by EU regulations (crypto-currencies, utility tokens, stable coins, etc.), the Pilot Regime relates to digital assets which qualify as financial instruments under MiFID and which are supposed to use market infrastructure trading services and post-trade infrastructure settlement services. That's why the Pilot Regime is essentially focused on listed financial securities, as only issuers of listed securities are legally obliged to deposit their securities within a CSD, while issuers of unlisted securities remain fully responsible for maintaining their economic and political rights and are therefore free to choose the underlying technology.

- **Authorised financial institutions should require permission**

Three types of DLT-based infrastructure can be tested in the Pilot Regime:

- The DLT MTF (DLT Multilateral Trading Facility), a multilateral trading system operated by an investment firm or a market operator;
- The DLT SS (DLT Settlement System), a securities settlement system operated by a central securities depository;
- The DLT TSS (DLT Trading and Settlement System), a new player providing both the services of a multilateral trading system and a securities settlement system.

Authorised financial institutions (investment firms, market operators, central securities depositories) will still need specific permission to operate a DLT market infrastructure under the Pilot Regime. Access to the Pilot Regime will be open to new entrants also. DLT operators will be subject to various organisational requirements, including robust IT and cyber arrangements, arrangements to safeguard clients' assets, record-keeping obligations, investor protection arrangements (including procedures for compensation or redress), KYC/AML requirements, etc. Competent authorities may decide, on a case-by-case basis, to require additional prudential safeguards from the DLT operator in the form of their own funds or insurance policies.

- **Permitted DLT operators should request exemptions**

Once given a permission to operate a DLT operators will be able to request all or part of the exemptions provided for under the Pilot Regime, thus creating a partial carve out from the current financial regulatory and operational regime, provided that they comply with the conditions attached to the exemptions and with any compensatory measures required by the competent authorities.

Some of the most notable provisions of the Pilot Regime refer to exemptions from:

- Intermediation, including possibility to offer direct access to natural persons to deal with own account as DLT infrastructure participants
- Transaction reporting, including possibility to offer direct access to regulator to view the financial transaction data
- Recording and settling DLT financial instruments with a CSD: the current rules envisage the performance of trading and post-trading (settlement) activities by separate market infrastructures. Central Securities Depository Regulation requires that financial instruments admitted to trading on a trading venue are recorded with a CSD. Due to the capabilities of this technology, it will be allowed to combine the activities normally performed by both Multilateral Trading Facilities (MTFs) and CSDs.

- CSDR settlement finality requirements, under the condition that the DLT settles transactions close to real time or intraday, and no later than on the second business day, and after the conclusion of the trade, discloses the rules governing the settlement and mitigates any risk, particularly with regard to insolvency proceedings.
- Rules on cash settlement, including the possibility to use innovative solutions, such as “settlement coins,” or commercial bank money in a tokenised form or e-money tokens (as defined in the MiCA) instead of cash. However, delivery versus payment (DvP) still has to be ensured.

b. Others points

- **Distributed ledger VS centralised ledger: a total paradigm shift**

The first level of the Pilot Regime text was mainly aimed at reducing the risks of the experiment by limiting the volume of tokenised issues and by requesting from participants the implementation of an “exit strategy” to be able to terminate the experiment in case of failure. The other key feature of the Pilot Regime is the introduction of the concept of DLT SS (Settlement System) and not DLT CSD. This is indeed important because if the CSD is also an SS operator, it also ensures a notary function by centralising the issuing account of listed securities. By recognising that these two CSD functions can now be dissociated in a Distributed Ledger, the legislator is implicitly challenging the systematic transfer of the record keeping of listed securities to a trusted third party such as a market infrastructure.

