EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2023 (DIGITAL SECURITIES SANDBOX) REGULATIONS 2023

2023 No. 1398

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of His Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 These regulations create the first Financial Market Infrastructure (FMI) sandbox, the 'Digital Securities Sandbox (DSS)'. The DSS will allow firms and the regulators to test the use of new technology across our financial markets. In particular, this will involve trialling the use of developing technology (such as distributed ledger technology, or in general technology that facilitates what are commonly referred to as 'digital assets') to perform the activities of a central securities depository (specifically notary, settlement and maintenance), and operating a trading venue. It will enable participating entities to be subject to modified legislative requirements, where the existing requirements act as a barrier or an obstacle to using new technology. In some cases, legislative requirements will be disapplied within the DSS, with the regulators able to make rules instead. The DSS will enable the Government and regulators to test and then make changes on a permanent basis to accommodate new and developing technologies.

2.2 These regulations create the framework which will enable the regulators (the Bank of England (the Bank) and Financial Conduct Authority (the FCA)) to operate the DSS. This includes:

- specifically setting out the activities and financial instruments in scope (as well as the relevant regulator for these activities);
- the eligibility criteria to apply to participate in the Sandbox and, if successful, become a Sandbox Entrant;
- the arrangements to ensure that regulators are able to appropriately supervise the DSS;
- termination and wind-down arrangements for DSS activities; and
- the relevant legislation being modified, disapplied or applied to new entities in the DSS.

2.3 In general, firms will be subject to a schedule of disapplied and modified legislation when participating in the DSS. This is referred to in the legislation as the 'FMI sandbox arrangements.' The legislation that is disapplied or modified is set out in the schedule: such temporarily modified legislation would apply directly to Sandbox Entrants, as well as to other firms that interact with the activity being undertaken in the DSS. All other legislation will continue to apply to the activities of the sandbox entrant and other participants in its unmodified form.

3. Matters of interest to Parliament.

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 The Financial Services and Markets Act 2023 (FSMA 2023) provides HM Treasury with powers to disapply, modify or apply to new entities elements of existing legislation, as well as the ability to confer powers onto the Bank and FCA to operate and supervise an FMI Sandbox. These powers are subject to parliamentary approval and scrutiny. The changes the government and regulators are making will allow firms to engage in activity that is not compatible with current regulation, while giving the regulators the necessary authority and powers to supervise this activity, in line with their statutory objectives. The Treasury has worked closely with the Bank and the FCA in developing the DSS.

3.2 The activity in the DSS will enable HMT, working with the regulators, to determine how UK legislation should be permanently amended to accommodate developing technology.

4. Extent and Territorial Application

4.1 The extent of this instrument (that is, the jurisdiction(s) which the instrument forms part of the law of) is England and Wales, Scotland and Northern Ireland.

4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is England and Wales, Scotland and Northern Ireland.

5. European Convention on Human Rights

5.1 The Economic Secretary to the Treasury (Bim Afolami MP) has made the following statement regarding Human Rights:

"In my view the provisions of the Financial Services and Markets Act 2023 (Digital Securities Sandbox) Regulations 2023 are compatible with the Convention rights."

6. Legislative Context

6.1 Sections 13 to 17 of, and Schedule 4 to FSMA 2023, give HM Treasury the power to create Financial Market Infrastructure (FMI) sandboxes through Statutory Instruments (SIs).

6.2 Each SI laid before Parliament would provide the legal basis for each sandbox and allow for the temporary disapplication, modification or application of relevant legislation for participants.

6.3 It would also set out the wider framework for that sandbox, including who can participate and what restrictions there will be on those participants and their activities. The powers in FSMA 2023 are designed to be flexible enough to allow for the creation of different FMI sandboxes, so that different technologies and practices can be tested by different entities. Each future sandbox would be set up via an SI laid before Parliament.

6.4 One key aspect of the powers is the ability to make permanent changes to legislation based on what is learned. To do this, HM Treasury will report to Parliament on the operation of a particular sandbox, explaining why and how it intends to change UK legislation permanently. The permanent changes themselves would be enabled by HM Treasury laying a further SI before Parliament via affirmative procedure.

6.5 The DSS is the first FMI sandbox to be set up under FSMA 2023 to allow testing (for a limited period) of the efficiency or effectiveness of carrying on certain FMI activities when using developing technology such as distributed ledger technology or "DLT".

