The UK Digital Securities Sandbox Takes Shape

15 April 2024

The Bank of England and the Financial Conduct Authority (FCA) are consulting on the implementation of the Digital Securities Sandbox (DSS). The DSS supports the issuance, trading and settlement of transactions in securities using distributed ledger technology (DLT). It will allow innovative market infrastructure to develop by adjusting financial services and potentially company legislation in the UK.

The DSS will be open to incumbent central securities depositories (CSDs) and operators of trading venues, along with new entrants. The focus is on the creation of Digital Securities Depositories (DSDs), which will perform one or more of the core functions of CSDs. Sandbox participants will need to be based in the UK and specify the obstacles to new business models that arise from existing laws. Temporary adjustments to those rules may become permanent in due course. With the current consultation, the Bank and FCA are seeking input on the following features of the DSS:

- The application process.
- The use of rule-making powers.
- The approach to managing financial stability and market integrity risks in the DSS.
- Supervision and enforcement.
- Fees to be levied by the Bank.
- Managing the limits on DSD activity within the DSS.

Challenges for Sandbox Design

The design of the DSS, including the range of financial instruments and the scale of the business that will be permitted within it, is critical to its success. In the European Union, where the DLT Pilot Regime launched in 2023, an overly-cautious legislative framework appears to have led to greater hesitancy than was expected. No DLT projects have been approved for the Pilot to date, and only four applications are being progressed. The European Securities and Markets Authority (ESMA) has identified several challenges in a recent letter to the European Commission:

- The absence of viable substitutes for central bank money to effect settlements.
- A lack of attention to the features of custody arrangements, including self-hosted wallets, in the context of digital securities.
- The need for interoperability between financial market infrastructures; eg, between trading venues and settlement systems.
- The tension between restrictions imposed on the scope of the Pilot Regime, in order to accommodate retail-level participation in multilateral trading facilities, and ongoing regulatory uncertainty about the conditions for retail participation.
- The lack of assurances to firms making investments under the Pilot Regime that they will be able to benefit from them after the initial testing window has closed.

The DSS has attempted to address some of these issues, up-front. By entertaining a broader range of business proposals and affirming the Government's intention to make permanent adjustments to financial services regulations, the UK hopes to encourage greater initiative and engagement from the private sector.

The UK Approach

Flexibility is the key to the DSS, but the current consultation provides greater certainty about the stages that firms will pass through on their sandbox journeys. It also sets out the 'gates' they will have to pass in order to progress between them. The five stages to the DSS will be:

1. Initial application.
2. Testing, and applying for authorisation to operate a trading venue and to be a DSD.
3. Go-live.
4. Scaling.
5. Operating outside of the DSS under a new regime.

The DSS is expected to encourage the issuance of sterling-denominated digital bonds, in the first instance. Other financial instruments, including stocks, money-market instruments, fund units, and emission allowances, can form part of the DSS. Overall limits have been calculated for sterling-denominated instruments, but the Bank is open to others being included.

Derivative contracts referencing in-scope assets can be included, provided that they are settled outside of the sandbox, but other derivatives are not within the scope of the DSS. Unbacked cryptoassets (such as Bitcoin) are not part of the DSS.

The focus of the DSS is on combining trading venue and settlement system functionality. Sandbox entrants will become DSDs when they take on one or more of the functions of a CSD for digital financial instruments. Recognised investment exchanges and investment firms operating MTFs or OTFs will need to obtain permission to act as DSDs through a variation of permission, but they will not be subject to the full range of requirements for CSDs.

New entrants will need to obtain permissions to act as DSDs from the Bank. If they intend to operate a trading venue, then they will also need permissions from the FCA to do so; but operating DLT-based trading venues alone (without addressing settlements in digital securities) is not expected to be part of the DSS. There is a challenge for trading venues looking to combine their core skills with settlement systems through consortia: they will be required to work through a single permissioned entity.

The Role of Cash

Recognising that wholesale tokenised central bank money is not currently available for the cash leg of settlements in DSDs, forms of commercial bank money will be permitted temporarily. Stablecoins not regulated by the Bank, e-money, and unbacked cryptoassets (such as Bitcoin) will not be allowed to substitute for central bank money in the settlement process. Changes may be made to the Bank's real time gross settlement (RTGS) system to make central bank money available for settlement purposes.

Market Limits

The Bank proposes to set limits for sterling-denominated financial instruments at levels that reflect the perceived ability of the market to absorb losses due to settlement failures. Key figures include (in billions of pounds):

- Gilts: 8-13.1
- Corporate Bonds: 17-28
- Asset-Backed Securities: 8-16

- Short-term money market instruments: 4.4-8.8
- Shares in FTSE350 companies: 6% of outstanding shares

These limits are based on the value of open positions, rather than trade volumes.

Regulatory Fees

The Consultation Paper provides visibility of the costs that are expected to be charged to applications and participants in the DSS. UK regulators already charge fees on a cost-recovery basis for certain applications. The DSS will continue this approach. Highlights of the proposed fees include:

- Application to become a sandbox entrant: £10,000
- Application to be approved to be a DSD: £40,000
- Application to be approved to operate an MTF or OTF: £50,000
- Application for a variation of permission by a Part 4A firm to operate an MTF or OTF: £25,000

The Bank proposes to charge £85,000 to each DSD for annual supervisory charges in Stage 3. Further fees are under consideration.

Next Steps

The consultation is open through 29 May 2024. The Bank of England and the FCA plan to respond to contributions in the summer of 2024, ahead of the DSS opening for applications. The first round of admissions to the DSS is expected in the fall of 2024.