
Consultation Response

Digital Securities Sandbox – joint Bank of England and FCA consultation

May 2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **Digital Securities Sandbox – joint Bank of England and FCA consultation**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

The below AFME feedback considers the DSS framework from a broad perspective, without a specific use case in mind. Each Sandbox applicant and entrant, as it gives further consideration to specificities of its own project, may identify further potential barriers or have specific observations.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Executive Summary

- **General comments:** AFME is highly supportive of the UK's ambition to create a Digital Securities Sandbox (DSS), and appreciates the proposed details on a staged approach to implementation. Given the novel nature of technologies, pace of innovation, and anticipated domestic and international market growth of DLT-based capital markets, further policy and regulatory changes may be required to the DSS. We therefore encourage authorities to continue to adopt a dynamic and flexible approach through the lifecycle of the DSS, and continue to engage with industry as knowledge and experience develop.
- **Limits:** given that limits are highly important to prospective participants' decision to participate in the DSS as Digital Securities Depositories (DSDs), we encourage the Bank to adopt a more flexible approach to the setting of limits for DSDs by both: 1) applying Go Live (Stage 3) limits on a firm-by-firm basis (rather than applying the same limit for certain asset classes to every DSD), and 2) allowing DSDs to progress to 'Scaling' (Stage 4) on a continuous, case-by-case basis (rather than, as proposed, at only one of two fixed review points).
- **Cash settlement solutions:** in the absence of available tokenised wholesale central bank money (CeBM), we welcome the ability to use tokenised commercial bank money (CoBM). We also recommend that the Bank specify in detail how it would consider settlement-related risks in relation to CoBM in comparison to CeBM. We continue to highly encourage the development of wholesale CeBM, which will help accelerate the DLT-based capital markets, and also urge the Bank to consider further how to incorporate solutions for CeBM (such as RTGS renewal, omnibus accounts etc.) into the DSS.
- **Exit:** to maintain a high level of regulatory certainty and market confidence, we recommend the regulators to 1) provide further clarity on their expectations for the potential exit routes (maturity of assets or transfer of assets to another FMI) to be deployed by DSS applicants, and 2) specify how they would support

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the execution of such strategies. We also support clarity that DSS participants may alter their exit strategies with regulatory approval following the commencement of the DSS.

- **Duration:** we note that the availability of the DSS is dependent on the finalisation of the proposed rules and regulatory guidance, which means that the DSS will be in place for considerably less than the legislated, and envisaged, duration of 5 years.
- **Ability to denominate assets in non-GBP currencies:** instruments denominated in non-GBP currencies should be allowed in the DSS, in accordance with current market and funding needs. We believe that this optionality would be welcomed by UK incorporated entities considering issuing securities in the DSS.

General Comments

AFME remains highly supportive of the overarching objectives of the DSS, and welcomes the continued high level of industry engagement from UK authorities in developing the DSS. We also appreciate the decisions of the Bank of England and Financial Conduct Authority (FCA) to set out proposed rules for the different stages of the DSS lifecycle in substantive detail.

Given the novel technology involved, there is potential for divergent use cases and models to emerge, which may necessitate further legal or regulatory changes in the future. Conceivably, this could also include changes to regulations outside of the existing DSS remit. We therefore encourage authorities to continue to adopt a dynamic and flexible approach through the lifecycle of the DSS, and continue to engage with industry as knowledge and experience develop.

We strongly encourage the regulators to adopt a holistic approach where possible, linking the DSS to other initiatives and forms of experimentation with innovative technology, including the development of on-chain Central Bank Money and digital gilt markets (although we strongly emphasise our understanding that participation in digital gilt experimentation should not and will not be limited to DSS entrants.)

To ensure the international competitiveness of the UK DSS, we also encourage authorities to reflect on potential 'lessons learned' from analogous initiatives in other jurisdictions. In particular, we highlight ESMA's recent analysis¹ of the first year of the DLT Pilot Regime (DLTPR) which identified several reasons for the relatively low uptake of the regime. AFME believes that challenges identified by ESMA in relation to the DLTPR may also be applicable to the DSS and should therefore be given careful consideration. AFME members anticipate significant industry experimentation both inside and outside of sandbox environments in the next few years. Regulators and policymakers will need to monitor international developments and react as appropriate, rather than necessarily commit to a fixed multi-year approach.

