

Title: THE FINANCIAL SERVICES AND MARKETS ACT 2023 (DIGITAL SECURITIES SANDBOX) REGULATIONS 2023 SI (Statutory Instrument) No: 2023/1398 Other departments or agencies: Securities and Markets Contact for enquiries: Timothy.Maloney@hmtreasury.gov.uk	De minimis assessment Date: 12/12/2023 Type of regulation: Domestic Date measure comes into force: 08/01/2024
Cost of Preferred (or more likely) Option No cost; Benefits cannot be robustly estimated	Equivalent Annual Net Direct Cost to Business per year No cost; Benefits cannot be estimated

1. What is the problem under consideration? Why is government intervention necessary?

What is the problem under consideration

- Financial market infrastructures (FMIs) are institutions that provide essential services for financial markets, such as the clearing, settlement and, recording of financial transactions, which allow financial market activity to take place.
- FMIs are systemically important, meaning that their failure could lead to financial instability. It is therefore vital to have a robust regulatory framework to ensure that risks are managed.
- FMIs also face pressure to innovate and adopt new technologies, in order to reduce costs, improve performance, and compete effectively.
- The adoption of developing technology across markets (particularly by the use of distributed ledger technology (DLT) in FMIs, to facilitate what are commonly referred to as ‘digital assets’), has the potential to transform financial markets, making FMI services more efficient, resilient, and transparent, and expanding their global reach. It also has the potential to change the traditional role of trading, clearing and settlement intermediaries.
- ‘Distributed ledger technology’ or ‘DLT’, which is frequently used to describe the technology underpinning digital assets and tends to refer to the recording, processing and storage of data in a distributed way (using a network of synchronised ledgers).
- The UK legislative framework is not currently built to support the use of DLT in FMIs, as the framework onshored from the EU and existing UK legislation predates the widespread use of digital assets.

Rationale for intervention

- As the functioning of FMIs, and their use by those operating in financial markets, is highly regulated, the potential benefits of digital assets or new forms of FMI can only be explored if the regulations governing FMIs are amended or modified to allow it. Government intervention, in the form of legislation, is therefore required.
- In 2021, HM Treasury conducted a Call for Evidence to examine the application of DLT 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 has not been built to support the use of DLT/digital assets in FMIs, and that changes would be needed to enable the use of DLT and realise its potential benefits.
- Sandboxes were highlighted by respondents as a key method for experimentation with new technology such as DLT in markets, as well as for understanding how legislation needs to change to most effectively support FMIs in their safe adoption and use of new technology or practices.
- After the Call for Evidence closed, the government announced in April 2021 that HM Treasury in conjunction with the Bank of England (the Bank) and the Financial Conduct

Authority (the FCA) would develop an FMI sandbox. This will test whether and how FMIs can use new technology or practices to perform specific activities, and to test modifications to the legislative framework.

- The Financial Services and Markets Act 2023 (FSMA 2023) provides HM Treasury with powers to set up FMI sandboxes via statutory instrument (SI).
- These regulations create the first Financial Market Infrastructure (FMI) sandbox, the 'Digital Securities Sandbox' or 'DSS' which will enable firms to experiment with the use of new technologies and practices by setting up digital FMIs (which can perform the activities of a central securities depository (specifically notary, settlement and maintenance), and operating a trading venue).
- If successful, HMT can make permanent amendments to UK law via further SIs, after having reported to Parliament, and entities in the DSS can proceed to operate outside of the DSS without limits.
- A list of legislation is on the face of the Act which can only be permanently amended by affirmative procedure.

2. What are the policy objectives and the intended effects?

The core objective of the Digital Securities Sandbox (DSS) is to facilitate the adoption of developing technology such as DLT in UK financial markets. Making FMIs more efficient, transparent and resilient could lead to lower costs for businesses and consumers, increased competitiveness of the UK financial sector, reduced risk and increased economic growth.

To deliver the outcomes, there are three general process aims of the DSS:

- 1. Testing how existing UK legislation needs to change to accommodate the technology associated with digital assets (such as DLT) and the new practices associated with it.** Temporary legislative modifications made within DSS would be assessed through discussion and analysis of outcomes between participants and regulators. The regulation may be subject to further modification during the period of the DSS depending on these assessments. HMT can then make permanent changes to UK legislation based on the outcome of testing.
- 2. Enabling the financial sector to test and adopt this developing technology in FMIs.** This would be done in a phased way, with activity initially restricted but increasing as entities progress through the DSS, and regulation being applied which is proportionate to the risk posed.
- 3. Testing the use of FMI sandboxes as a policymaking concept.** While the existing FCA Regulatory Sandbox has been up and running for several years, the DSS differs in that it is specifically targeted at FMIs, and will allow UK legislation to be modified and permanently changed. The DSS could be followed by further FMI sandboxes.

