



MC BORRELLI  
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LIMITED

# DLT PILOT SCHEME – COMPLIANCE TAKE OFF

## SPEEDREAD

Whilst there are many benefits for market infrastructures (“MIs”) (and firms they support) using distributed ledger technology (“DLT”), such as the trading and settlement of ‘tokenised’ securities, the applicable compliance requirements under the forthcoming DLT Pilot scheme are both varied and complex.

It is safe to say that the compliance journey for financial services firms, which lays out the path to safety, is ready for ‘take off’.

In this note, we answer the following questions:

1. What are the main elements of the DLT Pilot?
2. How does the DLT Pilot affect trading and settlement?
3. What are the key compliance obligations under each set of RTSs?
4. What must I do for regulatory access to DLT and to qualify for reporting exemptions?
5. How can we help?



# WHAT ARE THE MAIN ELEMENTS OF THE DLT PILOT?

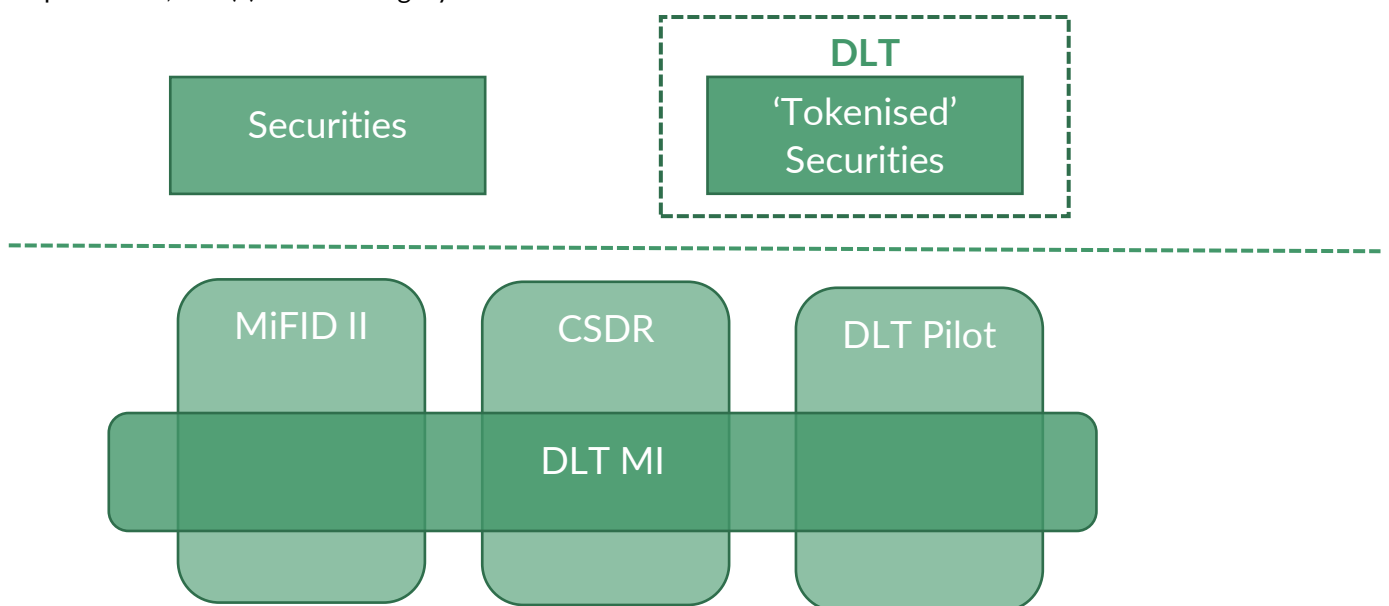
Earlier this month, European Securities and Markets Authority (ESMA), the EU's securities markets regulator, published its report on the distributed ledger technology pilot regime (DLT Pilot).

The DLT Pilot is, effectively, a regulatory sandbox which allows eligible firms to apply to operate a DLT-based trading facility and/or settlement system for financial instruments, within a flexible regulatory environment. The intention behind it is to facilitate the development of secondary market infrastructure for digital securities (including both "tokenised" securities and digitally native securities), and to help inform EU regulators as to what (if any) permanent changes to the regulatory framework would be beneficial.

While this is an EU activity and so not applicable in the United Kingdom, it is still an important document as it gives those in the United Kingdom an insight in the development of blockchain regulation. With this, we can consider what steps the FCA may consider taking.

The report provides guidance on certain technical elements and makes recommendations on compensatory measures on supervisory data to ensure a consistent application by DLT market infrastructures from the start of the regime, all points to be considered when preparing for future rules.

