IRSG
INTERNATIONAL REGULATORY STRATEGY GROUP

International Regulatory Strategy Group (IRSG)

RESPONSE TO THE BANK OF ENGLAND AND FINANCIAL CONDUCT AUTHORITY

DIGITAL SECURITIES SANDBOX CONSULTATION

Summary:

The International Regulatory Strategy Group (IRSG) is a joint venture between TheCityUK and the City of London Corporation. Its remit is to provide a cross-sectoral voice to shape the development of a globally coherent regulatory framework that will facilitate open and competitive cross-border financial services. The IRSG welcomes the opportunity to respond to the Bank of England (the Bank) and Financial Conduct Authority (FCA) (together, the Regulators) on "CP24/5: Digital Securities Sandbox joint Bank of England and FCA consultation paper" dated 03 April 2024 (the Consultation). Overall, we are strongly supportive of the Regulators' position in respect of innovation in the trading and settlement of securities and the operationalisation of the Digital Securities Sandbox (the DSS) and look forward to continuing to work together on the future digital assets regulatory landscape.

In summary:

- The DSS proposal is a strong starting point for a flexible and commercial sandbox that is capable of laying strong foundations for the use of innovative technologies in the UK capital markets. We welcome the glidepath approach as a positive step to mitigate cliff-edge risks and enable firms to build up compliance so that on graduating out of the DSS they are capable of meeting the general regulatory framework.

- A proportionate and flexible approach will allow for innovation while maintaining the security and efficiency of the financial system. This is vital to the efficacy of the DSS in supporting the long-term competitiveness of the UK's capital markets. The Regulators must keep in mind the principle of "same activities, same risks, same rules" to mitigate risks and avoid a lowering of the overall standards of regulatory outcomes.

- The scope of permitted assets should be extended to include the use of electronic money (e-money) and other permitted versions of stablecoins when used in the context of a Central Securities Depository (CSD) to settle transactions with other wholesale market participants.

- The FCA should clarify how these rules will be interpreted in the context of sandbox entrants who may wish to enable direct trading capabilities to retail customers.

- Firms should have a single point of contact for the Regulators for all DSS-related activities so that this can be managed in a streamlined manner and so that decisions can be taken by the Regulators in a concerted and coherent way.

For a more detailed response and analysis, please refer to the rest of the consultation response below. We wish to thank Clifford Chance LLP for their support in drafting this response.

#	Question / Response
1	Do you have any comments on the draft Guidance on the Operation of the Digital Securities Sandbox (Appendix A)?

We welcome the DSS proposal and see it as a strong starting point for a flexible and commercial sandbox that is capable of laying strong foundations for the use of innovative technologies in the UK capital markets. As the draft Guidance summarises in general terms the Regulator's approach to the DSS, we have set out some over-arching comments below.

- Application to become a sandbox entrant – We note that the Regulators propose to exercise their powers under the DSS Regulations to allow persons who are not authorised as a Recognised Investment Exchange, a CSD, a Multilateral Trading Facility or an Organised Trading Facility to participate in the DSS. The Consultation states that the DSS is open to "existing financial institutions" or "new entrants to this market" and that Regulators are open to applications from firms of all sizes and at all stages of development. The core conditions being that applicants must be legal persons established in the UK and must obtain the relevant authorisation or permissions before undertaking any regulated activity.

  In principle, this is a flexible approach which should enable innovation as long as the sandbox can facilitate a smooth glidepath for applicants and not impose unnecessary barriers to entry. By way of example, the consultation states that a consortium of firms who wish to apply together to operate a financial market infrastructure (FMI) under the DSS must establish a single UK entity. Such entity would of course not immediately hold a Part 4A permission or qualify as an FMI. It is clear that a Sandbox Approval Notice (SAN) would include core DSS activities such as the operation of a CSD, or of a trading venue. However, to the extent that any other regulated activities are being performed by the applicant, taking into account their particular business model, it should be possible for such entity to become a sandbox entrant and work through any necessary licensing process with the FCA as the firm progresses through the glidepath. As such it would be helpful if the DSS process could extend to any other licensing requirement that is in scope of the particular applicant's business model.