6.6 The legislation being temporarily applied, modified and disapplied within the DSS will be UK financial services legislation, specifically the Financial Services and Markets Act 2000, Companies Act 2006, the Uncertificated Securities Regulations 2001, and the UK Central Securities Depositories Regulation 2014. The provisions will continue to apply in unmodified form where legislation has not been temporarily applied, modified or disapplied.

7. Policy background

What is being done and why?

7.1 FMIs are institutions that provide essential services for financial markets, such as the clearing, settlement and, recording of financial transactions. FMIs are important in that their failure could have a serious impact on the financial system, so they are subject to strict regulation.

7.2 FMIs need to be innovative and adopt new technologies in order to reduce costs, improve performance, and compete effectively. An important example of this is the adoption of developing technologies that facilitate the digitalisation of financial assets across markets (particularly through the use of shared or distributed ledgers), which could facilitate greater efficiency, resilience and transparency (and potentially transform the way financial markets are structured). A key innovation in this space is 'distributed ledger technology' or 'DLT', which is frequently used to describe the technology underpinning the digitalisation of assets and tends to refer to the recording, processing and storage of data in a distributed way (using a network of synchronised ledgers).

7.3 The use of innovations such as DLT originated in what are commonly referred to as 'cryptoasset' markets. However, there are clear use cases beyond cryptoassets, and the financial services industry is now looking to test this in other (mainstream) financial markets. Their adoption has the potential to radically change the way markets operate. It could entail several different developments, such as the combining of functions currently performed by separate entities into single digital FMIs, 24/7 operation, instantaneous settlement of market transactions and much more. However, the government and regulators are also mindful of overall market functioning and stability as innovation progresses.

7.4 In 2021, HM Treasury conducted a Call for Evidence to examine the application of distributed ledger technology to FMIs, with the Government's response published in April 2022. A key issue identified in responses to the Call for Evidence was that the UK legislative framework was not designed with the use of DLT/digital assets in FMIs, and that changes will be needed to enable the use and potential benefits of such technology. However, it was not clear from the call for evidence how or the extent to which legislation needed to change, given uncertainty regarding what a future financial ecosystem based on technology such as DLT will look like, and how risks will be managed in that system.

Rationale for intervention

7.5 As the functioning of FMIs is highly regulated, the potential benefits of digital assets, and the changes to market practices they may facilitate, can be explored if the regulation governing FMIs is temporarily applied, modified or disapplied to permit such activity. This requires government intervention in the form of legislation.

7.6 Respondents to the 2021 consultation highlighted regulatory sandboxes as an effective way to understand how the law needs to change to best support FMIs in adopting and using new technologies or practices. Sandboxes have been used in different ways, both in and outside of financial services, as a safe environment in which to experiment, learn, and in some circumstances test new technology. The FCA launched its "Regulatory Sandbox" in 2016, which allows businesses to test new technologies and products in financial markets, in a controlled manner and with close regulatory oversight, within existing legislative frameworks. In addition to helping firms navigate the authorisations process, the FCA provides firms in the sandbox with informal steers to help them understand the potential regulatory implications of their business model.

7.7 After the Call for Evidence closed, the government announced in April 2021 that HM Treasury in conjunction with the Bank and the FCA would develop an FMI sandbox. Unlike the existing FCA Regulatory Sandbox, this would facilitate temporary applications, modifications and disapplications to UK legislation, in order to facilitate the live testing of new technologies or practices while performing specific activities. Subsequent to this, FSMA 2023 provided HM Treasury with the powers to set up FMI sandboxes via SI.

7.8 In December 2022, as part of the Edinburgh Reforms, the Chancellor announced the government would be implementing the first FMI Sandbox during 2023, as part of the ambition for financial services to be a sector at the forefront of technology and innovation.

7.9 In July 2023, following the passing of FSMA 2023, the government published a consultation setting out its proposal for the first FMI Sandbox, to be known as the 'Digital Securities Sandbox' or 'DSS', as part of a wider package of measures announced as part of the Chancellor's annual Mansion House speech. The consultation set out, and sought feedback on, the key features of the DSS, as well as further policy and legal issues around the utilisation of digital securities. The response to this consultation was published on 22 November 2023- this can be found at https://www.gov.uk/government/consultations/consultation-on-the-digital-securities-sandbox.

