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Additional Information

Level 1 Regulation
Regulation (EU) 2022/858 - DLT Pilot Regime Regulation (DLTR)

Topic
Exemptions for DLT market infrastructures

Additional Legal Reference
Article 5(8) of DLTR

Subject Matter
Exemptions for DLT SS/TSS operators on cash settlement

Question
For a DLT SS/TSS operator benefitting from the exemption in Art. 5(8) of DLTR, is it possible for them to settle payments using e-money tokens (EMTs) issued by the DLT SS/TSS

operator itself or by an e-money institution (as opposed to only settling payments with EMTs issued by a credit institution)?

ESMA Answer

08-03-2024

Original language

The intention of Regulation EU No 2022/858 (DLTPR) is to ensure that Union financial services legislation is fit for the digital age and contributes to a future-proof economy that works for citizens, including by enabling the use of innovative technologies. Under that Regulation, a CSD operating a DLT SS/DLT TSS and an investment firm or market operator operating a DLT TSS (DLT SS/TSS operator) may be exempted from certain provisions of Regulation (EU) No 909/2014 (CSDR) that are likely to create regulatory obstacles for the development of DLT SSs/TSS. Those exemptions are subject to conditions attached to them, including certain minimum requirements, and any compensatory measures to meet the objectives of the CSDR to safeguard investor protection, market integrity and financial stability. The DLT SS/TSS operator must demonstrate that the exemption requested is proportionate and justified by the use of distributed ledger technology. With this in mind, any exemptions provided under the DLTPR are strictly limited to the activity taken in accordance with that Regulation and with the overall goal of allowing innovative technologies to develop within set parameters; It should not be construed as providing any guidance on or limitation to the application of the CSDR outside the application of the DLTPR.

Generally, in line with international standards, CSDR strongly encourages the settlement of transactions in central bank money; where settlement in central bank money is not practical and available, commercial bank money may be used. But because that rule can be difficult to apply for a DLT SS/TSS operator, as currently there is no tokenized central bank money available for such purposes, an exemption is provided from the provision of that Regulation on cash settlement in order to develop innovative solutions under the pilot regime by facilitating access to commercial bank money, or the use of ‘e-money tokens’ (EMTs) subject

to safeguards.

It is assumed in the question that the DLT SS/TSS operator is authorised to provide the service and that the competent authority has agreed to exempt the CSD for the provision of such a service from the requirements under Article 40 of the CSDR in accordance with Article 5(8), first subparagraph, of the DLTPR. Where the exemption applies to DLT SS/TSS operators, it shall settle transactions on the basis of delivery versus payment and it shall comply with the requirements for the settlement of payments as listed in Article 5(8), second subparagraph, of the DLTPR.

Article 5(8), second subparagraph, of the DLTPR requires the settlement of payments to be made through the use of:

1. central bank money (including in tokenized form);

2. the CSD's own account in accordance with Title IV of CSDR (banking type ancillary services for CSDs);

3. commercial bank money (including in tokenized form) in accordance with Title IV of CSDR (banking type ancillary services for CSDs); or

4. 'e-money tokens'.

As described above, Title IV of CSDR does not apply to the settlement of payments in EMTs undertaken by a DLT SS/TSS operator benefiting from the exemption set out in Article 5(8) of the DLTPR. However, Article 5(8), fourth subparagraph, of the DLTPR would apply in this situation, providing certain requirements for the CSD to comply with (further discussed below) where the settlement of payments occurs using EMTs. In addition, Article 5(8) fifth subparagraph, of the DLTPR needs to be respected where applicable (also further discussed below).

Article 5(8) does not specify that the EMT used for settlement must be issued by a specific type of a financial institution; it does however need to be issued in accordance with the applicable legislation, i.e. Directive (EU) 2009/110/EC and Regulation (EU) 2023/1114. Subject to those requirements being fulfilled it follows that DLT SS/TSS operator could use EMTs issued by electronic money institutions.

