

Insights

WHAT NEW DIGITAL SANDBOX REGS HOLD IN STORE FOR UK MARKETS

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The Financial Services and Markets Act 2023 (Digital Securities Sandbox) Regulations 2023 came into force on Jan. 8, creating the U.K.'s first digital securities sandbox within which firms would be able to test new technologies under a modified legislative framework.

This development followed a consultation ending in August 2023, which set out HM Treasury's proposed approach to delivering the sandbox. Central to the regulations is the U.K.'s desire to modernize its financial market infrastructure through digital asset technology.

In fact, in an explanatory memorandum to the regulations, HM Treasury specifically mentioned distributed ledger technology, or DLT, as a potential innovation that could be incorporated into the activities of a central securities depository and trading venue.

Still, the memorandum expressed caution on the basis that new technology could compromise overall market functionality and stability.

In our view, the sandbox is a key path forward. The U.K. legal framework was simply not built with nascent technologies like DLT in mind. Nevertheless, it is crucial that current legal or regulatory gaps do not lead to inertia in the development of the U.K.'s technology landscape.

Accordingly, in this article we shall take a look at the application of the sandbox to DLT as well as further considerations regarding its implementation.

DLT IN FINANCIAL MARKET INFRASTRUCTURE

OVERVIEW OF DLT

At its core, DLT uses a digital ledger that is collectively updated and maintained by a network of computers. Proposed entries on the ledger are checked and validated by the network collectively.

If the proposed entry is accepted, a network update is pushed, such that every copy of the digital ledger updates simultaneously.

DLT is unique because there is no central authority to oversee or administer the process. Given their decentralized design, distributed ledgers may offer greater security, immutability and efficiency, relative to traditional ledgers.

BENEFITS

Incorporating DLT into the operation of a central securities depository or trading venue would be transformative. A trading and settlement platform built on DLT could tackle the issues associated with having an intermediated shareholding structure.^[1]

In this respect, the technology could enable investors to be the direct owners of their investments, bypassing intermediaries, which in turn improves transparency and the ability for shareholders to exercise their rights without the need for a CREST, the central securities depository for markets in the U.K. and for Irish stocks membership.

More broadly, DLT could bring new functionality including round-the-clock operations and near instantaneous, or "T+0," settlement.^[2]

The technology could also be used to spawn radically different configurations in the provision of shareholding, trading and settlement services in ways not yet conceived. DLT would also enable platforms to streamline and automate regulatory reporting.

This stems from the fact that data is drawn directly from the ledger rather than from a series of disparate reporting systems, meaning greater data consistency, less reconciliation and lower compliance costs overall.

OPENING THE DOOR FOR DLT

Despite the advantages of using DLT, the U.K. legal and regulatory framework presents a variety of issues that may need to be addressed.

COMPANIES ACT 2006

Various provisions of the Companies Act 2006 will need to be updated to accommodate the trading, settlement and maintenance of shares using DLT:

- Registration of transfer — Section 770: The concept of an instrument of transfer may need to be clarified to ensure that transfers using DLT can be regarded as involving a proper instrument of transfer;
- Securities — Section 783: References to securities should be widened to include those issued, traded, settled or maintained using DLT; and

- Company records — Section 1134: The provisions concerning company records would also need to be amended so that records kept by a company include those stored on a distributed ledger.

CENTRAL SECURITIES DEPOSITORY REGULATION

Having been brought into U.K. law by the [European Union \(Withdrawal\) Act 2018](#), the Central Securities Depository Regulation governs the operation of central securities depositories, as well as the settlement of financial instruments in the U.K.^[3]

A number of modifications will, however, likely need to be made to allow the use of DLT:

- Recording transactions — Article 3: The provisions need to be updated to accommodate the recording of transactions using DLT;
- Integrity and reconciliation — Article 37: The text refers to the use of reconciliation measures to ensure that the number of securities issued on a central securities depository aligns with the number of securities held by recipients. However, the reconciliation measures referred to only include traditional records of issuance and not collective records maintained using DLT; and
- Settlement — Article 40: The procedures involving digital or tokenized forms of payment using DLT are not expressly recognized.

UNCERTIFICATED SECURITIES REGULATIONS 2001

The Uncertificated Securities Regulations allow title in securities to be validly evidenced and transferred without a written instrument. As a result, the regulations disapply certain formalities under the Law of Property Act 1925 that would normally be required in the disposal or assignment of property.

Various issues include:

- Purpose — Regulation 2(1): There is no explicit language enabling the transfer of securities to and from a distributed ledger; and
- Rectification — Regulation 25: The process to rectify an issuer's register of securities does not expressly cover securities issued using a DLT.

SANDBOX MODIFICATIONS

In light of the current framework, HM Treasury intends for the sandbox to facilitate the testing of new technologies, including DLT, by creating an environment subject to applied, disapplied and modified legislation.