Questions

1. Do you have any comments on the draft Guidance on the Operation of the Digital Securities Sandbox (Appendix A)?

In relation to the draft Guidance on the Operation of the Digital Securities Sandbox (Appendix A), we provide comments and suggestions relating to the following areas:

- Scope
- Limits
- Cash settlement

¹ See https://www.esma.europa.eu/sites/default/files/2024-04/ESMA75-117376770-460_DLT_Pilot_Regime_-_Letter_to_EU_Institutions.pdf

- Currency denomination

Scope

We welcome the clarification that banking-type services are classified as ‘ancillary’ and not ‘core’ DSD services and could be provided to Sandbox entrants by eligible non-DSS participants irrespective of their home jurisdiction. This is important to increasing the attractiveness of the DSS by allowing the widest possible set of service providers to interact with the DSS, outside of those providing core CSD services.

Limits

Any volume limits placed on DSDs will be a key element of a firms’ assessment of the business case for DSS participation and the investment required. However, we are concerned that the proposed Stage 3 (Go Live) limits per DSD, coupled with the proposed fixed review points for DSDs to apply to proceed through Gate 3 to Stage 4 (Scaling) (at T+15-18 months and T+ 30-40 months), likely will disincentivise participation in the Sandbox and thus inhibit the UK’s competitiveness in DLT-based capital markets.

Although the scale and nature of potential DSS issuances are yet unknown, in line with current market trends, it is possible that a single large issuance could use up most or all of the proposed Go live (Stage 3) limits, and thus, prevent the DSD from having the opportunity to attract additional issuers and innovate further, until the DSD becomes eligible to apply to proceed to Stage 4 (Scaling) at one of two fixed review points (potentially up to 18 months later). For example, a recent issuance of DLT-based sovereign bonds in another jurisdiction was for more than £6bn HKD².

As a result, we encourage the Bank to adopt a more flexible approach to setting limits for DSDs by both: (a) applying Go live (Stage 3) limits on a firm-by-firm basis (rather than applying the same limit for certain asset classes to every platform), and (b) allowing DSDs to progress to Scaling (Stage 4) on a continuous, case-by-case, basis (rather than, as proposed, at only one of two fixed review points). Both any limits and restrictions on a firm’s ability to apply to increase limits should be tailed to the specified risks post by a given platform or transaction proposition.

Cash settlement

We continue to strongly encourage the development of tokenised wholesale central bank money (CeBM), which will help accelerate the DLT-based capital markets. To this end, we urge the Bank to maintain a joined-up approach across the organisation and consider further how to incorporate solutions for CeBM (such as RTGS renewal, omnibus accounts etc.) into the DSS.

In the absence of tokenised wholesale central bank money, we welcome the clarification that settlement in commercial bank money (CoBM) will be permissible in the DSS. In response to the proposal in the draft guidance that “the Bank will allow settlement in commercial bank money with no or limited credit or liquidity risk, or equivalent private forms of money”, we note that the use of CoBM does not necessarily create substantial additional risks, especially given the limits around DSS sandbox issuance limits. Of course, much will depend on the actual application, but the use CoBM has several benefits, notably the ability to accommodate settlement of non-GBP denominated issuances while avoiding FX risk.

² On the 7 February 2024, the Government of the Hong Kong Special Administrative Region of the People’s Republic of China issued HKD6 billion-equivalent of digitally native green bond in four currencies (HKD, CNH, USD and EUR) using the HSBC Orion digital assets platform. See <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2024/02/20240207-6/> and <https://www.gbm.hsbc.com/en-gb/insights/financing/first-multi-currency-digital-bond-offering>.

In terms of settlement-related risks, we suggest the Bank to specify in more detail how it will assess specific risks in relation to the use of both CoBM and CeBM, for example including: principal risk³; replacement cost risk⁴; counterparty credit risk⁵; and liquidity risk⁶.

