

CLIENT ALERT

# Bank of England and UK Financial Conduct Authority Open Digital Securities Sandbox to Applicants

9 October 2024

## AUTHORS

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On 30 September 2024, the Bank of England (the “**BoE**”) and the Financial Conduct Authority (the “**FCA**” and together with the BoE, the “**Regulators**”) published Joint Policy Statement PS24/12<sup>1</sup> (the “**Joint PS**”), guidance and other materials<sup>2</sup> setting out their approach to implementing and operating the UK Digital Securities Sandbox (the “**DSS**”). The DSS was opened to applications on 30 September 2024.

The DSS is a regulated live environment that has been created to explore how developing technologies can be used by firms to undertake the notary, maintenance and settlement activities traditionally associated with central securities depositories (“**CSDs**”) for financial securities either alone, or together with the operation of a trading venue.<sup>3</sup> Accordingly, successful applicants to the DSS are referred to as digital securities depositories (“**DSDs**”).

<sup>1</sup> <https://www.bankofengland.co.uk/Paper/2024/policy-statement/boe-fca-joint-approach-to-the-digital-securities-sandbox;>

[https://www.bankofengland.co.uk/financial-stability/digital-securities-sandbox/guidance-on-operation-digital-securities-sandbox.](https://www.bankofengland.co.uk/financial-stability/digital-securities-sandbox/guidance-on-operation-digital-securities-sandbox)

<sup>2</sup> Such materials include the application form for Gate 1; the draft Gate 2 application form for firms seeking to be approved as DSDs; the guidance on the operation of the DSS; and the DSS rules instrument (which sets out the rules that will apply to DSDs at the Go-live stage of the DSS once firms pass Gate 2).

<sup>3</sup> As the framework governing the operation of a trading venue is not being modified, the FCA considers it unlikely that a firm only intending to operate a stand-alone trading venue would be accepted into the DSS.

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The BoE will be responsible for the regulation of a firm's DSD activities, while the FCA will remain responsible for the regulation of traditional authorised persons.<sup>4</sup> The DSS is due to run until the end of 2028, but may be extended by HM Treasury ("HMT"), if necessary, to transition to a new regulatory regime.

### Background and Overview of the DSS

The Regulators are launching the DSS with the overarching aims of facilitating innovation, protecting financial stability and protecting market integrity. In particular, the DSS has been created to encourage innovation in financial market infrastructure ("FMI"), most notably through using new technologies such as distributed ledger technology ("DLT") in 'post-trade' processes, aiming to make them faster and cheaper.

The DSS is a new regime and the first FMI "sandbox" created under the FMI sandbox powers conferred on HMT by the Financial Services and Markets Act 2023 ("FSMA 2023").<sup>5</sup> It will therefore serve as a test-case for this new form of policymaking, where regulators can observe activity and consider whether changes to rules or legislation are required to enable it. The DSS will facilitate the use of developing technology, such as DLT, in the issuance, trading and settlement of digital securities by allowing firms to operate, without the legal obstacles and barriers that prevent the use of developing technologies, under a temporarily modified legal and regulatory framework.

It is important to note that DSS activity will be 'live' and the Regulators' intention is that the wider financial ecosystem should be able to interact with a DSS entrant in broadly the same way they would with any regulated firm, subject to certain limits (as further described below). However, market participants should note the potential risks of doing so as DSS entrants will not immediately be required to meet the same standards of resilience as a fully authorised FMI.

The DSS consists of different stages of permitted activity: there will be a series of gates ("**Gates**") for DSS entrants to move through to progress from one stage to the next, with the amount of permitted activity increasing with each stage. This "glidepath" will enable successful entrants to eventually progress from the DSS to a possible new permanent regime.

The powers in FSMA 2023 allow the government to legislate using secondary legislation to put in place a permanent regime, after reporting to Parliament. A smooth transition should be available for successful DSS entrants into any new permanent regime introduced when the DSS closes.

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<sup>4</sup> The BoE and FCA have entered into a memorandum of understanding regarding the DSS, which sets out how they will co-operate with one another in relation to the operation of the DSS.

