UK FINANCE

Response to the HM Treasury's consultation paper on its proposed Digital Securities Sandbox

August 2023

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing around 300 firms, we act to enhance competitiveness, support customers and facilitate innovation. We welcome the opportunity to respond to HM Treasury's ("HMT") consultation paper on its proposed Digital Securities Sandbox (the "DSS")[1], which will be the first financial market infrastructure sandbox delivered under the powers granted as part of the Financial Services and Markets Act 2023. For more information about UK Finance, visit www.ukfinance.org.uk.

Simmons & Simmons LLP assisted UK Finance in preparing this response. Simmons & Simmons is a leading international law firm that combines its experience in digital assets, capital markets and financial regulation to deliver effective solutions for its clients. Contact Rosali Pretorius, George Morris, Oliver Ward and Gordon Ritchie or visit www.simmons-simmons.com for further information.

Executive summary

UK Finance is grateful for the opportunity to respond to the DSS consultation paper and for HMT's, the Financial Conduct Authority's and Bank of England's thoughtful engagement with industry participants to date. We are highly supportive of the DSS and are enthused by its potential to accelerate innovation and showcase the UK's strengths as a leader in the digital assets transformation. It is clear from the DSS design proposal that HMT has understood the industry's concerns in certain important areas, e.g., in the difficulties posed by product limits. We would encourage HMT, the Prudential Regulation Authority ("PRA"), and the Financial Conduct Authority ("FCA") to support further two-way engagement between industry participants (including firms' own legal experts), regulatory representatives, and other legal experts specialising in digital assets and securities tokenisation. Save where otherwise defined, defined terms in this response have the meanings ascribed to them in the consultation paper.

The key points we have identified when preparing this response are as follows:

a) We welcome HMT's proposal to allow for the combining of the functions performed by central security depositories ("CSDs") and multi-lateral trading facilities ("MTFs") and/or organised trading facilities ("OTFs") in one financial market infrastructure ("FMI"). The ability to combine these functions will enable the benefits of FMI digitalisation to be more fully realised, including efficiency gains, lower costs and risk mitigation, as long as any potential conflicts of interest are properly disclosed and mitigated. However, whilst we generally believe the scope of activities permitted in the DSS is an appropriate starting point, we encourage HMT to remain open-minded and be prepared to redesign the UK's overall approach to the regulation of FMIs, including through the expansion of the DSS and/or further sandboxes. This will allow the industry to explore different and more transformational configurations in the provision of issuance, settlement, trading and custody functions, which could result in a financial markets ecosystem that looks very different to the ecosystem that exists today, involving new models that sit outside the incumbent market structure-participant roles.

   We think this sort of flexible approach would be a key differentiator to the EU's distributed ledger technology ("DLT") Pilot Regime. Whilst we have generally supported the EU's efforts, we believe the way it has embedded traditional incumbent market structure and participant roles in its legislative framework, along with the imposition of low thresholds, has significantly constrained its attractiveness to institutional investors, as well as its ability to truly support innovation in financial services market infrastructure. That said, we encourage HMT to collaborate and partner with other leading jurisdictions and connect to their pilots or sandboxes.

b) We firmly support the principle, expressed by HMT in the consultation paper, that digital securities should be treated in the same way as conventional securities as far as possible. This is reflected in firms' ability

[1] www.gov.uk/government/consultations/consultation-on-the-digital-securities-sandbox

to conduct 'non-DSS activities' in relation to digital securities issued through the DSS, which is positive and appreciated. This will require careful consideration and guidance to be successful, however.

c) We agree that flexibility in relation to the payment leg of digital securities is imperative, as some of the key benefits of DLT-based systems may only be realised through on-chain payment solutions. While we appreciate the clear statement that tokenised commercial bank money will be permitted, we believe HMT should clarify what that term includes (i.e., deposit tokens), and also what other payment options will be permitted and when.

d) Although we support the overall DSS proposal, certain points still require clarification and refinement. These areas include, for example, the products that will be permitted (particularly funds), whether it will be open to UK branches of non-UK entities (which we firmly support), how firm-specific limits are to be apportioned, and how participants are to exit the DSS. There are various other parallel processes that will need to be progressed in order for the DSS to fulfil its objectives, such as the legal reviews and reforms mooted by the Law Commission, and clarity as regards the PRA's approach to the prudential treatment of digital securities.

e) Flexibility is a significant potential strength for the DSS. We believe it is important for regulators to be adaptable, taking full advantage of its ability to refine and improve the DSS over time, both to expand the scope of the DSS and rectify any shortcomings. However, one of the consequences of the DSS' flexible design is the dependency on the regulators that oversee the scheme. As such, regulators must be well-resourced, responsive and objective in order for the DSS to function optimally.

f) We strongly commend the proposal to form an industry committee to consider jointly the experience and desired outcomes of participating in the DSS and provide cross-industry recommendations. UK Finance stands ready to assist with convening this cross-industry body.

g) As advocated in our previous work[2], we request that HMT (via the Debt Management Office) supports the DSS by issuing a digital gilt. This would raise the profile of the DSS, demonstrate HMT's confidence in the technology involved, and encourage wider adoption and experimentation.