The **Logic Chain for this measure is included as Annex B**, mapping how the DSS will work and how it will deliver improved outcomes such as increased innovation and competition.

3. What policy options have been considered, including any alternatives to regulation?

Please justify preferred option

Option 0 (Do nothing) - FMI underpin financial market activity and should be encouraged to improve the services they offer clients through research and innovation. Under the current model, firms are already innovating in some areas. However, without action, firms will continue to face barriers to innovating, in the form of incompatible legislation, and therefore it may not be possible to realise many of the benefits of developing technology (and therefore fully enable digital assets). Furthermore, HM Treasury and the regulators will continue to lack the evidence base for making changes to legislation that will facilitate innovation in future. By doing nothing we will also fail to deliver on the government's commitment to implement the first FMI Sandbox this year.

Option 1 (Preferred Option) - Set up the Digital Securities Sandbox (DSS) to enable firms to set up and operate FMIs using innovative technology, performing the activities of a central securities depository (specifically notary, settlement and maintenance), and operating a trading venue, under a legislative and regulatory framework that has been temporarily modified.

Option 2 (Non-preferred) – Permanently modify legislation now instead of after exploration in the DSS. To overcome the barriers firms, face to innovating and adopting new technologies, the government could permanently modify legislation now. However, it is not yet clear exactly how legislation needs to be modified. There is a possibility that new proposals will be adopted without fully understanding the risks, which could lead to unintended consequences that could harm the financial system. Permanently changing legislation now could also stifle innovation. If it is not possible to test the use of digital assets in FMIs in a safe environment first, firms may be less likely to experiment and adopt them.

Outline of preferred option – Option 1

- The DSS is a regulatory initiative that will enable firms to experiment with the use of new technologies and practices by setting up digital FMIs (which can perform the activities of a central securities depository (CSD) and operating a trading venue), under a legislative and regulatory framework that has been temporarily modified to accommodate developing technology used as the basis for digital assets, such as DLT.
- These activities will be performed in relation to existing security classes (which could either be digitally native issuances or digital representations of existing securities). Limits will be put in place for participating entities, which can be increased as progress is made. These limits will reflect the ability of a participating entity to meet requirements and manage risks.
- These will be real-world market activities and assets. The intention is that any digital securities issued, traded, settled and maintained via entities in the DSS will be able to interact with wider financial market activities (e.g. for collateral posting or repos), where this can be done in compliance with existing legislative and regulatory frameworks.

Scope

- The assets in scope of the DSS include digital representations of a subset of financial instruments defined in the Regulated Activities Order (RAO), including debt, equity, money market instruments and fund units.
- The activities in scope of the DSS include the activities of a CSD (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)) and operating a trading venue (a multilateral trading facility ('MTF'), an organised trading facility ('OTF'), or a Recognised Investment Exchange ('RIE')).

- Firms applying to the DSS can be designated as a Sandbox Entrant (SE), followed by designation as a Digital Securities Depository (DSD) and/or authorised to operate a trading venue.
- 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.
- DSS participants will be permitted to perform non-DSS activities related to DSS entities and assets, subject to existing regulatory or industry frameworks and notifications. This could include (but is not necessarily limited to): custody, primary market activity, transfer, 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.
- The conditions under which DSS activities will take place will be set out via the Sandbox Approval Notice (SAN) issued to each Sandbox Entrant. 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.
- The conditions under which DSS activities will take place will be set out via the Sandbox Approval Notice (SAN) issued to each Sandbox Entrant. 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.
- The regulators will set capacity ranges for different asset classes and individual limits for FMIs, based on regulatory objectives such as financial stability.

Eligibility/application

- Firms should only apply to the DSS if there are clear legislative or regulatory barriers/obstacles standing in the way of their proposed business model. If they are able to operate their proposed business model in line with legislation and regulation as it currently stands, they should apply for authorisation under existing regulatory frameworks. Firms will need to be a legal entity in the UK.
- The application forms may vary depending on the relevant activities, but are likely to request information such as:
 - Scope – details of the core and ancillary activities for proposed activities with specified users and default arrangements.
 - Regulatory barriers - Regulatory barriers and temporary modifications sought, with duration and compliance plans.
 - Preparedness – evidence of financial resources and business plan demonstrating projected growth.
 - Organisation - basic company information, governance arrangements, outsourced activities, and proposed links to other FMIs.
 - Other information - technology outline, settlement arrangements, winding down plans, and other required information.