- Proportionality - In order to meet its innovation objectives it is important that the DSS does not effectively exclude the participation of newer entrants. This will require a proportionate and flexible approach to be taken by the Regulators, both in terms of the applicable rules and compliance requirements, as well as the fees payable. Keeping in mind the principle of “same activities, same risks, same rules” should mitigate risks and avoid a lowering of the overall standards of regulatory outcomes.

- Settlement Assets – The Consultation states that the Bank will allow the use of commercial bank money with little or no credit or liquidity risk, or equivalent private forms of money, to be used as a payment asset within the DSS. However, while the Bank would assess this on a case-by-case basis, it is unlikely that e-money or stablecoins not regulated by the Bank would meet the required standard. In this context, it is important to note that e-money issued by commercial banks constitutes a debt claim against the issuer. As such, when used in the context of a CSD to settle transactions with other wholesale market participants it is not clear

why e-money that is permitted to be issued by credit institutions under the electronic money regulations 2011 could not be used as a settlement asset. The success of any FMI using innovative technology is heavily dependent on the ability to use innovative settlement assets.

- Retail participation – One of the perceived benefits of the use of innovative technology in the capital markets may include the ability to enable retail investors to participate in the trading process and acquire digital securities directly. Neither the Consultation nor the guidance in Appendix A provide any position as to how the Regulators perceive the exposure of retail investors to DSS assets and whether or not projects that propose retail participation would be permitted.

  More specifically, under FCA rules (and under the recognition regulation) trading venues may admit persons who, *inter alia,* are of good repute, have sufficient level of trading ability, competence and experience and have sufficient resources for the role they perform. It would be helpful for the FCA to clarify how these rules will be interpreted in the context of sandbox entrants who may wish to enable direct trading capabilities to retail customers. The EU DLT Pilot Regime allows for direct participation of retail investors under certain conditions. The UK regime must provide similar clarity and flexibility to secure its long-term international competitiveness.

- Possibility of amending business plan and withdrawal – As a particular sandbox entrant develops and refines their business model after Gate 1, it would be helpful if the guidance addressed how the Regulators envisage amendments to the SAN, in particular, if certain aspects of the business model become less relevant or the sandbox entrant wishes to withdraw partly or entirely from the DSS.

- Use of technology outside of the sandbox – It is imperative that the DSS is not the only way in which firms are allowed to innovate in financial markets. In order to operationalise the sandbox, HM Treasury (HMT) has amended key pieces of legislation including the Central Securities Depositories Regulation (CSDR). Many of the changes disapply provisions that would potentially act as a barrier for the adoption of digital financial instruments in the wider capital markets. However, some of the changes that have been made merely confirm that certain uses of technology are permitted. See for example Article 3(2) of CSDR which has been amended as follows:

  > Where a transaction in transferable securities takes place on a UK trading venue the relevant securities shall be recorded in book-entry form**[, including a form of recording of transferable securities using developing technology,]** in a CSD or third-country CSD on or before the intended settlement date, unless they have already been so recorded.
  >
  > Where transferable securities are transferred following a financial collateral arrangement, those securities shall be recorded in book-entry form**[, including a form of recording of transferable securities using developing technology,]** in a CSD or third-country CSD on or before the intended settlement date, unless they have already been so recorded.

Various securities projects could be structured, issued and operate using DLT technology and meet the requirements of the existing (unmodified) CSDR, assuming that the recording in book entry form would already include DLT as is generally understood in the market. While the DSS is being introduced to broaden the possibilities of using new technologies like DLT in the financial markets, in making these clarifications/confirmations, the government has created uncertainty around the permissibility of utilising these technologies outside of the DSS. In order to avoid this, the Bank and ideally HMT should state that the relevant changes made as part of the DSS are confirmatory, that uses of DLT that were not expressly restricted prior to the establishment of the DSS will be unaffected by its implementation and that there are other ways in which firms can continue to innovate outside of the DSS.