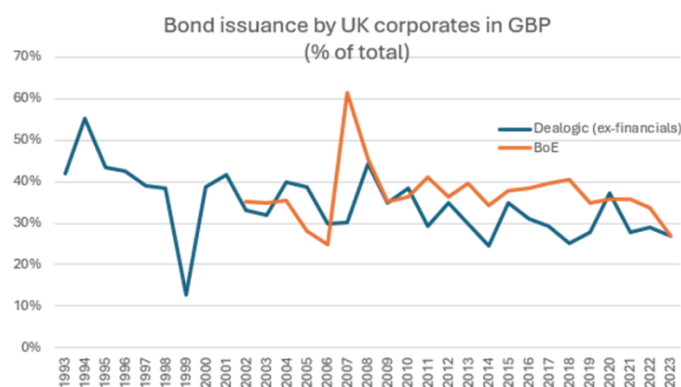
In any case, AFME members note that, given the proposed firm-specific and aggregate limits and limited time duration on DSS activity, the deposit risk to large financial institutions when providing banking-type services should be limited.

Furthermore, on eligible cash settlement assets, we note the Bank's view that it is unlikely that e-money or stablecoins not regulated by the Bank would meet the required standard to be used as a settlement asset. We would welcome the opportunity for further dialogue on this point, once these settlement assets become more established.

Currency Denomination Optionality

AFME members strongly support the permission of issuances in non-sterling currencies. We believe that this optionality would be welcomed by UK incorporated entities considering issuing securities in the DSS and is crucial to ensuring the DSS is attractive to participants.

Indeed, we note that Dealogic and Bank of England data⁷ illustrates that well over half of debt issued by UK corporates is in non-GBP currencies. For example, in Q1 2024, 74% of the gross capital raised through bonds issued by UK issuers was denominated in currencies other than pound sterling.



Source: AFME research, Dealogic and Bank of England data

³ the risk that a counterparty will lose the full value involved in a transaction. For example, the risk that a seller of a financial asset will irrevocably deliver the asset but not receive payment. This risk can be addressed by having the DSS application demonstrate its compliance with PFMI principle 12, notably by having appropriate exchange of value systems (i.e. DVP settlement).

⁴ the risk that a trading counterparty will default before a trade has settled and that the other party must replace it with a new trade and a different counterparty at current market prices. We consider that this risk can be mitigated in various ways (e.g. netting, collateral, or shortening settlement cycles).

⁵ the risk that a counterparty will be unable to meet fully its financial obligations when due or at any time in the future. This can arise on the side of the DSD entrant or its banking service provider when extending (intraday) credit to its participants to settle trades, or can also arise when DSD customers leave long balances with the DSD entrant or its banking service provider. This risk could indeed be more prevalent when CoBM is used, but can be mitigated in a number of ways, including by using adequate collateral arrangements, or the ability of participants to transfer their settlement assets. The limitations on the DSS sandbox and a high creditworthiness of the banking services provider should also help mitigate any counterparty credit risks associated with the use of CoBM. In this context, it is worth highlighting that settlement at the International CSDs currently takes place in commercial bank money.

⁶ the risk that a counterparty, whether a participant or other entity, will have insufficient funds to meet its financial obligations as and when expected. Similar to the above, liquidity risks are arguably more prevalent when CoBM is used, but these risks can again be adequately mitigated in the context of the DSS.

⁷ <https://www.bankofengland.co.uk/statistics/details/capital-issuance>

We note that multi-currency settlement is possible in traditional CSDs and is highly likely to be a desirable feature of any new infrastructure model. Issuers at the forefront of experimentation with digital bonds have issued securities in multiple currencies. For example, the European Investment Bank (EIB) (GBP, SEK, EUR), and the Hong Kong Market Authority (HKMA) (CNH, USD, EUR, HKD).

The permission of non-GBP issuances within the DSS will help support the complex financing needs of UK corporates, whilst encouraging the related settlement activities to remain within the UK regulatory perimeter.

2. Does the approach mitigate cliff-edge risks for sandbox entrants graduating out of the DSS?

We welcome the clarity provided by regulators regarding the potential exit routes for DSS participants. For assets that do not have a defined term-date, we note that the transfer of assets to another FMI – either another DSD or a traditional CSD – is envisaged as key potential exit strategy, and that applicants should provide details of their exit plan at the point of application. In this context, we would welcome further clarity on regulators' expectations regarding the level of detail that can be provided in applications, when DSS entrants will have a very limited visibility of FMIs to whom assets could potentially be transferred in the case of a wind-down. We would also welcome clarification that DSS entrants will be able to alter their exit plans post-application, subject to regulatory approval.

