

A BRAVE NEW WORLD

THE RISE OF DLT MARKET INFRASTRUCTURES (PART 2/3)

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On 24 September 2020, the European Commission (EC) adopted the “Digital Finance Package”, drafting Digital Finance and Retail Payments Strategies and proposing legislations on crypto assets and digital resilience. With the aim of achieving a more consumer-friendly digital financial services the EC also wants to ensure consumer protection and financial stability in these yet largely unregulated fields.

In contrast to earlier regulatory initiatives that were often the result of market abuse, imbalances or even global crises, European authorities aim at being pro-active this time – not just with a view to crisis prevention but with a view to Europe’s competitiveness and innovation in Digital Finance by establishing standards that could then be adopted globally.

This new package builds upon the EC’s “FinTech Action Plan” of 2018 which acknowledged that in the EU’s financial sector, firms are authorised and supervised based on their activities, services and products. Where this legislative framework has been strict and consistent for the traditional portfolio of assets, products and services, the majority of crypto assets are not covered by such legislation. For those crypto assets that are not covered by the legislative framework, this raises concerns about investor protection, market integrity and financial stability. On the other hand, the status quo constitutes an unlevel playing field because firms that provide services in association with crypto assets that qualify as financial instruments within the meaning of MiFID II¹, various regulations become applicable. Subject to the relevant services provided, and besides MiFID itself, these are the Prospectus Regulation², the Transparency Directive³, the Market Abuse Regulation (MAR)⁴, the Short Selling Regulation⁵, the Central Securities Depositories Regulation (CSDR)⁶, and the Settlement Finality Directive.

As part of the Digital Finance Package, the EC has proposed a new legislation on crypto assets, called Regulation on Markets in Crypto Assets or MiCA. It provides definitions and stipulates clear standards and conduct rules with provisions covering capital requirements, custody of assets, a mandatory complaint holder procedure available to investors, and rights of the investor against the issuer. The main difference to MiFID – to which it contains references – is that it governs services in relation to assets that are “a digital representation of values or rights that can be stored and traded electronically” (= crypto assets).

A new and remarkable approach; the new regulation is considerate of the prematurity of the crypto assets market both in terms of potential adaptations becoming necessary and, even more important, allowing the relevant market to be regulated to develop.

As part of the Digital Finance Package, the EC has issued a proposal for a “pilot regime for market infrastructures based on distributed ledger technology”. The distributed ledger technology (DLT) pilot regime addresses market infrastructures that wish to try to trade and settle transactions in financial instruments in crypto-asset form. The so-called ‘sandbox’ approach of the DLT pilot regime allows temporary derogations from existing rules. This aims at enabling regulators to gain experience on the use of DLT in market infrastructures, though ensuring that they can deal with risks to investor protection, market integrity and financial stability.

Under existing regulation, the combination of trading and post-trading activities within one legal entity is not permitted; trading and settlement must be performed by separate market infrastructures. According to the CSDR, financial instruments admitted to trading on a trading venue (under the MiFID definition) must be recorded with a central securities depository (CSD).

Since the use of DLT can accelerate the processes of trading and settlement and bring them as close together as if being conducted simultaneously, the DLT pilot regime, once adopted, allows a DLT market infrastructure to facilitate the trading of DLT transferable securities, their initial recording, the settlement of transactions in DLT transferable securities and their safekeeping.

A DLT market infrastructure, under the pilot regime, can be either a DLT multilateral trading facility (DLT MTF) or a DLT securities settlement system (DLT SSS). The operational governance frameworks are similar to the existing ones, i.e., a DLT MTF must be operated by a market operator that is approved under the laws of MiFID whereas a DLT SSS must be operated by a CSD approved under the laws of the CSDR.

If an operator of an MTF wants to obtain authorisation as a DLT MTF, the same basic rules apply as are applicable for the operation of a ‘traditional’ MTF. However, if it can meet specific technical and organisational (including reporting) requirements, it may apply for being made exempt from the book-entry obligation or the obligation to recording with a CSD.

If an authorisation is granted, it will have a maximum initial duration of six years so as to align with the tenor of the pilot regime the further shape of which shall be decided upon by European legislative bodies five years after its entry into force.

As the EC has written, “the Union financial services legislation was not designed with DLT and crypto assets in mind [...]”. And although there are caps on the issuer size issuing on a DLT market infrastructure – the market capitalisation may not exceed EUR 200 million – and restrictions on certain instruments and their sizes, this is a huge step forward in the regulation of digital financial markets.

Read in [part 1](#), whether this has the potential to further disrupt the industry and which developments to expect next.

“The rise of DLT Market Infrastructures” is the second in a series of three articles that examine the impact of technology on modern settlement infrastructures. In part 1, Spectrum’s Thibault Gobert discusses the CSDR and how “traditional” regulation is reaching its limits and in part 3 the CSDR introduction of shortening of the settlement cycle.

Read part 1:

Read part 3:

today to discuss how we can help you to grow your retail client business.

¹ Directive 2014/65/EU, the “Markets in Financial Instruments Directive”

² Regulation (EU) 2017/1129

³ Directive 2013/50/EU

⁴ Regulation (EU) No 596/2014

⁵ Regulation (EU) No 236/2012

⁶ Regulation (EU) No 909/2014

⁷ Directive 98/26/EC

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