- Application of remaining requirements – While the disapplication of certain rules in the DSS offers regulatory flexibility and fosters innovation in digital securities, participants in the sandbox are still subject to applicable laws, regulations, and overarching regulatory objectives, even if certain requirements are temporarily relaxed or modified. The challenge arises in determining how the remaining requirements, as amended, are applied and complied with within the sandbox environment. Participants would benefit from further clarity on this and how to ensure continued compliance. Clarity, transparency, and collaboration between regulators and the industry is crucial for the successful implementation of sandbox initiatives.

- Protection to participants – the Regulators should provide further information on how the DSS provides protection to downstream participants (rather than sandbox entrants). This should include clarity on the Regulators' supervisory responsibility to warn downstream participants of any issues found in the DSS that may influence their ongoing or future involvement with the DSD/Exchange.

- Eligibility – the Regulators should provide further clarity on who is eligible to apply to the DSS and whether their sandbox activity is limited to DSD/CSD/RIE/trading venue activity. This is in light of the Regulators' ability to receive applications from firms other than those expressly listed in the DSS Regulations.

- Proof of audit requirements - To avoid overly burdensome audit requests, the criteria for entry into the sandbox should include independent proof of audit requirements, such as System and Organization Controls (SOC) summary reports or certificates, or penetration test reports.

- Aggregate limits in the DSS - the proposed limits on the value of securities that can be issued and traded within the DSS are restrictive and risk deterring entrants by limiting the prospect of commercial gains. The UK should learn from the EU's DLT Pilot Scheme and avoid the same shortcomings and limited entrants. Furthermore, consideration should be given to introducing a range of limits which would apply depending on the entrant/type of business model/whether users are regulated. For example, there may be cases where the proposed limit will make the DSS unviable as a route for innovation– for example, if it was to successfully test a digital gilt or if an existing CSD wanted to test the digitisation of securities. Given many users will be regulated entities and will be subject to their own self-imposed limits due to risk management requirements this could be another factor considered.

#	Question / Response
2	Does the approach mitigate cliff-edge risks for sandbox entrants graduating out of the DSS?

We understand that cliff-edge risks should be mitigated via the glidepath approach. Although each firm will pass through the same stages, the applicable processes and requirements for a firm in each stage will depend on its business model. In our view, the glidepath is a useful tool enabling firms to build up compliance so that on graduating out of the DSS they are capable of meeting the general regulatory framework (potentially as amended). However, it is important to recognise that not all DSS participants would qualify as systemically important FMIs, even after graduating from the DSS and it is important that regulation is proportionate. As such we welcome the proposal of the Regulators to consider a regime for non-systemic FMIs which may be more appropriate for certain Digital Securities Depositories (DSD) even once they have graduated the DSS. However, this should not bring about a lowering of the overall standards of regulatory outcomes. The principle of "same activities, same risks, same rules" should be held.

#	Question / Response
3	Do you have any comments on the effectiveness of the glidepath approach described above?

N/A

#	Question / Response
4	Are there any known regulatory barriers and/or risks to/from the technology or business models not covered in the end-state rules that the Bank should consider at the outset?

N/A

#	Question / Response
5	Is the full set of rules set out in Appendix B consistent with the objectives and design principles of the DSS?

We generally agree that the full set of rules in Appendix B is consistent with the objectives and design principles of the DSS. However, we would refer to the response expressed above (see question 2) that ultimately not all DSDs may be systemically important so it should be possible to operate a framework for lower risk DSDs with a proportionate prudential framework.

#	Question / Response
6	Do you have any feedback on the Bank's approach to creating the Gate 2 rules or the Gate 2 rules themselves?