Legislative modifications

- FSMA 2023 provides HMT with the power to create FMI sandboxes that temporarily modify and disapply legislation to remove existing regulatory barriers and to provide regulatory flexibility. A list of the legislation in scope of the DSS is on the face of the Act.
- HM Treasury (working with the regulators) will need to assess what permanent legislative amendments will be put in place, informed by the activity conducted in the DSS. Legislation can only be permanently amended via the affirmative procedure, along with an obligation for HMT to report to Parliament. This will require a separate impact assessment.

Sandbox operations

- The DSS will last up to five years, with the possibility of extension by HM Treasury.
- Entities can exit the DSS by continuing to operate under a permanently amended legislative framework outside of the DSS or by winding down their activities in the DSS.

- The FCA and Bank will regulate and enforce the DSS, with powers to modify, suspend, terminate, or revoke permissions and direct entities to engage or cease engaging in specified actions.
- Participating entities will need to be fully open and transparent with the regulators to enable effective supervision of their activities and updates to their SAN. Some information may also need to be shared with the government to enable legislation to be changed in an informed way, these requests would be consistent with existing disclosure requirements.
- The FCA and Bank will set out further guidance for potential applicants to the DSS in due course.

4. Please justify why the net impacts (i.e., net costs or benefits) to business will be less than £5 million a year.

Summary: Because participation in the DSS is optional, this measure does not impose any costs on businesses. Where businesses participate, they may be able to benefit from savings and business opportunities that arise from adopting new technologies and innovations, however, we are unable to quantify this robustly.

- What will businesses have to do differently?
 - Participation in the DSS is optional. Firms who are interested in participating in the DSS will need to apply and meet the requirements set out by the regulators.
 - If firms do not choose to participate in the DSS then they will continue to operate under the existing legislation that currently applies to them.
- How many businesses will this impact per year?
 - Only entities participating in the DSS and firms interacting with those entities will be directly impacted by it.
 - We are unable to state the number of businesses that will be impacted per year, as we do not know how many firms will apply to participate in the DSS or the number of entities that will be interacting with them.
 - However, we have some indication of numbers from responses to the DSS consultation. The Government received 19 expressions of interests across a mix of incumbent FMIs, existing regulated FS firms, and new entrants (see annex).
 - Informal engagement with industry suggests that more expressions of interest may be sent. Note, submitting an expression of interest does not constitute an application to the DSS and applications are subject to regulator approval.
- What is the direct cost/benefit per business per year?
 - As stated above, participation in the DSS is optional. Therefore, firms will not experience any involuntary costs.
 - When choosing whether or not to apply to the sandbox, firms should consider the costs involved, which will be set out in the application process led by the regulators (and include fees levied by the regulators).

In the remainder of this section, we set out our assessment of the anticipated costs and benefits, noting that there is limited evidence at this time given the intrinsically open-ended nature of a regulatory sandbox.

POLICY COSTS

Transitional costs for firms applying to the DSS

Familiarisation costs

- If firms choose to apply to the DSS and are successful in their application they will incur familiarisation costs. These would be associated, where relevant, with adapting to provisions in legislation they do not currently apply to them

Cost of application

- To participate in a sandbox, firms must submit an application, which requires resources and careful preparation to ensure a successful application, and understanding both the modifications to legislation and FMI legislation where it is unmodified. Any firms that do not currently have existing relevant authorisations will have to achieve designation/authorisation as part of the DSS process and compliance with the requirements, and so adaptation costs may be higher.
- Regulator fees for participation in the DSS have not yet been confirmed. For reference, the Bank of England's 2023/24 fees for financial market infrastructures are:
 - £45k for recognition payable by all incoming CSDs (this is similar to a possible Go Live fee in the DSS– i.e. when firms are designated as DSD and are allowed to do live business)
 - £154.8k for regular annual fees to be paid by all CSDs (DSDs will need to pay a regular fee in the DSS).
- The Bank has suggested using a +/- 50% error band around these costs, given they have not yet produced any estimates of fees in the DSS. They will also consider whether they end up with a full or partial cost recovery regime.
- For new operators of an MTF or OTF the FCA's current authorisation fee is generally £50,000 (or £25,000 to vary permissions).

