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UK Digital Securities Sandbox – the final framework

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The Bank of England and Financial Conduct Authority have now launched the UK Digital Securities Sandbox. This allows regulated market infrastructures and new entrants to apply to operate digital securities market infrastructure within a more flexible legal and regulatory environment. The final framework is largely based on the regulators' initial proposals, but with a number of welcome adjustments.

Background

The Financial Services and Markets Act (FSMA) 2023 empowered the Treasury to create financial market infrastructure (FMI) sandboxes. These were intended to promote innovation by allowing for experimentation with novel market infrastructure models within a live, regulated environment. The Digital Securities Sandbox (DSS) is the first FMI sandbox to be created under those powers.

The Treasury's legislative framework for the DSS (DSS Regulations) came into force in January this year. This empowered the Bank of England (BoE) and Financial Conduct Authority (FCA) to operate the DSS within the confines of those regulations.

After consulting on their initial proposals around the operation of the DSS, the BoE and FCA have now finalised and launched the DSS. In doing so, they have published a bundle of new materials, including final Policy Statement, Gate 2 Rules, Guidance and links to the DSS Landing Page and DSS Dashboard.

What's new?

Here are some of the key changes and fresh insights from the final package. For a reminder of the original proposals see our previous blogpost

1. Renewed commitment to a flexible, reactive and applicant-led approach.

The DSS Regulations gave the regulators broad powers to make, amend and waive rules for sandbox entrants, including to tailor rules to accommodate individual proposals. This was highly welcomed by industry, and favourably compared against the EU's DLT Pilot Regime, which adopted a more prescriptive approach. There were concerns, however, that the regulators' initial proposals seemed to narrow down the scope for flexibility and applicant-led outcomes.

The regulators have taken on board these concerns. In particular, they reiterate throughout the Policy Statement that they will be receptive to individual requests and may waive or modify a rule for a firm to address a material obstacle to their particular business model. They also plan to hold regular roundtables with industry to discuss policy issues on an ongoing basis to help inform their approach.

In addition, the BoE has made further modifications to the Gate2 rules and deferred publication of the end-state rules. The latter is intended to avoid prejudging the outcome of the DSS and provide more room for the final framework to be shaped by the learnings within the DSS. This all sounds very promising. We will have to wait and see how it plays out in practice.

2. Inclusion of non-sterling denominated assets.

In response to strong industry pushback on the proposal to limit the DSS to sterling denominated assets and settlement in sterling, the regulators have now dropped these restrictions. They say they may consult with overseas authorities in some cases to check they have no concerns (particularly in relation to foreign government debt).

This shift in approach will be a great relief to the market, as there were broad concerns that a restriction on multi-currency arrangements would be at odds with the general regulatory framework for central securities depositories, limit the appeal of participating in the DSS and potentially undermine the UK's role as a leading global financial centre.

3. Requirement for a UK legal entity, separate from other cryptoasset business.

In contrast to the shift on asset classes and settlement currencies, the requirement for applicants to be established in the UK remains in place. This will prevent overseas entities from applying, including through a local branch. It will not prevent overseas firms from interacting with sandbox entrants, for example as customers or service providers. The Guidance also includes a new requirement that firms that provide "*FMI activities in relation to cryptoassets which do not qualify as financial instruments*" do so from a separate legal entity that is not an applicant to the Digital Securities Sandbox. This could create challenges for some businesses.

4. Scope to apply for uplifts to go-live limits.

For certain asset classes, the regulators will impose aggregate capacity limits on the volume of those assets that can be recorded or traded on market infrastructures within the DSS. These aggregate limits will be allocated equally among participating firms within each stage. This is designed to mitigate incremental risks of settlement failures and outages that could arise from relaxing certain regulatory standards.

For key sterling assets classes, the regulators have set the individual limits that will apply at the go-live stage, with limits for subsequent stages to be calculated later on (by reference to the number of participants that clear the relevant Gates, among other things). There were concerns within the industry that the go-live limits initially proposed were unduly restrictive, and would make it difficult for firms to emulate real world conditions, including in relation to liquidity and the handling of multiple issuances.

The regulators have responded by introducing further flexibility to allow for firms to be granted uplifts (upon application) once the initial limits have been reached. In relation to non-sterling asset classes, the

BoE intends to calculate and set limits for activity in non-sterling assets that "*hold an important position regarding the functioning and financial stability of the financial system*". These limits will be published as soon as practicable. Individual limits may also be imposed in relation to other asset classes on a case-by-case basis.