We generally agree that the approach of creating Gate 2 rules and that the Gate 2 rules themselves are the right approach. However, there are certain aspects of the Gate 2 rules that may have to be reconsidered or clarified:

- Record Keeping (Article 29) – The rules impose a requirement that records should exist for a period of at least 5 years. While this is a reduction of the end requirement, it is unclear how this requirement could be complied with if a particular sandbox entrant decides to withdraw from the process.

  More generally, this requirement should be capable of being met via the particular technology that is used. For example, it should be possible to meet record keeping requirements through the immutability of a distributed ledger.

- Settlement Finality (Article 39) – We agree in principle with the proposal that the Gate 2 rules would not require firms to obtain a settlement finality designation under the Settlement Finality Regulations (SFRs). However, it is unclear precisely what "protection to participants" means in this context. In the absence of a settlement finality designation, DSDs would have to rely on contractual provisions in the form of a rulebook or similar that would say that transactions in securities are valid and binding. However, there remains the risk of insolvency rules applying in the case of insolvency of participants (or the DSD).

- Participant default (Article 41) – In line with the comments in respect of settlement finality, any default procedures would not be capable of withstanding challenges to finality of transactions on the default of participants.

#	Question / Response
7	Are there any specific features of technology and/or business models that would be incompatible with the proposed Gate 2 rules?

We have not identified any specific examples that would be incompatible here.

#	Question / Response
8	Are there any requirements in the proposed Bank's DSS rules which would conflict with the frameworks that govern a firm which is also regulated by the FCA and/or the PRA?

We have not identified any particular requirement that would conflict with frameworks that govern a PRA and/or FCA regulated firm. We welcome the Regulators' position that, in respect of DSS activities, the Regulators would consider waiving or modifying certain requirements that may overlap with existing rules on a case-by-case basis. This is an important aspect that will give DSDs flexibility to design innovative business models.

#	Question / Response
9	Do you agree with the proposed approach to managing potential interactions between Bank, FCA and PRA requirements?

The Consultation does not fully describe how the day-to-day interaction with the Regulators would work. In particular, where a sandbox entrant or DSD is separately authorised, there may be ongoing supervisory contacts in addition to DSS regulatory/supervisory contacts and PRA supervisory contacts in respect of any banking activities. Different teams at the Regulators may have different priorities and it may be challenging to obtain a balanced position in respect of approach to rule modifications or waivers. In that sense, we would welcome the ability for firms to have a single point of contact for all DSS-related activities so that this can be managed in a streamlined manner and so that decisions can be taken by the Regulators in a concerted and coherent way.

#	Question / Response
10	Do you agree with the Bank's proposed capital requirements for DSDs, both at Gate 2 and end state?

N/A

#	Question / Response
11	Do you agree with the proposed approach to capital requirements where firms are also subject to other prudential regimes?

N/A

#	Question / Response
12	Do respondents have views on how the proposed regime balances the need to protect financial stability while allowing enough activity in the DSS to facilitate innovation?

A careful balance must be found here. FMIs are vital to the security and efficiency of the financial system and the foremost priority should be ensuring that UK FMIs remain a beacon of integrity within the global financial system. The DSS is a welcome step towards achieving digitisation within the existing FMI regulatory framework, for example by providing a controlled environment to disapply some of the rules in place for traditional FMIs. This allows for innovation while upholding wider financial stability.

However, we note that participation in the DSS will be a costly process, both on account of the DSS fees payable but also the time spent on compliance and potential cost of advisory fees throughout, creating a huge barrier to entry for smaller firms. By preventing smaller firms – often pioneers of innovation - from participating in the DSS, the UK could risk missing out on the full potential of the DSS to facilitate innovation. A proportionate approach would enable institutions of different sizes and business models to compete on an equal footing. The Regulators should engage with the industry to better understand the impacts of barriers to entering and progressing through the DSS, and should periodically review the regime to evaluate the extent to which innovation is being supported. As noted earlier (see question 2) the principle of "same activities, same risks, same rules" should be held to avoid a lowering of the overall standards of regulatory outcomes.

#	Question / Response
13	Do you agree with the Bank's proposed fee regime for the DSS?

N/A

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