However, it should be noted that where a DLT SS/TSS operator provides services in relation to EMTs that are equivalent to the services listed in Section C, points (b) and (c), of the Annex to the CSDR, such services shall be provided by the DLT SS/TSS operator in accordance with Title IV of the CSDR or by a credit institution, as required under Article 5(8), fifth subparagraph, of the DLTPR. Hence, whilst Article 5(8), second subparagraph, of the DLTPR does not refer to Title IV of the CSDR where the settlement of payment is undertaken using EMTs, it is clear from Article 5(8), fifth subparagraph, of the DLTPR that such a DLT SS/TSS operator has to be authorized, or use a credit institution, to provide services listed in Section C, points (b) and (c), of the Annex to the CSDR.

To determine whether a service is covered by Article 5(8) fifth subparagraph, of the DLTPR such services (including equivalent services bearing in mind the different technology underpinning the DLT Pilot Regime) are being provided, it is important to take into account the specificities of settlement using DLT.

Only if the specific characteristics of the DLT allow for settlement using EMTs to be undertaken in a way that does not amount to the provision of services equivalent to those listed in Section C, points (b) and (c), of the Annex to the CSDR, would a DLT SS/TSS be able to use EMTs for settlement without the need to comply with Title IV of CSDR or rely on a credit institution.

An example of a settlement model that may be feasible (depending on its actual design and function and depending on supervisory assessment of each specific case) within the DLT Pilot, without amounting to any of the services referred to in the fifth subparagraph of Article 5(8), but whose operation would rather be covered by the service of settlement and that of providing accounts to participants in the DLT SS/TSS), is a model where EMTs are used to perform pre-funded atomic settlement on the DLT SS/TSS. Atomic settlement is a programmatically guaranteed settlement of both the asset and the payment leg of the transaction using DLT. In other words, where, in the context of the DLT Pilot regime, the elements of a transaction settlement process are such that market participants or persons acting on their behalf pre-fund their asset account and their cash account and submit transfer orders to the DLT SS/TSS for the purpose of atomic settlement, whereby the execution of those orders by the DLT infrastructure programmatically leads to the settlement of a transaction, this scheme (depending on its actual design and function) could be an example of where the settlement of payments could occur using EMTs without requiring an involvement of a credit institution in accordance with, and limited to, the DLT PR. Under the

DLT PR the authorized DLT SS/TSS may provide, subject to complying with the requirements, settlement of payments in EMT (including an account related to EMT) to the participants in a DLT SS/TSS.

However, the validity of the example provided is strictly conditioned to atomic settlement models (a) which due to the considerations set out above may not amount to any of the services referred to in the fifth subparagraph of Article 5(8), (b) that are authorized under the DLT Pilot, (c) that are using EMT issued in accordance with the applicable legislation (see above for div) and (d) that are relying on appropriate derogations available.

Moreover, recital 29 expresses the expectation that the DLT SS/TSS operators should ensure that any novel forms of risks raised by the use of DLT SS/TSS are addressed to ensure investor protection, market integrity and financial stability. The DLT SS/TSS operator would therefore still comply with the requirements set out in Article 5(8), fourth subparagraph, of the DLTPR to “identify, measure, monitor, manage, and minimise any risks arising from the use of such means”.I

It is also important to note that Article 5(8), fifth subparagraph, of the DLTPR does not refer to the services specified under Section C, point (a), of the Annex to the CSDR, hence, subject to the DLT SS/TSS being exempted under the DLT pilot regime and fulfilling the requirements listed under Article 5(8), fourth subparagraph, of the DLTPR , such service (cash account related services) should not have to be provided by the DLT SS/TSS operator in accordance with Title IV of the CSDR nor by a credit institution. The term ‘cash accounts’ is not defined. Since the DLTPR explicitly allows settlement in EMTs, cash accounts should be understood, for the purpose of that Regulation, as including accounts that hold EMTs, which may also be provided by electronic money institutions in line with Article 6 of Directive 2009/110/EC, where those accounts are provided to participants in a DLT SS/TSS for the purpose of settling transactions.

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