UK Finance are available to discuss any element of this response further and look forward to working with HMT as the DSS progresses.

Consultation questions

This section sets out our responses to the consultation paper questions. References to chapters and boxes (e.g., 'Box 2A' etc) track those set out in the consultation paper.

Consultation questions set out in Chapter 2 – Digital Securities Sandbox: Key features

Box 2.A:

1. Do you agree with the broad approach set out above to digital securities in scope of the DSS? Please outline any comments or concerns as part of your answer.

We understand HMT's approach to determining the product scope of the DSS will involve listing a certain sub-set of financial instruments as defined in the RAO[3], so using the regulatory classifications set out therein. As a general point, HMT, the FCA and the PRA should carefully distinguish terminology in respect of tokenised securities, cryptoassets, and the underlying DLT, and ensure that usage is not conflated or misinterpreted by industry participants. We assume the financial instruments within the DSS will all be types of "specified investments" as listed in Part III of the RAO.

We make four comments in relation to this overall approach:

a) While we see the rationale in tying the DSS product scope to an existing set of regulatory classifications, we query whether it will result in DSS participants spending more time than

[2] See our report "Unlocking the Power of Securities Tokenisation", available at: www.ukfinance.org.uk/policy-and-guidance/reports-and-publications/unlocking-power-securities-tokenisation

[3] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544

necessary considering the regulatory nature of the products being issued and traded. Firms might be confident, for example, that the products to be recorded and settled through a DSD are debt or equity securities (within the common understanding of those terms), but might not be confident on whether they are a type of "specified investment" that is permitted by the DSS. This could be avoided if a broader definition was adopted. See also our response to Q2, below.

b) If the specified investments approach is retained, then the list of permitted specified investments should be constructed broadly, rather than being limited to a more specific regulatory classification. In the case of debt securities, for example, HMT should be permitting a wide range of specified investments as set out in the RAO – so, all instruments that fall within Article 77 (*Instruments creating or acknowledging indebtedness*) as opposed to permitting just "bonds", which is referred to specifically in Article 77(1)(d) of the RAO. See also our response to Q2, below.

c) Paragraph 2.9 of the consultation paper refers to the DSS excluding "unbacked cryptoassets". We would request HMT is more specific in its terminology here, as it is currently unclear what this is intended to exclude (aside from exchange tokens, which are referenced as an example). This is for two reasons:

    1) First, paragraph 1.3 refers to an unbacked cryptoasset as being a cryptoasset that is "unsupported by any asset" but the meaning of "unsupported" is not explained. We are conscious market participants could interpret "unsupported" as being similar to "unsecured" in a traditional context, which would rule out digital securities that represent an unsecured debt claim against the issuer (as opposed to being secured on a particular pool of property). Another interpretation would be seeing "unsupported" as excluding digitally native securities that do not evidence an interest in a traditionally-held security. We assume neither scenario is intended to be excluded but members would welcome clarification.

    2) Second, digital securities issued via a permissionless systems will use exchange tokens as part of its technological construct – it is not clear whether these sorts of arrangements will be allowed or not, given the exclusion. For example, if a digital security is issued on the Ethereum network, then Ether – an exchange token and an unbacked cryptoasset, which is native to Ethereum – will be needed to pay transaction ('gas') fees that arise when the digital security is issued and transferred. We assume HMT does not intend to exclude these sorts of digital securities, given statements made elsewhere in the consultation paper about the possibility of using permissionless systems, e.g. paragraphs 3.1 to 3.4 and Q22. See also our response to Q23.

d) While we think it is already clear from the consultation paper, we want to emphasise that certain tokenisation structures are possible without legislative modifications or derogations, so will not need to be carried out under the DSS. So, if a firm uses DLT to record assets on its internal books and records, this does necessarily change the nature of the underlying assets (for example, where a token represents an entitlement to a security held in conventional form elsewhere, or a deposit liability owed by a financial institution to its customers). These sorts of tokens should not be considered products within the scope of the DSS. They should instead be treated in the same way as any other electronic book entries, subject to the supervision by the regulators under the conventional regimes (without additional regulation or permissions under the DSS being required).

2. What specific kinds of digital securities/asset classes should be considered for inclusion in the DSS?

We suggest the following kinds of digital securities should be considered for inclusion in the DSS as a minimum, each being types of specified investments under the RAO (per our response to Q1):

a) Shares (Article 76 of the RAO);

b) Instruments creating or acknowledging indebtedness (Article 77 of the RAO);

c) Government and public securities (Article 78 of the RAO);

d) Certificates representing certain securities (Article 80 of the RAO);

e) Units in a collective investment scheme (Article 81 of the RAO); and

f) Rights to or interests in investments (Article 89 of the RAO).