In addition, AFME members consider that the design, parameters and time-limited nature of the DSS are likely to result in issuer and/or investor preference for short-term corporate debt. We note this preference is likely to be relevant for asset class limits and subsequent allocation among Sandbox participants.

3. Do you have any comments on the effectiveness of the glidepath approach described above?

With regards to the duration of the DSS, we note that the 5-year time period for the DSS has already commenced. This therefore means that, in practice, the DSS will be time-limited to and only be accessible for approximately 4 years (depending on the finalisation of the rules and regulatory guidance). As the regulators have indicated that the DSS will close to new applicants at a future point (expected approximately 30-40 months after the launch of the DSS), we also encourage the regulators to provide advance market notice to improve predictability on entrance.

In this context, we also note that unlike for DSDs (for which there is a streamlined and DSS-specific authorization process), participants that do not have the correct permissions for a trading venue will need to follow the Part 4 authorisation process or apply for a variation of permission (VoP). This can be time consuming and may hinder progress through the DSS. It would be helpful to have a faster-track Part 4A/VoP process.

We welcome the ultimate objective of the DSS to support the creation of a future-state, permanent regulatory framework. It is conceivable that clear paths forward will emerge within the envisaged lifetime of the DSS, and we encourage regulators to be proactive and decisive in determining permanent modifications to the regulatory regime. In addition, to ensure regulatory certainty, sufficient and advance market notice needs to be provided ahead of any proposed changes to the regulatory regime.

We appreciate that regulators have given careful consideration to balancing the needs of different Sandbox entrants. We consider it highly probable that DSS participants will progress at different speeds, and therefore encourage regulators to maintain a flexible approach to permitting firms to move through the Stages.

4. Are there any known regulatory barriers and/or risks to/from the technology or business models not covered in the end-state rules that the Bank should consider at the outset?

We welcome the Bank's commitment to consider a permanent, bespoke regime for the operation of non-systemic digital FMIs, subject to a proportionate regulatory and prudential framework. Given the potential of this regime to enable new business models, increase competition among incumbent FMIs and new entrants, and also reduce single-points-of-failure in the financial system, we welcome further proposals and guidance from the Bank on how it plans to facilitate the development of non-systemic digital FMIs. As an industry, we stand ready to further engage with the Bank on the evolution of this important regime.

5. Is the full set of rules set out in Appendix B consistent with the objectives and design principles of the DSS?

No specific comments.

6. Do you have any feedback on the Bank's approach to creating the Gate 2 rules or the Gate 2 rules themselves?

See answer to Question 1 in relation to Limits.

7. Are there any specific features of technology and/or business models that would be incompatible with the proposed Gate 2 rules?

No comment.

8. Are there any requirements in the proposed Bank's DSS rules which would conflict with the frameworks that govern a firm which is also regulated by the FCA and/or the PRA?

No comment.

9. Do you agree with the proposed approach to managing potential interactions between Bank, FCA and PRA requirements?

No comment.

10. Do you agree with the Bank's proposed capital requirements for DSDs, both at Gate 2 and end state?

We generally do not have significant concerns with the proposed approach to capital requirements, provided there is no double counting between the DSS treatment and other prudential regimes for relevant firms. We do note, however, that the success of the DSS may depend on other regulations and regimes that are out of scope of the DSS, including the UK's transposition of the BCBS standards on crypto assets.

11. Do you agree with the proposed approach to capital requirements where firms are also subject to other prudential regimes?

See answer to Question 10 above.

12. Do respondents have views on how the proposed regime balances the need to protect financial stability while allowing enough activity in the DSS to facilitate innovation?

As stated in our answer to Question 1, we acknowledge the need to balance innovation with financial stability risks through the imposition of volume limits within the DSS. However, we emphasise that the approach the Bank takes to setting limits will be a critical to prospective participants' decision to invest in the DSS, and therefore we encourage the Bank to adopt a more flexible approach to setting limits for DSDs by both: (a) applying Go live (Stage 3) limits on a firm-by-firm basis (rather than applying the same limit for certain asset classes to every DSD), and (b) allowing DSDs to progress to Scaling (Stage 4) on a continuous, case-by-case, basis (rather than, as proposed, at only one of two fixed review points).

13. Do you agree with the Bank's proposed fee regime for the DSS?

We agree with the proposed fee regime for the DSS and do not have any significant concerns with the Bank's proposed fee regime.

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