<sup>5</sup> The Financial Services and Markets Act 2023 (Digital Securities Sandbox) Regulations 2023 (SI 2023/1398), which came into force on 8 January 2024, created the framework to enable the BoE and the FCA to operate the DSS.

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### Assets in Scope

Live activities will involve issuing, trading and settling real digital securities. Those securities can be used in the same way as traditional ones. For example, firms will be able to use the securities issued inside the DSS in repurchase agreements or write derivative contracts based on securities in the DSS as they normally would any other. The following financial instruments are examples of what could be issued and traded in the DSS: equities; 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.

Both digitally native and tokenised securities are in scope of the DSS, however the trading and settlement of derivative contracts and of 'unbacked cryptocurrencies' such as Bitcoin are not within the scope of the DSS. HMT would be responsible for determining whether any such cryptoassets brought within the FCA's regulatory perimeter would fall within the scope of the DSS as a result.

DSDs will be able to settle securities denominated both in sterling and non-sterling currencies within the DSS. Accordingly, the BoE will in due course also publish limits for activity in non-sterling assets (including corporate bonds in Euros and US dollars) that hold an important position regarding the functioning and financial stability of the financial system.

### Limits

Limits are the Regulators' main mitigant against financial stability risks from the DSS and form an important part of the Joint PS. Live (Gate 2) activity in the DSS will be subject to specific limits that have been set based on market analysis for the different asset types in scope of the DSS. The initial Gate 2 ('Go-live') limits are as follows, and may be increased in certain circumstances ahead of a Gate 3 application if the DSS entrant reaches its initial Gate 2 volume limit before it can apply for Gate 3:<sup>6</sup>

- Gilts: £600 million (firms can request up to £1.25 billion)
- Corporate bonds: £900 million (firms can request up to £1.5 billion)
- Asset-backed securities: £600 million.
- Money market instruments: £300 million.
- Equity: limits will be calculated on a per-stock (for FTSE 350 companies) basis and will be specific to each entrant's application.

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<sup>6</sup> When a financial instrument matures, the DSD can reuse that limit capacity for other issuances.

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The aggregate limits across all entrants will be published by the BoE once DSS entrants enter the Go-live stage.

Where fund tokenisation activity is taking place in the DSS, individual DSS entrants will be subject to firm-level limits which will be set such that DSDs can only record the units of a fund up to a certain size, i.e. as a cap on the total assets under management (“**AUM**”). That restriction will apply from Gate 2 and the AUM cap will increase as firms move through the stages of the DSS. The BoE will informally consult the fund management industry before publishing these limits. However, in contrast to other asset classes, the Regulators will not impose an aggregate limit on fund tokenisation activity in the DSS.

### Money Laundering Regulations

HMT intends to bring the MLRs<sup>7</sup> into scope of the FMI sandbox powers in FSMA 2023 and provide a temporary exemption so that engaging in DSS activity does not in itself make a firm a “cryptoasset exchange provider” or a “custodian wallet provider” under those regulations.

### Eligible Applicants

The Joint PS confirms the approach to eligibility proposed in the joint consultation paper published in April 2024,<sup>8</sup> which set out the following eligibility requirements for entering the DSS, among others:

- The applicant must be established in the UK.
- The activities and assets which are the subject of the application must be within the scope of the DSS (see ‘Assets in Scope’ above).
- The applicant must have identified one or more regulatory or legal barriers and/or obstacles to using developing technology which prevent the applicant from operating its optimal business model outside of the DSS, and which would be removed or alleviated by the modified framework.<sup>9</sup>
- There are no significant adverse incidents in the supervisory or enforcement history of the applicant or other adverse information.

Applicants do not already need to be regulated, nor do they need to hold the necessary permissions for the proposed DSS activity prior to application. However, firms should consider whether the scope of their proposed activities in the DSS may require other regulatory permissions (such as those which fall under Part 4A of the Financial Services and Markets Act 2000 (“**FSMA 2000**”)).

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<sup>7</sup> The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017.

<sup>8</sup> <https://www.bankofengland.co.uk/paper/2024/cp/digital-securities-sandbox-joint-bank-of-england-and-fca-consultation-paper>.

<sup>9</sup> The Joint PS states that the Regulators will consider applications even where the relevant activity could lawfully be carried on outside the DSS.