Activities and instruments in scope of the DSS

7.10 There are four main activities directly in scope of the DSS (i.e. activities being performed in the DSS where the underlying legislation/regulation is being modified or disapplied). The first three are the activities of a CSD, specifically notary (the initial recording of a security in a securities settlement system), settlement (the operation of a securities settlement system), and maintenance (providing and maintaining securities accounts at the top tier level). The fourth is operating a trading venue (specifically a multilateral trading facility ('MTF'), an organised trading facility ('OTF') or a Recognised Investment Exchange ('RIE')).

7.11 These are activities that can be performed in the DSS by applying the framework of applied, disapplied and modified legislation. The DSS will also allow CSD activities and the operating of a trading venue to be performed within one entity (existing legislation requires that these be kept separate).

7.12 Firms that successfully apply to the DSS will be designated as a Sandbox Entrant. However, to then progress to performing the activities of a CSD in a live environment, they will need to be designated as a 'Digital Securities Depository' (DSD) by the Bank - this is a designation specific to the DSS that will enable a Sandbox Entrant to perform one, or a combination, of the activities of notary, settlement and maintenance within the framework of temporarily applied, disapplied and modified legislation in the DSS. To operate a trading venue, a Sandbox Entrant will need to be authorised and have permissions to operate an MTF or OTF, or have an exemption as an RIE. Entities can obtain all three designations/authorisations and combine the existing roles of CSD and trading venue within one FMI.

7.13 The assets in scope of the DSS include digital representations of certain financial instruments defined in the Regulated Activities Order (RAO), specifically those in paragraphs 1-3 and 11 of Part 1 of Schedule 2. This includes debt, equity, and money market instruments, and units in collective investment undertakings. These are defined as FMI sandbox instruments under the DSS. The drafting is intended to be broad, so that as wide a variety of instruments as possible can be included. However, derivative instruments (as defined by paragraphs 4-10 of Part 1 of Schedule 2 of the RAO) are not in scope.

7.14 The regulators may put in place limits on the overall activity in the DSS, and for participating entities. These limits will be set to minimise any impact on wider financial stability from the failure of a Sandbox Entrant. Firm-specific limits will be managed via the SAN issued to each Sandbox Entrant. In addition, HM Treasury may direct regulators to put in place further restrictions within the DSS overall.

7.15 Where modified legislation does not apply, it will be possible to perform non-DSS activities in relation to DSS entities and assets in accordance with the existing legislative and regulatory framework. This is to ensure that further parts of the lifecycle of an asset, in addition to the four activities directly in scope, can be performed in relation to assets in the DSS, for example: custody, payments, repurchase and reverse repurchase agreements ('Repo'), lifecycle management (for example, corporate actions), securities financing and lending arrangements, clearing of transactions relating to sandbox assets and use of assets as collateral.

7.16 Derivative contracts and instruments that refer to an asset held at a DSD are permitted, however (as referred to in 6.13), they must be settled under the existing, unamended, relevant regulations.

7.17 A key principle of the DSS will be that digital securities issued/traded/settled via an entity in the DSS are the same as their traditional equivalents, such as bonds, equities, and fund units. This means that, aside from where particular modifications to legislation are made as part of the DSS, they should accordingly be treated in the same way as their traditional equivalents from a legal and regulatory perspective. This facilitates the principle that these instruments are capable of being utilised across markets, for example as collateral or as part of repo transactions, where this can be done in compliance with existing laws and regulations.

Applicability of the DSS framework beyond directly participating entities

7.18 The temporarily applied, disapplied and modified legislative framework in the DSS will apply for Sandbox Entrants in the DSS, but also more widely to those engaging directly or indirectly connected with the activities of the Sandbox Entrant in the DSS. An example is where a person outside of the DSS decides to invest or sell securities traded and settled on a platform operated by a Sandbox Entrant in the DSS, as a "user" of the Sandbox Entrant's platform within the DSS. Further examples include entities that provide services to or receives services from a sandbox entrant, "users" or persons that carry on activities or provide services that are related to an FMI sandbox instrument.