5. Fund tokenisation.

In relation to fund tokenisation activity, the BoE intends to apply individual, but not aggregate, limits. These will be in the form of a cap on the total assets under management. The regulators have also emphasised that some units in collective investment undertakings are capable of amounting to "transferable securities". This means that they may need to be recorded in a regulated central securities depository (or "digital securities depository" within the DSS) to satisfy Art 3(2) UK Central Securities Depositories Regulation (CSDR). The Policy Statement also notably adds that "*this requirement could be expanded in future to adequately capture risks to financial stability as activity evolves*". This could potentially limit the scope for structuring arrangements to fall outside the Art 3(2) requirement.

6. Additional review point.

The initial proposals contemplated two scheduled 'review points' during which firms could apply to progress through Gate 3 to benefit from the higher stage 4 limits. In response to concerns that sandbox entrants could find themselves "stuck" in stage 3 for many months with no surplus capacity for further activity, the regulators have said they will add a third review point if necessary. This would happen midway between the two originally proposed review points. This, along with the new up-lifts, will help alleviate some of the concerns around the go-live limits.

7. Clarifications in relation to settlement.

The regulators received a lot of feedback in relation to settlement assets but have not substantially changed their position. In short, they will not allow stablecoins or e-money to be used for settlement in the DSS (for any currency), nor will they mandate settlement in central bank money for the time being while the BoE continues to develop its offering. Their position echoes the themes of the BoE's recent approach document on innovations in money and payments. That said, the BoE does now indicate that it could potentially waive or modify these requirements to accommodate other solutions that meet the singleness of money principle.

The BoE has also made certain clarifications in the Gate 2 Rules with regard to settlement. For example, it has made clear that it expects sandbox entrants that are not themselves authorised as deposit-takers to use the services of an appropriately authorised commercial bank to hold their members' cash balances and effect payments. It acknowledges that this may make it harder for some firms to offer settlement across a single ledger.

8. Measures aimed at supporting smaller new entrants.

Some of the modifications that the BoE has made to the Gate 2 Rules are aimed at creating a more proportionate framework for smaller new entrants. For example, it has reduced the minimum capital requirements and removed the more prescriptive requirements in relation to links with other central securities depositories.

The regulators have also said they will "*keep under review as a key priority the question of whether a new permanent regime for non-systemic settlement activity is appropriate*". This is a pertinent issue, because it is currently unclear whether smaller firms would be able to exit the DSS without evolving to meet the more onerous requirements aimed at systemic infrastructures.

9. Other amendments to the Gate 2 rules.

The regulators have also made a number of other changes to the Gate 2 rules. For example, certain targeted amendments have been made to the DSS version of the Uncertificated Securities Regulations (USRs) with a view to addressing technology-neutrality concerns. The Gate 2 rules have also been revised to clarify that requirements in relation to settlement finality refer to contractual protections that determine when a transaction is final, rather than designation under the Settlement Finality Regulations.

While there were a number of queries raised around custody, the FCA has not proposed any modifications to its custody rules within the DSS. It notes that it is continuing to consider changes to the custody regime for security tokens outside the DSS. Likewise, at this stage the BoE has not made any changes to allow for retail users to be included as 'participants' in a digital securities depository, but is continuing to consider this.

10. Money Laundering Regulations to be brought within scope.

Some industry participants raised concerns that engagement in the DSS could potentially trigger requirements under the Money Laundering Regulations (MLRs) to register as a cryptoasset exchange provider or custodian wallet provider. This could happen if the assets traded or recorded qualify as "cryptoassets" under the MLRs. There remain debates around the scope of that definition.

Neither the regulators nor the Treasury is yet empowered to amend the MLRs within the DSS. This would require changes to primary legislation. The Policy Statement reports that the Treasury intends to push forward those amendments to allow for a temporary exemption to the MLR registration requirement within the DSS. This could potentially provide an opportunity for other amendments to the primary or secondary legislation, if the Treasury is so minded.

11. Activity involving developing technologies outside the DSS.

One issue of great importance to the market is that the operation of the DSS does not in any way hamper the use of developing technologies outside the DSS (in accordance with generally applicable law and regulation). The Policy Statement helpfully confirms that the acceptance of a particular model into the DSS should not be interpreted as a view from the regulators that it is not possible to pursue that model in any form outside the DSS.

Relatedly, the regulators acknowledge that there are use cases which it may be possible to implement in compliance with existing laws and regulations but which it may be advantageous to test within the DSS to consider the future regulatory and legal regime applicable to them. The conditions for participation in the DSS require there to be barriers or obstacles that prevent the firm from operating its "optimal business model".

What's next?

The DSS is now open for applications. The application form is available through the DSS Dashboard.

While the regulators are not bound to process applications within a set timeframe, the Guidance outlines some indicative timing. This suggests they expect Gate 1 applications to be processed within 4 - 5 weeks of receipt of a complete application and for Gate 2 applications to take between 4 and 12 months, depending on the nature of the applicant and application. The first opportunity to scale to Gate 3 is expected in October - December 2025.