

ARTICLE

The UK Digital Securities Sandbox is officially open

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On September 30, 2024, the UK Digital Securities Sandbox was officially declared open. The announcement was made by the Bank of England (BoE) and the UK Financial Conduct Authority (FCA), following the consultation earlier this year on the operation of the Digital Securities Sandbox (DSS) and the supervision of entities in it.

The news is positive: there are a number of industry wins following concerns raised during the consultation process. However, there are still a few areas where prospective DSS entrants may be disappointed – in particular, the regulators have maintained the position that UK branches are not eligible to enter the DSS.

This article sets out a summary of the background to the DSS's development, together with a discussion of key points of industry interest and the regulators' stance as set out in their Policy Statement and other publications.

Background

A sandbox, in summary, is a temporary supervisory regime which allows firms to carry out certain specific activities within set parameters, to assess whether those activities can be brought safely into the existing regulatory regime. The aim is to promote innovation by flexing existing regulatory rules, which would otherwise bar or fetter firms seeking to carry out those activities.

The legal basis of the Digital Securities Sandbox (DSS) originates in HM Treasury's power to modify and disapply existing regulations in order to allow financial market infrastructures (FMIs) to test FMI activities. In 2023, HM Treasury consulted on the use of this power to test FMI activities in relation to digital securities, and subsequently granted the BoE and FCA the necessary power to make, modify and disapply rules and technical standards in the context of a sandbox established for UK FMIs seeking to trial developing technologies.

Accordingly, the BoE and FCA consulted in turn on their approach to operating the DSS in practice, which drew considerable interest from firms wishing to enter the DSS and firms engaging with prospective DSS entrants. There has been substantive debate around the scope of assets which may be used by DSS participants, the eligibility criteria for entry, and over-limiting participants during their time in the DSS or, looking ahead, to when they exit the DSS.

Basic structure of the DSS

DSS participants will fall into one of three business models:

- Firms undertaking notary, settlement and maintenance CSD activities (referred to as a Digital Securities Depositary or "DSD").
- Firms operating a trading venue.
- Firms providing both of the above (as a "hybrid entity").

Accordingly, in-scope activities are being an investment exchange operator, CSD, multilateral trading facility or organised trading facility. The scope of

instruments which may be used when carrying on DSS activities is, in short, limited to non-derivatives (except where derivatives are capable of being transferable securities).

To be eligible to enter the DSS, applicants must:

- Be a UK-based entity (not a branch).
- Conduct activities and deal in assets in such a way that is in scope of the DSS.
- Certify that they face potential regulatory barriers or obstacles to conducting their activities outside the DSS.

In addition, the eligibility criteria require that there be no significant adverse incidents in the supervisory or enforcement history of the applicant, and that the applicant apply as a single UK legal entity (including where it is part of a wider group).

Applicant DSDs are required to pay GBP10,000 on application.¹

The DSS itself is composed of different stages, with a series of “gates” for DSS entrants to move through as their permitted activity increases at each stage. DSD fees apply at the go-live stage: GBP40,000 when approved, and an estimated GBP85,000 annual fee charged on a cost-recovery basis and allocated equally across DSDs. There will be further consultation on fees for the scaling stage.

Summary of gates and stages²

Stage	Purpose	Legal designation	Criteria/applicable rules
Initial application	Identify firms eligible to join the sandbox	None	Eligibility criteria
Gate 1 - Testing stage	Testing stage and seek authorisation to operate a trading venue or to be a DSD	Sandbox entrant holding Sandbox Approval Notice (SAN)	Continue to meet eligibility criteria

Gate 2 - Go-live stage	Ability to carry out live business under initial limits	DSD and/or operator of a trading venue holding updated SAN	Gate 2 Bank rules (if DSD or hybrid) FCA requirements (if operator of trading venue or hybrid)
Gate 3 - Scaling stage	Scaling the business For DSDs, glidepath to authorisation	DSD and/or operator of a trading venue holding updated SAN	Gate 3 Bank rules (if DSD or hybrid) FCA requirements (if operator of trading venue or hybrid)
Gate 4 - Operating outside DSS under new regime	For DSDs, authorisation to operate outside the DSS	CSD/new category of FMI	End-state Bank rules

Regulators' response to industry sentiment

The Policy Statement includes positive news on a number of points which had been raised by the industry. The key policy changes are:

- Extending the scope of the DSS to include non-GBP denominated assets.
- Flexing the Gate 2 capacity limits and allowing uplifts to limits while firms are in the go-live stage – which will allow smoother transitions to the scaling stage.
- Adding the option of a third Gate 3 progress review window – again, which will allow smoother transitions to the scaling stage.
- Reducing the minimum DSD capital requirement to 6 (instead of 9) months of operating expenses.
- Removing detailed provisions relating to the use of bank guarantees and letters of credit used to secure DSD links in favour of relying on article 48 of Chapter 2 of the Gate 2 Bank rules.
- Confirming that where DSDs must ensure that any securities settlement system they operate offers “adequate protection” (article 39 of Chapter 2 of the Gate 2 Bank rules), such can include protection by contractual means.

