

## **NAVIGATING THE NEW UK DIGITAL SECURITIES SANDBOX: WHAT IS IT, AND HOW DO I APPLY?**

HM Treasury (HMT) has introduced legislation to launch the UK's Digital Securities Sandbox (DSS). The DSS will allow certain financial market infrastructure providers (and market participants) to test the use of new technology (including distributed ledger technology or DLT) in capital markets while benefitting from a temporary waiver or modification of legal requirements that may otherwise hinder the use of such technology. Waivers or modifications of particular requirements may ultimately be made permanent and pave the way for significant advancement of the digital capital markets. We cover what you need to know, including how to apply, key considerations, and how the DSS compares with its EU equivalent, the DLT Pilot Regime.

### **CONTEXT**

The DSS is the first example of HMT's use of the power granted to it under the Financial Services and Markets Act 2023 (FSMA 2023) to create sandboxes which allow financial market infrastructures (FMIs) and other designated persons to test and adopt new technologies and practices by temporarily disapplying, modifying or applying certain other legislation for specific testing purposes with the ultimate aim of designing a regulatory capital markets environment that encourages technological innovation.

The DSS enables the modification or waiver of any legal requirements related to the provision of trading and settlement infrastructure for digital securities where such requirements would otherwise be restrictive to FMIs use of technologies such as DLT to carry on FMI activities.

Whilst the Financial Services and Markets Act 2023 (Digital Securities Sandbox) Regulations 2023 (the DSS Regulations) establish that the DSS will come into force on 8 January 2024, it will not be possible to submit applications until the regulators have designed the applicable requirements framework via their rules.

### **Consultation**

The creation of the DSS follows a [consultation](#) on the DSS by HMT, and its related [response](#) (the Response). The Financial Conduct Authority (the FCA) and the Bank of England (BoE) are the appropriate regulators that will both supervise the DSS and exercise the powers granted to them in relation to it by the DSS Regulations.

HMT's consultation invited expressions of interest from those considering participating in the DSS. As noted in the Response, at the time of publication, HMT had already received 19 expressions of interest from potential applicants, across a range of incumbent FMIs, existing regulated firms, and new entrants.

### **DSS**

The introduction of the DSS is a key pillar of the UK's efforts to ensure that it becomes a global hub for cryptoasset technology and investments, with the aim of subsequently attracting a wide spectrum of market actors. It follows the launch of the EU's Pilot Regime earlier in 2023, which strongly mirrors the DSS insofar as it allows operators of DLT market infrastructures to experiment with the use of DLT in issuance and post-trade processes by enabling regulatory authorities to disapply certain specific provisions of the regulatory rules applicable to FMIs and trading venues. The coincidence of both regimes illustrates a broader trend of FMIs and other key market players towards engagement with technological innovation. In the past few years we have seen a sustained focus across Europe on the potential benefits of using DLT in the bond markets, with key milestones including both individual jurisdictions' adaptation of their legal frameworks to such innovative, and high-profile innovative issuances, (as demonstrated by several notable issuances by the EIB).

See [our recent briefing](#) for more on the wider digital bonds landscape and upcoming legal and market developments.

### **Who can apply?**

Similarly to the EU DLT Pilot Regulation, the DSS is largely applicable to FMIs. However, it grants regulators additional flexibility when compared to its European counterpart.

An eligible entity can apply to the DSS to carry on any of the four activities permitted within the DSS: notary, settlement, maintenance (the activities of a central securities depository (CSD)) and operating a trading venue in relation to digital assets. Additionally, ancillary activities to the four permitted activities may benefit from the modified legislative and regulatory framework under the DSS.

These activities must be carried on as part of the business of a person that falls into one of the following categories:

- recognised investment exchanges (RIEs), excluding overseas investment exchanges;
- recognised central securities depositories (CSDs);

- the operator of a multilateral trading facility (MTF) who is also an investment firm; or
- the operator of an organised trading facility (OTF) who is also an investment firm.

In addition, the DSS gives regulators flexibility insofar as it enables them to allow other UK established persons to apply to participate in the DSS in order to carry on activities that relate to the four permitted activities mentioned above.

### ***Eligibility***

To be eligible to apply, the FMI must have been established in the UK (i.e. constituted under the law of any part of the UK or having, for the duration of the FMI sandbox arrangements, a registered office or head office in the UK). The DSS allows participants to operate in accordance with (modified) UK regulatory requirements, meaning that the participants must be directly supervised by the appropriate UK regulator (depending on the activities undertaken, this will be the BoE, the FCA, or both). Therefore, applicants must be established in the UK in order to facilitate such supervision. However, HMT clarified in its Response that participating FMIs do not have to commit to being governed by English law in order to participate in the DSS. The Response also noted that it is likely that a legal entity will need to have been established at the application stage (for example, applicants may be asked to provide a Legal Entity Identifier (LEI) code to the regulators as part of an application).