The main elements of the DLT pilot are to help in the industry in the development of the trading and settlement for 'tokenised' securities, i.e. digital representations of traditional securities and enabling market participants, as well as European Union ("EU") regulators, to gain experience on new opportunities and issues raised by DLT alongside ensuring the three core pillars of financial regulation are met: (a) financial stability; (b) investor protection; and (c) market integrity



# HOW DOES THE DLT PILOT AFFECT TRADING AND SETTLEMENT?

Cryptoassets are a core application of DLT technology in finance. 'Tokenised' securities can constitute Security Tokens (a type of Cryptoassets), which are supported by DLT-based solutions. DLT-based solutions promise to augment the listing, trading and settlement of securities.

Key benefits involved are:

- ✓ **Transparency:** public ledgers provide information available to all participants in a distributed ledger (subject to certain rules), allow for the tracing of transactions throughout the life cycle of the security, and can act as a register of ownership.
- ✓ **Data integrity:** data stored on the ledger has a high level of integrity, since consensus among participants is necessary to modify data blocks (subject to certain rules).
- ✓ **Disintermediation:** DLT-based solutions could provide direct access to secondary markets with peer-to-peer models, decreasing the need for intermediation, and reducing costs and counterparty risks.
- ✓ **Efficiency:** improved efficiency for listing, trading and settlement due to decentralisation, improved access to information, real-time execution of transactions, and ease of exercising contractual rights, processing payments and transferring funds.

Key obstacles involved are:

- ✗ **Vulnerabilities of crypto-asset markets:** liquidity mismatches; credit and operational risks making stable coins and their providers susceptible to runs on their reserves; increased use of leverage in crypto-based investment strategies; concentration risk on platforms trading crypto-assets; lack of transparency and regulatory oversight of the sector.
- ✗ **Vulnerabilities of the distributed ledger technology:** uncertainty remains on potential operational and security issues arising from the distributed ledger technology.
- ✗ **Limited interoperability:** limited interoperability both between DLT-based infrastructures and traditional market infrastructures, and between DLT-based infrastructures.



## WHAT ARE THE KEY COMPLIANCE RISKS UNDER EACH SET OF RTSS?

The regulatory technical standards (“RTS”) applicable to DLT MIs may be those that have been put in place under Regulation EU No 600/2014 (“Markets in Financial Instruments Regulation” or “MiFIR”). MiFIR lays down a variety of RTSs that concern two key areas: (a) transparency; and (b) regulatory reporting/record keeping.

A sample of compliance obligations are disclosed below.

Area	RTS Reference	Example Compliance obligation
Transparency	1 - 2 (Instruments and transactions)	Report underlying financial instrument data for certain instruments and transaction types
	1 - 2 (Pre-trade transparency waivers)	Report underlying financial instrument data (unless transparency waiver secured)
Regulatory reporting/recordkeeping	22 (Details to be reported)	Report or cancel transactions in the case of error
	25 (Clock synchronisation)	Synchronise “business” clocks to record the date and time of reportable events

## WHAT CAN I DO FOR REGULATORY ACCESS TO DLT AND OTHER FUTURE PREPARATION?

Certain DLT MIs (e.g. DLT MTFs) may need to choose between: (a) the full exemption from RTS 22, which will be accompanied with the obligation to record all relevant details on the DLT and to grant direct access to the regulators; and (b) the full application of RTS 22. It is important for this decision to be made well in advance to give sufficient time to prepare for – and implement – a regulatory change management programme.

Furthermore, given the emerging possibility to use the ISO 20022 methodology to store all type of information that should be reported, firms should begin their technical preparations to ease the implementation process, such as storing data elements on external databases and experiment with standardising the signature of smart contracts.



Store data on  
external database

Retrieve data from  
external database

Storing data on  
the DLT

## HOW CAN WE HELP?

Our services (e.g. compliance advice, training, compliance audits and risk assessments) are supplied to cryptoasset ecosystem actors for all activities across all of the industry segments, particularly the Issuing/Distribution and Investing segments.

Our clients benefit from comprehensive compliance coverage of the United Kingdom regulatory perimeter alongside a supreme understanding of European Union financial regulation relating to such as securities, derivatives, exchanges, investment management, bank supervision, financial crime and risk management.

## WHO ARE WE?

MCBorrelli provides you with crypto compliance as a service.

At MCBorrelli we have combined decades of experience in financial regulation which has built the foundation of our understanding of the way that crypto is regulated and looks ahead to future regulation.

Our skill and experience mean that we can give you the crypto compliance service that you need.

We will work with you to identify the relevant issues, identify the best solution and then implement that solution. And along with that we will bring you up-to-date training and audit services. For all your staff and for all parts of your business.

For a **FREE CONSULTATION** email [mb@mcb-ltd.co.uk](mailto:mb@mcb-ltd.co.uk)