As an illustration, the recording of transactions in book-entry form under Article 3 of the Central Securities Depository Regulations is now modified to include any form of recording using developing technology. The full set of modifications are set out in a schedule to the regulations and include some of the provisions identified earlier.

Firms must apply and be accepted into the sandbox as a so-called sandbox entrant in order to perform the activities in scope. Only U.K.-established entities meeting eligibility criteria in Article 3 of the regulations can participate.

ACTIVITIES IN SCOPE

HM Treasury has stated in the memorandum that any legislative modifications will be principally focused on the following activities:

- Notarization: the recording of a security in a settlement system;
- Settlement: the delivery of securities from one party to another;
- Maintenance: the operation of securities accounts; and
- Trading: the operation of multilateral trading facilities or organized trading facilities.

The first three are the activities of central securities depositories, while the fourth activity relates to operating a trading venue.

We see modifications to these activities as crucial to facilitating the use of DLT in the financial markets. As an example, the sandbox will allow participants to perform all four activities within a single entity.

Existing legislation requires trading venues to separately engage a central securities depository to notarize, settle and maintain transactions on its platform. Permitting a single entity to conduct all four activities with the aid of DLT would certainly help realize the full potential of the technology.

Still, the sandbox permits nonsandbox activities to be carried out, subject to current legal and regulatory requirements. Again, we see this enables firms inside the sandbox to integrate with the wider financial market by allowing different activities across the value chain to be performed.

ASSETS IN SCOPE

The sandbox allows for digital representations of select financial instruments including debt and equity securities, money market instruments, and undertakings for collective investment in transferable securities.

Derivatives are excluded in the sense that no derivatives-specific legislation is modified under the regulations. Clearly, the drafting of the regulations is broad and is intended to cover a variety of

instruments.

A key principle of the sandbox is that digital securities issued, traded or settled within the sandbox, including by way of DLT, will be treated the same as their traditional equivalents from a legal and regulatory perspective.

Similar to permitting both sandbox and nonsandbox activities, this principle enables firms inside the sandbox to integrate with the wider financial market, since digital securities can be dealt with across markets.

FURTHER CONSIDERATIONS

Despite the flexibility of the sandbox, there are a number of considerations in its operation.

GOVERNANCE OF DLTS

The memorandum has not clarified whether the use of DLT in the sandbox would need to be operated on a permissioned basis, where access is restricted to authorized entities.

Certainly, permissioned ledgers that retain an ability to supervise or override transactions would be easier to regulate from a conventional perspective. This, of course, removes the upside of permissionless ledgers, which includes opportunities for disintermediation, self-custody and new models of governance.

The drafting of the sandbox is technology-neutral, likely in view of the government's broader objective to progress the U.K. technology landscape generally. However, further guidance or modifications may be needed to ensure that different permutations of DLT can validly exist under current law.

INTERNATIONAL ADOPTION

Technologies inside the sandbox would ideally be developed in line with international standards. This ensures a higher degree of compatibility and, in turn, adoption and integration of DLT into the financial market infrastructure.

Accordingly, international cooperation, perhaps secured through industry and government initiatives, will be needed to develop cross-border systems and to harmonize legal or regulatory approaches, noting that some jurisdictions may not even recognize transactions conducted using DLT.

CHOICE OF GOVERNING LAW

Establishing a governing law for assets on a distributed ledger is challenging, since DLT allows cross-border operations by design.

As mentioned, entries and transactions on a distributed ledger are collectively determined by nodes, some of which may be located overseas, such that the sandbox requirement to have the system controlled by a U.K.-based entity may not be possible.

At present, there is no specific requirement in the sandbox to designate English law as the governing law, although it would be interesting to observe how participating firms operate in practice.

NEXT STEPS

The sandbox will be a key driver of implementing DLT into the financial market infrastructure. As part of its mandate, HM Treasury will be empowered to report the results of sandboxes to Parliament and to explain whether any legislation requires permanent change.

HM Treasury is also permitted under the regulations to create further sandboxes, each with different configurations.

Accordingly, we see these powers as opening the door to further innovations including, for example, using DLT to achieve the share dematerialization recommendations posed by the digitization taskforce in their interim report.

Ultimately, the sandbox allows firms and regulators to test new technologies in a controlled manner and is an acknowledgment that changing the U.K. legal framework is an ongoing process. We welcome this latest development.

The sandbox will open for a period of five years until Jan. 8, 2029, and will be operated by the Financial Conduct Authority and the Bank of England.

This article was originally authored by Tom Bacon and Andrew Tsang and published on Law360

FOOTNOTES

[1] [The impact of DLT on the intermediated shareholding structure is discussed in our previous article.](#)

[2] This is the idea that trades are settled on the same day they are executed. "T" refers to the transaction date while "0" refers to the number of days needed to settle the transaction. Most securities transactions are conducted on a T+2 basis, but this may change with the incorporation of DLT.

[3] Central Securities Depository Regulation (EU) No 909/2014.

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Tom Bacon

London

tom.bacon@bclplaw.com

+44 (0) 20 3400 3706

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