While the Pilot Regime seems to question the relevance of some intermediation constraints imposed by current regulations, it does not mention other types of intermediation such as those freely chosen by market participants. In its recent guide on DLT, the French Association France Post Marché (FPM) also addressed the subject of disintermediation in post-trade activities. According to its analysis, it would be the intermediaries imposed by current regulations that would mainly be impacted by the new technology, i.e. the CSD but also the custodians. These imposed intermediaries have two essential roles to play in securing the transfer of ownership of listed securities: to “centralise” the record keeping (centralised ledger) for issuers or investors; and to operate a settlement system, the first role appearing until now to be a sine qua non condition for the exercise of the second, both of which then allow these intermediaries to offer a wide range of value-added services (tax, reporting, corporate transactions, collateral, etc.)

According to the guide, the transition from a “centralised ledger” approach to a “distributed ledger” approach should make it possible to better secure record keeping and thus enable the issuer to retain responsibility for the record keeping of listed securities in the same way as for unlisted securities. In theory, it would then be possible to have a single legal regime for all financial securities in a Distributed Ledger, whether they are listed or unlisted.

- **This single regime appears to be very close to the French model of “essentiellement nominatif” securities**

This single regime appears to be very close to the French model of “essentiellement nominatif” securities, which already allows for a single form of securities, the so-called Registered form, for listed and unlisted securities. In this model, it is the issuer of the securities and not the CSD that is responsible for record keeping and custody of registered securities.

For these securities, the CSD must only ensure the role of Settlement System (SS) operator, similar to what the Pilot Regime has planned with its DLT SS. If this regime for essentially registered securities has not been a huge success in France so far, it is mainly because of current technology limitations. The use of the Distributed Ledger could therefore completely change the situation and eventually make the current distinction between bearer and registered securities obsolete. Indeed, registered securities deposited in a Distributed Ledger could combine the current advantages of registered securities (knowledge of investors by the issuer) and bearer securities (ease of settlement) without any additional cost for participants with even probable cost reductions. CSDs and custodians would continue to perform their current role for

these listed registered securities, i.e. operator of an SS for the CSD and administration service (“nominatif administré”) for the custodians, while of course continuing to offer all the value-added services mentioned above.

This European Pilot Regime therefore appears to be a wonderful opportunity to rethink, simplify and optimise the management of market operations, and in particular the entire post-trade segment. It also appears that the French market is particularly well placed to make the most of this experiment. Firstly, because its current model seems to be able to converge fairly easily with that of the Pilot Regime, but also because it took an interest in the subject very early on, which enabled certain French players to acquire real expertise that they should be able to use during the Pilot Regime experiments.

- **Main market players affected by this Pilot Regime**

The players primarily affected by the Pilot Regime are market and/or post-trade infrastructures looking to benefit from the exemptions provided for. They will need to identify and then justify to the regulator the exemptions that they consider necessary to adapt and optimise their processing with DLT. But these new DLT infrastructures will of course only work if other players seek out their services, assuming that issuers decide to issue security tokens³ and that investors want to invest in this digital asset class.

With that in mind, communication between these different players appears to be fundamental to the success of the Pilot Regime. Infrastructures need to know the expectations of issuers and investors and, conversely, issuers and investors need to know the additional features and/or benefits that these new infrastructures can provide them through DLT. Insofar as investments are to be made by the various players, it is also important that they be able to justify these investments internally and, in particular, to estimate the return on investment during and after the Pilot Regime. There are currently discussions among certain market authorities and professional associations to determine how to optimise these investments, e.g. by capitalising on all or part of current value chains, where possible.

2. Chronology of events: key dates

- 24/09/2020: First proposal of European regulation known as "Pilot Regime"
- 02/06/2022: Publication of “Pilot Regime” (Regulation EU 2022/858)
- 23/03/2023: Pilot Regime came into force
- 23/03/2026: End of EU first experiment but renewable once
- 23/03/2029: End of EU experiment

3. Reference text(s)

- 2022/858 REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on a pilot regime for market infrastructures based on distributed ledger technology

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32022R0858>

³ Security tokens: securities registered in distributed ledgers

- Publication from Paris-Europlace working group

[Paris – Europlace – Le Régime Pilote au service de la numérisation des marchés de capitaux ? Rapport #2 du Groupe de travail « Finance numérique et cas d’usage » – AFG – Association Française de la gestion financière](#)

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