7.19 Any disapplication or modification of legislation as it appears in the schedule to these regulation, or the continued application of legislation, therefore applies to the activities of a Sandbox Entrant that is engaged directly in the DSS, as well as to the relevant activities of entities that are ancillary to those of a Sandbox Entrant, in order to achieve the purpose of the DSS, as described in section 13(1)(a)-(b) of FSMA 2023.

7.20 Further, the modifications in the schedule will apply such that they carry across to those provisions not expressly referred to in the schedule as well, for example, as the definition of a "rule" in FSMA 2000 has been modified for the purposes of the DSS to include all rules made under FSMA 2023, this modified definition of rule carries across to all FSMA 2000 provisions.

7.21 The DSS framework will only apply where a firm is interacting with the activity a Sandbox Entrant undertakes in the DSS. For example, where an issuer is not utilising a DSD in the DSS, but is using an existing CSD, then the provisions of unmodified UK CSDR would apply. Similarly, the regulator's powers under FSMA 2000 apply as modified to DSS activities, but in unmodified form to non-DSS activities.

7.22 This principle also applies for Sandbox Entrants themselves. For instance, an investment firm may simultaneously operate a trading venue in the DSS and operate a trading venue outside. As none of the requirements that apply to operation of a trading venue have been modified in the DSS, this means that existing legislation or regulator rules and technical standards that apply to the operation of a trading venue will apply both to activities inside the DSS as well as outside the DSS. However, to the extent that a trading venue is able to undertake the activities of a DSD in the DSS, the temporarily applied, disapplied and modified legislation in the DSS will apply to their DSS activity, while all of their non-DSS activity takes place according to existing legislation, The regulators may therefore require firms to appropriately segregate DSS and non-DSS activity for supervisory purposes.

Overseas firms

7.23 Firms directly participating in the DSS as a Sandbox Entrant will need to have a legal entity established in the UK, given that activity in the DSS would be carried out according to modified UK legislation/regulation and be supervised by UK regulators. For example, this would mean that an overseas investment firm operating an MTF could not itself directly become a Sandbox Entrant, unless it established a UK legal entity to operate the MTF. However, there is no specific limitation in the regulations regarding on overseas firms utilising or interacting with a Sandbox Entrant, subject to meeting regulatory requirements. For example, an overseas firm could be a participant in/user of a Sandbox Entrant, or provide ancillary services to it.

Operation of the DSS

7.24 The regulations provide that any person determined by the regulators and established in the UK (which for the purpose of these regulations means constituted under UK laws for the duration of the DSS) should be able to apply to be in the DSS, in addition to the specific types of FMI entity that are also eligible. Entities should only apply to the DSS if the modified legislation clearly benefits their proposed business model. If the model can just as effectively be achieved in line with legislation and regulation as it currently stands, then it is expected that they should apply for authorisation under existing regulatory frameworks.

7.25 The regulations make provision for the regulators to create and operate a joint application process for the DSS. Following an application, the regulators should give reasons if an application to the DSS is accepted but with variations to the application sought or rejected. As noted, firms applying to the DSS can be designated as a Sandbox Entrant, and then subsequently designated as a DSD for performing CSD activities and/or authorised with permission to operate a trading venue, depending on the scope for their approval. The regulations operate such that the Bank is able to charge fees in order to grant the designation of a DSD, while the FCA can charge fees for granting authorisation to operate a trading venue.

7.26 The conditions under which DSS activities will take place will be set out via the Sandbox Approval Notice (SAN) issued to each Sandbox Entrant by the regulators. The SAN will act as a ‘visa’ detailing the permitted activities being performed and the restrictions in place, including what limits have been allocated to that entity.

7.27 The regulations make provision for the regulators to make rules in relation to participating entities in the DSS, in some cases this will replace legislation that has been disapplied as part of these regulations. The regulators will have further flexibility to waive rules in particular cases, modify them or apply them when otherwise they would not apply, where appropriate.

7.28 The regulators will have access to all their existing supervisory and enforcement powers to supervise firms in the DSS, including intervention powers. The regulators will also have powers that are unique to the DSS. These include powers of direction in respect of Sandbox Entrants and a general power to modify, suspend or cancel a SAN where necessary or expedient for the purposes of implementing and operating the FMI sandbox arrangements: this latter power can also be used if a Sandbox Entrant is in breach of requirements relating to the DSS. Entities in the DSS will be expected to provide all necessary information to the regulators and have systems in place to assist the regulators in their supervision. Provisions are also made in the regulations to facilitate regulator cooperation in the on-going operation and supervision of the DSS.