Cost of building new systems to join the DSS

- Once firms have applied to join the DSS and have been accepted by the regulators, they need to ensure they are able to participate. This would require investment to build and operate new and innovative systems that support their proposed activities. The cost of this will depend on what kind of technology they utilise and their intended use case.

Ongoing costs for firms participating in the DSS

Cost of running the platform

- Once firms have applied to join and been accepted to the DSS there will be ongoing costs. These costs may include firms hiring staff to run the Sandbox process, operating costs and legal fees.

Cost of winding down DSS operations if not successful

- A firm may deem participation in the DSS unsuccessful if they decide that the platform being tested is unviable economically, or does not deliver greater benefits than existing systems, and decide to exit a sandbox. Alternatively, the regulators may decide that a particular participant is unable to meet a regulatory requirement.
- In either case the participating firm would need to bear the costs of winding down their sandbox operations. Where a firm is unable to bear the costs, they would be subject to standard insolvency procedure.

Cost of transitioning to operate outside the DSS if successful

- Once regulators have determined that an entity is meeting requirements that are sufficient for operation outside the DSS, the entity will arrive at a 'completion' stage. At this point, it is

ready to apply for unrestricted activity and where necessary seek full authorisation outside of the DSS.

- This may involve costs depending on what adaptations are required to move into a permanently modified legislative framework outside of the DSS.

POLICY BENEFITS

Ongoing benefits for firms

Greater innovation in FMIS and trading venues

- Through the DSS, firms can apply new technologies and practices to the activities of a central securities depository and operating a trading venue, to achieve significant benefits such as increased efficiency, resilience, transparency, and access to UK capital markets.
- A previous EU analysis estimated that widespread use of DLT in the EU could save up to €4 billion per year on reporting costs and several billion euros over time on clearing, settlement, collateral management, and other intermediary functions in the European derivatives market.
- The Global Financial Markets Association (GFMA) also published a report estimating \$15-20 billion in annual global infrastructure operational savings from the use of DLT. When operating at scale, DLT could enable transformative growth, broader market access, and new liquidity pools (e.g., approximately \$16 trillion global market for tokenized illiquid assets by 2030).
- The full benefits of efficiency gains from the DSS will only be realised several years after implementation. Due to the high uncertainty surrounding technological advances and market acceptance, these benefits can only be broadly estimated. Therefore, the figures presented are simply estimates of the potential savings, based on a number of assumptions. For the purposes of this Impact Assessment, we conclude that we do not have robust enough evidence to offer a monetised estimate of net impact.

Regulatory framework adapted to innovation

- Firms in the sandbox can operate under new and flexible regulations that allow innovation in FMI services, especially when using new technologies, while meeting the same regulatory outcomes as today. These new technologies can be adopted more generally once permanent changes are made to UK legislation.

5. Please confirm whether your measure could be subject to call-in by BRE (Better Regulation Executive) under the following criteria. If yes, please provide a justification of why a full impact assessment is not appropriate:

a) Significant distributional impacts (such as significant transfers between different businesses or sectors)

No.

b) Disproportionate burdens on micro, small, and medium businesses (below 500 employees).

No. We do not expect the DSS to have a disproportionate impact on small and micro businesses.

Participation in the DSS will be optional for all firms, including small and micro businesses. Firms will need to decide whether the costs of participation are worth it, given the potential

benefits. If firms do not choose to participate, they will continue to operate under the existing legislation.

c) Significant gross effects despite small net impacts

No.

d) Significant wider social, environmental, financial or economic impacts

No.

e) Significant novel or contentious elements

No. Although, we are exercising a broad power which will make temporarily modifications to a range of primary legislation as well as conferring powers on the regulators.

Sign-off for de minimis assessment: SCS

I have read the de minimis assessment and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.

SCS of Securities and Markets Team

Signed: ***Tom Duggan***

Date: 29/11/2023

SCS of Better Regulation Unit

Signed: ***Phil Witcherley***

Date: 04/12/2023

Sign-off for de minimis assessment: Minister

I have read the de minimis assessment and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.

Bim Afolami, Economic Secretary to the Treasury

Signed: ***Bim Afolami***

Date: 12/12/2023

Further information sheet

Annex A: Consultation respondents

Type Respondent	Number of Respondents
Bank	1
Digital payment provider	2
Incumbent FMI	2
Investment Bank	1
Law firm	1
New FMI entrant	7
Public body	1
Supranational body	2
Technology firm	12
Trade association	7
TOTAL	36

We received 19 Expressions of Interest, but this number is likely to change. Note, submitting an expression of interest does not constitute an application to the DSS.

Annex B: Logic Chain