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### Stages and Gates of the DSS

The DSS has been designed so that participants can scale their business with access to higher limits as they demonstrate their compliance with the regulatory requirements at each Gate. As mentioned above, at the end of the DSS, the intention is that interested participants will have the opportunity to transition to a new permanent regime if the technology is successfully adopted. These stages and Gates are summarised in the table below.

The Regulators have stated that the assessments at Gate 1 and Gate 2 have different purposes and so will be different in scope, and passing through Gate 1 does not guarantee applicants will pass successfully through Gate 2.

<b>Stage</b>	<b>Purpose</b>	<b>Legal Designation</b>
<i>Initial application stage</i>	<i>Identify firms eligible to join the DSS</i>	<i>None</i>
<b>Gate 1</b>		
<i>Testing stage</i>	<i>Testing stage and seek authorisation to operate a trading venue or to be a DSD. No live business.</i>	<i>DSS entrant Sandbox Approval Notice (“SAN”) issued to the entrant, setting out the extent of the firm’s DSS approval.</i>
<b>Gate 2</b>		
<i>Go-live stage</i>	<i>Ability to carry out live business under initial limits</i>	<i>DSD/authorised operator of a trading venue SAN updated covering permissions and any conditions.</i>
<b>Gate 3</b>		
<i>Scaling stage</i>	<i>Scaling the business with a glidepath to full authorisation of DSDs</i>	<i>DSD/authorised operator of a trading venue SAN updated covering permissions and any conditions.</i>
<b>Gate 4</b>		
<i>Possible new permanent regime<sup>10</sup></i>	<i>Full authorisation to operate outside the DSS for DSDs</i>	<i>To be decided/new category of FMI</i>

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<sup>10</sup> The BoE confirmed in the Joint PS that it has decided not to publish the draft Gate 4 end-state rules at this juncture. The BoE anticipates that it will publish draft Gate 3 rules, and a revised draft version of the Gate 4 (end-state) rules once the DSS has been up and running for at least 15 months.

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In order to progress through Gate 2, firms will be required to provide a self-attestation, which includes a line-by-line commentary on how they meet the Gate 2 rules<sup>11</sup> (which include, for example, having adequate governance and operational procedures in place), and complete an initial questionnaire<sup>12</sup> to outline their business plan and the risks involved. The BoE will then send targeted follow-up questions to gain a deeper understanding of the firm.

As DSDs progress through the scaling stage, they will be held to standards closer to those which will likely be expected under a possible new permanent regime.

The Regulators' guidance sets out indicative timelines for passing through the DSS Gates and have said that they will aim to process Gate 1 applications within four to five weeks and Gate 2 applications within four to 12 months depending on the regulatory status of the applicant (e.g. unauthorised, so-called 'hybrid' entities applying for both DSD and FCA trading venue permissions will take longer to process). The Regulators note that DSS entrants will progress through the different Gates at different speeds, depending on the Gates in question and the speed at which they can collect the necessary documentation. Precise timings for the Gate 3 review points are yet to be decided by the BoE, but the BoE has indicated that the final Gate 3 review point will not occur for firms before mid-2027.

### Regulators' Powers

The Regulators will have supervision and enforcement powers in respect of both DSS entrants and other persons engaging in DSS activity (e.g. service-users, service providers). This could therefore include persons who are neither authorised nor exempt from the general prohibition under FSMA 2000.

The FCA has updated its Handbook specifically for the DSS to account for additional powers which have been conferred through the DSS rules. All other sections of the FCA Handbook continue to apply where relevant to DSS entrants and other persons engaging in DSS activity.

### Future Steps

FSMA 2023 requires HMT to publish a report to Parliament on the DSS setting out its assessment of the DSS and whether and how permanent changes will be made. This report must be made by January 2028. Once any new legislative framework is in place, DSDs will need to be authorised under that legislation in order to operate outside of the DSS without limits.

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<sup>11</sup> <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/digital-securities-sandbox/boe-dss-rules-instrument-2024.pdf>.

<sup>12</sup> <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/digital-securities-sandbox/draft-gate2-application-process-and-questionnaire.pdf>.

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## Bank of England and UK Financial Conduct Authority Open Digital Securities Sandbox to Applicants

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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