For global firms, it will be disappointing that these changes did not include any flexibility around UK branches of non-UK entities taking part.

The Policy Statement did, however, acknowledge that the consultation had prompted requests for clarity on participant eligibility and how non-sandbox entrants would interact with DSS participants. In relation to third-party technology providers, the regulators confirmed that while such parties may apply to the DSS, they are not necessarily expected to do so and may be able to help DSS participants delivery services as a third-party supplier.

Furthermore, the Policy Statement confirms it is unlikely a DSD would be designated a critical third party (CTP) under the UK's new CTP regime.

Accordingly, such providers would not be subject to direct supervision, but the relevant resilience, recovery and outsourcing requirements would apply to the arrangement.

Notably, the regulators' responses on extending scope of the DSS to non-GBP denominated assets and moving to a more flexible approach on Gate 2 capacity limits are good news.

- For non-GBP denominated assets, the Bank will publish limits as soon as possible for non-sterling assets “that hold an important position regarding the functioning and financial stability of the financial system”. These are expected to include corporate bonds in EUR and USD (and possibly others).
- For the Gate 2 capacity limits, the Policy Statement confirmed that the regulators have uplifted these limits for gilts and sterling corporate bonds, and uplifts will also be possible for other asset classes.

Further, on the Gate 2 capacity limits, the Bank confirmed that where uplifts have been applied, firms within the go-live stage may be subject to different firm-specific limits. This is different to the original consultation paper proposals, and the change in approach is hoped to facilitate firms needing extra capacity to grow their business meaningfully. Uplifted limits will be set out in the published SANs.

Gate 3 and beyond

The consultation paper included proposals in relation to the Gate 3 Bank rules (for DSS participants scaling up) and End-state Bank rules (for firms which have exited the DSS). These prompted significant industry feedback which centred on the disadvantages of having a rigid set of rules, which draw heavily from the existing regulatory regime, before the DSS has even started.

As a result, the Bank confirmed that it would be revisiting these proposals once the DSS has been running for at least 15 months, so that the regulators can take on board learnings and observations from DSS activities over that period. The Bank expects to publish updated drafts of Gate 3 and End-state Bank rules after this 15-month period, and has confirmed that there will be industry engagement about these revised draft rules.

More broadly on industry engagement, the regulators have confirmed that they have taken note of consultation feedback on the need for clear and open communication about the progress of the DSS. They will hold periodic and ad-hoc roundtables to discuss the DSS with participants, as well as enabling discussion with wider industry on significant legal or policy questions.

What happens next

The DSS is officially open. The Guidance sets out indicative timeframes for DSS entrants as follows:

- Approximately four to five weeks to assess the type of applicant
 - Approximately four to five weeks to decide Gate 1 application;
 - To progress from submitting a Gate 2 application to live activity:
- Four months for DSDs.
 - Four to six months for authorised hybrids.
 - Six to 12 months for unauthorised hybrids.

Over the coming months, firms will enter the DSS and start to move through the gates and stages. We await further information on the scheduling of roundtable meetings with entrants and wider industry to discuss how the DSS is operating in practice.

The updated Gate 3 and Gate 4 Bank rules are expected only after the DSS has been operational for 15 months – so this will be January 2026 at the earliest.

The Consultation Paper noted concerns as to how the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs) should be applied. The Policy Statement confirms that HM Treasury intend to bring the MLRs in scope of the legislation that can be modified for the purposes of the DSS, and will provide a temporary exemption from those requirements for firms engaging in DSS activities.

The application window is expected to close in March 2027. As a reminder, the DSS will be operational until December 2028, but may be extended.

Helpful links

- [Digital Securities Sandbox Policy Statement](#).
- [Guidance on the operation of the Digital Securities Sandbox](#).
- [FCA landing page link here](#) and the [application form to enter DSS and supporting notes here](#).
- [BoE landing page including draft application progress and questionnaire for Gate 2](#).

Footnotes

1. Note that the FCA fee regime was not subject to the consultation and the existing fee regime will apply. Entrants applying for MTF and OTF permissions would therefore need to pay the Category 8 charge or, if eligible to apply to vary their permissions, 50% of a Category 8 charge. The Category 8 charge is currently GBP54,380.

2. Adapted from Table B: Stages of the DSS in the Policy Statement.

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