The effect of this is that UK branches of firms established overseas and recognised overseas investment exchanges would not be eligible to apply. However, there will not be a specific limitation on overseas firms receiving services from, or interacting with, DSS participants subject to meeting regulatory requirements. It is important to note that groups and consortiums may apply to become sandbox entrants, subject to the implementation of a clear governance structure.

The DSS Regulation makes provision for users of the services provided by the sandbox entrant, service providers and other persons carrying on activities or providing services in connection with an FMI sandbox instrument that is used in connection with the DSS activities to participate in the FMI sandbox arrangements, including by carrying on ancillary activities. This is a welcome clarification as it provides legal certainty to service providers of the DSS participants, and it means that their clients can benefit from the same modified legislative framework.

### **Application process**

The regulators will design the application process: the exact application forms, when the DSS will be open to applications, how long application windows will be open for and how long the application process will be expected to take. We expect that in line with the usual regulatory rule-making process, any DSS rules or guidance will be subject to the typical consultation process so as to allow market participants the opportunity to provide feedback on the proposed rules. However, it is currently unclear when the consultation window would be.

### ***Key information to be provided***

The DSS Regulations clarify that an individual Sandbox Approval Notice (SAN) will be issued to each sandbox entrant after approval of its application, which we understand will outline the particular scope of waivers modifications and the types of assets that a DSS participant can provides services in.

The information that a prospective sandbox entrant must provide in their application for participation in the DSS is determined on an applicant-specific basis, but includes (and is not limited to):

- the proposed FMI activities (and any applicable ancillary activities) to be undertaken in the DSS and the extent to which they will be carried on by the sandbox entrant at any time;
- the instruments that will be used on the sandbox entrant's platform when undertaking such FMI sandbox activities; and
- the regulatory and/or legislative barriers that are currently preventing them from (or are likely to prevent them from) innovating when undertaking their specific FMI activities outside of the DSS environment.

The regulators also have discretion to ask further questions of the applicant as may be necessary to ascertain its eligibility to participate in the DSS. Without having had oversight of the specific rules that the regulators will be putting in place for the operation of the DSS it is difficult to judge what level of detail around waivers and modifications applicants will be expected to provide. However, it would be reasonable to assume that applicants will be asked to identify at least the key legislative and regulatory provisions for modification in their applications.

Once an application to participate in the DSS has been approved and a SAN has been issued, the applicant will then be considered a "sandbox entrant" who may participate in the DSS.

Any breach of the SAN by a sandbox entrant could result in its cancellation, suspension or modification by the appropriate regulator.

### ***Further considerations***

**Modified SAN** – The appropriate regulator has the discretion to approve or reject an application, as well as to approve an application subject to certain conditions or variations to the approval sought in the original application.

**Associated fees** - Digital securities depositaries (DSDs) participating in the DSS are likely to be subject to fees for doing so, with exact amounts to be confirmed in due course by the BoE.

**Notifying relevant parties of DSS participation** – As part of the application process companies will be asked to confirm that they have contacted HMRC in order to make it aware of the intended participation (and to flag potential issues, such as those related to stamp duty reserve tax (SDRT)). HMT has recommended engaging with HMRC as soon as possible on this.

**Wind-down plan** – Although a wind-down plan will not be required as part of an application to enter the DSS, it may need to be in place and agreed with the appropriate regulators before live activity can commence.

## Sandbox entrants: scope of assets and activities permitted in the DSS

### *Scope of assets*

**In-scope** - The DSS Regulations provide that transferable securities (including debt and equity securities, money market instruments and units in collective investment schemes) are capable of being included in the DSS. Derivatives are excluded from scope. As outlined above, the specific assets that will be subject to a particular SAN may vary between DSS participants. Non-GBP denominated assets are permitted and are not prevented by the DSS legislative framework, but it remains to be seen how the market develops in this respect.

In addition to derivatives, the other notable exclusion from the scope of the DSS Regulations are any other unbacked cryptoassets. This is unsurprising given that the purpose of the DSS is to test the effect of certain legislative modifications on the operation of FMIs related to securities.

### *Scope of activities*

The exact scope of the activities that are permitted for each individual sandbox entrant will be outlined in its SAN (the DSS activities). The SAN should also provide information on any approved ancillary activities, along with any other modifications or variations to the original approval sought by the applicant.

To the extent that the authorisation and supervisory processes for other activities (or ancillary activities) are already compatible with digital assets and can be performed in line with existing regulatory requirements, these may be performed with, for, or by DSS participants without modification under the DSS. For example, firms who safeguard and administer securities in scope of the DSS would be expected to meet the requirements of the current regulatory framework in the Client Assets Sourcebook (CASS), unless the particular use of technology requires a modification of the rules. Sandbox entrants must make the extent to which they have been approved to participate in the FMI sandbox arrangements publicly available.

Whilst the appropriate regulator has ultimate discretion over the SAN, a sandbox entrant is permitted to apply to the regulator for the SAN to be modified, waived or suspended.