7.29 The DSS will last up to five years from the date that the regulations are made, with the possibility of extension by HM Treasury. Participating entities will exit the DSS in one of two ways: 1) continuing to operate but under a permanently amended UK legislative framework or 2) by winding down their activities in the DSS which may include transitioning FMI sandbox instruments outside of the DSS. Any Sandbox Entrant able to undertake activities consistent with regulatory outcomes will be able to apply to continue their activities with restrictions specific to the DSS lifted under a new regime created from that amended legislative framework. The intention is that any application, disapplication or modification can be permanently adopted, avoiding any “legislative gaps” in the process which would otherwise be disruptive and costly for those engaged in the DSS.

7.30 To enable a firm to exit the DSS smoothly, HM Treasury may need to permanently amend UK legislation, in line with the powers set out in FSMA 2023. A list of legislation in scope is provided on the face of the Act – primary legislation can only be permanently amended by affirmative procedure, with an obligation for HMT to report to Parliament ahead of this process.

7.31 In cases where insufficient progress towards operating under a new regime is being made, and there is no realistic path to be capable of operating permanently, participants may have their permissions revoked and be required to wind-down their activity in the DSS in an orderly way. A wind down could also be triggered for other reasons, including a commercial decision by the firm, or failing to meet requirements set by the regulators

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 These are the first regulations made under the relevant powers in FSMA 2023.

10. Consultation outcome

10.1 The consultation on the Digital Securities Sandbox closed on 22 August 2023. HM Treasury received responses from a range of different stakeholders, including trade associations, incumbent FMIs, investment firms, technology firms looking to use the DSS to deploy digital asset technology in securities markets and cryptocurrency exchanges.

10.2 The fundamental design of the DSS was well received. Feedback praised the emphasis on facilitating innovation, without compromising on regulatory outcomes. Responses emphasised that while the starting point is existing legislation, the flexibility to change requirements in response to novel use cases through the DSS was important. Responses also highlighted a quick and safe transition out of the DSS was seen as essential, with a need to avoid legislative, regulatory, technological and administrative gaps.

11. Guidance

11.1 HM Treasury does not propose to provide any guidance in relation to this instrument. The Bank of England and Financial Conduct Authority will provide guidance in due course on the operation of the DSS.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 A full impact assessment has not been prepared for this instrument because the impact of this SI is small (the cost to businesses is < £5m per year). A de minimis impact assessment is submitted with this memorandum and published alongside the Explanatory Memorandum on the legislation.gov.uk website.

13. Regulating small business

13.1 The legislation does not apply directly to activities that are undertaken by small businesses.

13.2 Participation in the DSS as a Sandbox Entrant is not mandatory (though entities interacting with a Sandbox Entrant will need to consider how the legislation as it applies in the DSS will apply to them). Firms, including any considered to be small and microbusinesses, will need to estimate any costs of participation and decide whether there is a strong enough business case to do so. If firms do not choose to apply to participate they will continue to operate under the existing legislative framework.

13.3 HM Treasury therefore does not anticipate an impact that falls disproportionately on small and microbusinesses and therefore no action is needed to mitigate the impact on them. The overall impact should be a benefit to markets, given that the DSS could help the market become more efficient and transparent.

14. Monitoring & review

14.1 The regulation does not include a statutory review clause, and, in line with the requirements of the Small Business, Enterprise and Employment Act 2015, the Economic Secretary to HM Treasury (Bim Afolami MP) has made the following statement:

“It is not proportionate to include a review clause in this instrument because the estimated annual net direct cost to business is less than £5 million and the number of small businesses in scope is very low.”

15. Contact

15.1 Timothy Maloney at HM Treasury (email: Timothy.Maloney@hmtreasury.gov.uk) can be contacted with any queries regarding the instrument.

15.2 Tom Duggan, Deputy Director for Securities and Markets, at HM Treasury can confirm that this Explanatory Memorandum meets the required standard.

15.3 Bim Afolami MP, Economic Secretary to HM Treasury, can confirm that this Explanatory Memorandum meets the required standard.