

The Digital Securities Sandbox – An Expansion of UK Financial Technologies

JUNE 4, 2024

BACKGROUND

On 3 April 2024, the [Bank of England](#) (BoE) and the [Financial Conduct Authority](#) (FCA) invited responses in relation to the UK's Digital Securities Sandbox (the DSS), a regulatory testing environment, or 'sandbox,' which aims to allow participants to use developing financial technologies, including distributed ledger technology (DLT), in the issuance, trading, and settlement of securities. The consultation period ended on 29 May 2024 and we anticipate that the DSS will soon open to applications. Set forth below is a summary of the anticipated features of the DSS.

Why is the DSS needed?

The adoption of financial technology, including DLT, in financial market infrastructure (FMI) offers numerous benefits, including improved transparency and traceability, faster settlement times, reduced operational costs, immutability and increased security, the ability to incorporate smart contract functionality and increased efficiency through automation.

The UK's primary approach to regulating new financial technologies, including digital assets, has been to integrate them into the existing, highly regulated, and well-established FMI framework. However, this approach makes it challenging to balance the potential rewards against the high costs and complexities of adapting new technologies to fit within the existing regulatory regime.

The DSS aims to facilitate technology adoption by allowing FMIs to develop and test services under temporarily lightened regulatory requirements, while still protecting financial stability and market integrity by maintaining regulatory oversight. Additionally, it offers regulators the time and opportunity to understand how best to amend the current regulatory framework to support innovative FMIs.

As covered in our [previous client alert](#), the DSS is the first use of an FMI sandbox since the Financial Services and Markets Act 2023 came into effect. This act gave HM Treasury the power to temporarily disapply or modify legislation in order to create a sandbox for new financial technologies.

The DSS [regulations](#) came into force on 8 January 2024 and will continue to be in effect for five years.

KEY FEATURES OF THE DSS

What activities fall within the scope of the DSS?

The DSS is designed for carrying out:

- notary, settlement and maintenance services;
- operating a trading venue (namely, a multilateral trading facility (MTF), an organised trading facility (OTF) or a recognised investment exchange (RIE)); or
- a combination of the above,

in each case, involving the use of a developing technology (such as DLT), in a manner not currently permitted under any existing non-DSS legal and regulatory framework.

What instruments can be traded?

The DSS permits the trading of a variety of financial instruments, including shares, corporate and government bonds, money market instruments such as commercial paper and certificates of deposits, units in collective investment undertakings (fund units) and emissions allowances. However, the trading of derivative contracts and unbacked digital assets (such as Bitcoin or Ether) will not be permitted.

How will the DSS operate?

The DSS will be comprised of the following five stages of permitted activity, with each stage marking an increase in the amount of permitted activity available:

- **Stage 1: Initial application**, where firms apply to enter the DSS;
- **Stage 2: Testing**, where approved entrants test their systems in a non-live environment and prepare to meet the expected regulatory requirements needed to operate within the DSS;
- **Stage 3: Go live**, where entrants are granted permission to undertake live activities (subject to monetary limits);
- **Stage 4: Scaling**, where entrants can increase their activities and begin to consider how they will meet any requirements necessary to continue such activities once they exit the DSS; and
- **Stage 5: Operating outside the DSS under a new regime**, whereupon HM Treasury will create a permanent regime based on findings from the DSS trial period and any entrants interested in using the permanent regime will undergo any necessary transitions to their operations outside the DSS.
- **Who is permitted to enter the DSS?** To be approved to participate in the DSS, entities must be established in the UK but can be unregulated at the point of the application for entry. However, the necessary authorisations and permissions must still be obtained by any applicants prior to being permitted to carry out any activities within the DSS. Only entities which are a recognised investment exchange that is not an overseas investment exchange, a recognised CSD, or an investment firm with the necessary permissions to operate a multilateral trading facility (MTF) or an organised trading facility (OTF) will be able to pass through gate 2 of the DSS and carry out regulated activities.
- **How much will it cost?** Fees will be confirmed in the final proposals, but the consultation paper proposed a “pay-as-you-go” approach – allowing entrants to pay the relevant fees as only when they pass through the various stages of the DSS. The key fees currently proposed are:
 - Application fee for entry into the sandbox (stage 1): £10,000;
 - Application fee to ‘go live’ (stage 3): £40,000; and
 - Annual supervision fee (stages 3-4): £85,000.

These fees will be in addition to any applicable FCA fees, which remain unchanged, including a £50,000 fee to become an authorised trading venue and application fees of £25,000 to vary any relevant permissions required to operate a trading venue.

FOCUS OF THE CONSULTATION PERIOD

During the consultation period, the BoE and FCA sought input from interested firms on a number of features of the DSS, including:

- the effectiveness of the staged approach to the DSS, including whether the process effectively mitigates ‘cliff edge’ risks when a participating firm graduates out of using the DSS and into a more permanent regime;
- any conflict between the DSS regulations and other existing regulatory frameworks which govern potential entrants;
- the proposed capital requirements for entrants;
- whether the proposed regime strikes the right balance between allowing innovation and protecting financial stability; and
- the proposed fees.

LESSONS FROM EUROPE

A similar pilot regime in the EU, which came into effect on 23 March 2023, also allowed participants to test financial technologies, including DLT, in a controlled environment (the EU DLT Pilot Regime). However, as at 3 April 2024, there were no authorised entries, and only four applications had been received.

The European Securities and Markets Authority attributed the lack of uptake to an overly restrictive framework (allowing only applicants that were already regulated) and a lack of clarity regarding how firms could make permanent use of the systems established under the regime.

In contrast, the DSS offers greater flexibility and allows unregulated firms to apply to participate. It also leverages a bespoke regulatory framework, ensuring that the regulatory environment can be tailored to each entrant to ensure maximum efficacy. The DSS’s staged implementation also allows entrants to gradually adapt, better understand its functionality and make any necessary adjustments as they move through the trial. This staged approach aims to increase the likelihood of a successful transition to a permanent regime, with the BoE and FCA confirming that evidence gathered during the final stages of the DSS can be used to support an application under a more permanent regime. This greater flexibility, increased clarity and a clearer path towards graduating from the DSS to a permanent trading regime are expected to promote greater interest in and use of the DSS, compared to the EU DLT Pilot Regime.

KEY TAKEAWAYS

The DSS gives further indication that the UK government is taking steps to increase interest in UK markets by implementing new technologies to attract investment. The use of technologies such as DLT within the DSS could result in greater efficacy in the settling of trades, leading to savings by market participants including investment funds and banks. While the DSS does offer greater flexibility for a wider range of entities to make use of this technology, firms wishing to make use of the DSS will still need to have or to obtain the necessary permissions to carry out regulated activities before they can be an active participant in the DSS, so any interested applicants should carefully consider whether they wish to undertake such steps. Furthermore, as each stage of the DSS comes with separate fees and includes capital requirements, interested firms should ensure that they have the liquidity and capital to be able to successfully move through the stages of the DSS before applying.

NEXT STEPS

Following the expiry of the consultation period on 29 May 2024, we expect to receive joint feedback from the BoE and FCA during Summer 2024. Applications will then open, with the first cohort expected to become entrants from

Autumn 2024. Firms interested in exploring an application should start considering their submission now.

6 Min Read

The DSS is expected to close for new entrants in early 2027, with the DSS continuing until 9 January 2029.

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