## Sandbox entrants: live activity stage

At the core of the DSS is the aim to promote innovation and technological advancement in the operation of FMIs. At the live activity stage, the FMI activities will be tested under the modified sandbox legislative and regulatory environments, and such modifications may be made permanent depending on the outcome of the activity. Specific laws and regulations are in scope of the DSS Regulations (i.e. can be modified for the purposes of testing in the DSS) given their current potential incompatibility with digital securities. The specific modifications are listed in the Schedule to the Regulations, but include in their scope the **UK CSDR, FSMA 2000, the Companies Act 2006 and the Uncertificated Securities Regulations**. These are either specifically disapplied, or, in the case of some requirements, replaced, by regulator rules, allowing the BoE and FCA to tailor rules to accommodate (i) the DSS generally or (ii) individual DSS applicant proposals.

In cases where legislation related to non-DSS activities has not been specifically altered or excluded, it is typically expected that it will remain applicable without modifications. However, HMT has indicated that it may make changes to the Financial Collateral Arrangement Regulations and Settlement Finality Regulations beyond the scope of the DSS to facilitate the adoption of innovative technologies or models.

### ***Flexibility and collaboration***

The Response emphasises that converting certain requirements into regulator rules should provide flexibility for any modifications not anticipated in advance (rather than "hard-wiring" certain requirements into the DSS Regulations from the outset), and HMT can subsequently lay further statutory instruments amending the DSS if necessary. Limits to issuance, trading and/or settlement activity undertaken via the DSS will be set on a case-by-case basis and therefore are not hardwired into the legislation but are instead likely to be set out in individual SANs.

The Government expects that the DSS will facilitate regular conversations between regulators and DSS participants, demonstrating the collaborative nature of the DSS and the capacity for entrants within it to shape its outcome: identifying a need for the DSS to "retain flexibility to test novel forms of entity and activity". During the lifetime of the DSS, regulators will consider whether and how to adapt the regulatory regime to account for new entities, such as non-systemic entities carrying on CSD activities, and those combining the function of a CSD and trading platform.

A report on the FMI sandbox arrangements, including a description of the sandbox arrangements, an assessment of their efficiency and whether (and if so, how) the Treasury proposes to exercise its power to permanently implement any of such arrangements that were tested under the DSS, must be made available by the regulators by 10 January 2028.

### **How does the DSS compare with the EU Pilot Regime?**

There are clear parallels between the DSS and the EU Pilot Regime given the potential under both for key market participants to test innovative DLT-based capital markets innovations. However, the DSS (and the wider FMI sandbox framework) is much broader overall and offers market participants greater flexibility. Significantly, unlike the EU Pilot Regime, the DSS is not focused solely on promoting the use of DLT: it instead promotes the use of 'developing technology', which includes, but is not limited to, DLT. The potential participants are also wider under the DSS: the broad participation outlined above could in practice include FMI providers and participants in these systems as well as, conceivably, unregulated service providers such as technology companies and any other person that HMT specifies.

The DSS also facilitates the disapplication of a wider range of legislation, and, unlike the EU Pilot Regime, goes further by allowing for the modification of legislation or even the application of specific legislation in certain scenarios: in particular in terms of the way in which it enables the modification, amendment and creation of rules by the BoE and the FCA, thus creating the opportunity for a bespoke regulatory framework. There is also no power under the EU Pilot Regime to permanently implement successful legislative changes before its expiry. [See our previous article for more detail on the EU Pilot Regime.](#)

## Timing and next steps

Whilst the DSS Regulations will come into force on 8 January 2024, the final timing of application windows is yet to be confirmed by the regulators. In the meantime, however, HMT continues to welcome [expressions of interest](#) from potential applicants.

The DSS will last for five years until 8 January 2029 (although it is capable of being extended) and permanent amendments to legislation can be made before the end of this period, meaning such amendments would also apply to entities that did not participate or were ineligible to participate, such as overseas operators of FMI entities, (subject to the entities being authorised by the appropriate regulator). It should be noted that once a sandbox entrant leaves the DSS, the relevant legislative and regulatory frameworks will continue to apply in connection with any DSS activities performed in their capacity as such.

We would recommend that interested eligible entities submit an expression of interest to HMT and begin thinking through the details that will be required for an application in order to be in the best place to swiftly submit a formal application once the window opens in due course. In order to maximise the potential outcome of the DSS, an entrant to the sandbox will need to take a holistic, multidisciplinary approach both to its application and to subsequent stages during the testing cycle; engaging pragmatically with the issues that it faces both at a product level and at a legal/regulatory one.

Please get in touch if you would like to discuss any of the stages of the DSS in further detail.



## CONTACTS



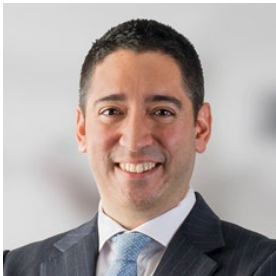
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