As a broader point, we are supportive of funds being within the scope of the DSS at the outset regardless of their legal form. Care should be taken that they are all covered if the specified investments approach were adopted, as funds can take one of several legal forms which might map to more than one category of specified investment used in the RAO. For instance, shares in a fund taking the form of a company may fall in Article 76, but not if the company is an open-ended investment company. Ideally all legal forms of funds, including authorised unit trusts, real estate investment trusts, authorised contractual schemes and limited partnership interests etc would be permitted within the DSS.

We would also request clarification that the DSS is neutral and permissive as to the specific form of the instrument (e.g. both digital bearer and registered form securities should be permitted, which could adopt one of the structures outlined in the UKJT legal statement on digital securities) and that certain formalities (e.g. paper-based certificates) would not be required. We expect the latter to be achieved by disapplying legislative provisions that mandate those formalities.

Finally, it should be possible to issue/trade digital securities that are denominated in non-sterling currencies under the DSS. We would note that the European Investment Bank issuances have been in multiple currencies (including euro, sterling, Swedish krona) and as an international jurisdiction, in our view the UK would be missing an opportunity if it were to only permit sterling-denominated securities in the DSS.

3. Do you have any novel use cases or use cases for non-systemic asset classes that you wish to discuss with regulators? Have you identified any regulatory adjustments required to support these use cases?

We have not offered a response to this question, because we think it is more appropriately addressed by individual firms. We have encouraged UK Finance members to contact HMT directly.

Box 2.B:

4. Do you agree with the broad approach to activities, designations and authorisations in the DSS as outlined above? Please explain your answer.

Our initial impression of the approach to activities, designations and authorisations is that it is closely aligned with the manner in which regulators supervise conventional FMIs under the existing regulatory framework. This is because of the requirement for firms to be designated as a DSD (when performing notary, settlement and maintenance activities) and/or authorised as an MTF or OTF (when operating a trading venue, unless exempt). This implies that regulators are expecting DLT FMI to function in an analogous manner to conventional CSDs, MTF and OTFs and be regulated in broadly the same way (primarily under CSDR and MiFID), subject to the specific modifications and derogations granted under the DSS.

Our concern with this sort of approach is that it does not fully take account of the possibility that DLT may lead to changes in the overall structure of the financial markets, which may in turn necessitate a different approach to supervision (including as regards designation/authorisation). Indeed, if HMT's intention is to genuinely allow firms to trail new approaches to the issuance and distribution of digital securities – and to position the UK as a leader in technology and innovation – then the DSS should be structured to allow firms to carry-out notary, settlement, maintenance and trading activities (as well as certain related activities, e.g. custody[4]) *without* creating a full DLT-based FMI that is authorised in the same way as CSDs and/or MTFs or OTFs at present. In other words, we think the DSS should allow firms to explore different configurations of the financial markets ecosystem and to carry out one or more components in the end-to-end issuance-distribution model without the need

[4] See our response to Q26 and Q27 for further thoughts on custody.

for establishing a fully regulated FMI, subject to respecting certain international financial stability standards (i.e. the PFMI and IOSCO principles).

A related point is that DLT-based solutions naturally present an opportunity to distribute certain key functions amongst market participants. Those key functions are currently provided in a centralised manner by market infrastructures, which constrains market competition between different potential providers. The DSS should be designed to allow alternative structures to develop, given the benefits this could create in terms of market competition. This is not to say all DLT-based projects will be discrete and function separately. Moreover, where activities are 'unbundled', and 'distributed' (or performed by different members), certain hybrid structures could be developed to include an overarching 'control function' (where a DSS FMI is responsible for access rules, governance, regulatory and supervisory interaction, oversight, compliance etc, all in a manner consistent with the PFMI and IOSCO principles) while the transaction processing responsibilities are distributed among participants.

That said, from our helpful subsequent discussions with HMT, FCA and the Bank of England, we understand the intention *is* to allow greater flexibility in the general approach to regulating DLT-based FMIs and firms carrying-out issuance, settlement and trading functions. We think that intention needs to be made clear in the statutory instrument establishing the DSS and all future guidance etc, considering the points we make above.

As separate and more specific points:

a) We understand that (per paragraph 2.4 of the consultation paper) proposed FMIs which fully comply with existing legislation will not need to apply to the DSS. By extension, we assume that that DSS applicants with 'hybrid' DSS proposals (that contain both conventional and novel design elements) will not need to explain how and why the conventional elements comply with existing rules and regulations. The focus should instead be entirely on the novel elements that require legislative modifications. Firms would be grateful for clarification on this point.

b) Similarly, firms both in and outside the DSS may wish to use DLT to perform various internal functions (i.e. as part of internal systems). We assume that these sorts of systems will be permitted as long as their use does not conflict with firms' existing regulatory obligations. Confirmation of this point would be welcomed.

c) HMT should be prepared to adapt the DSS' permitted activities over time (as well as various other features, particularly as regards scope). This is particularly true as we expect there will likely be a preference for expanded functionality to be addressed within the DSS where possible, rather than establishing a new sandbox (where a separate application would need to be made). We acknowledge that a new and separate sandbox will be more appropriate in some cases, however.

5. Do you have any comments or concerns with the process outlined in Annex A?

We make the following observations in relation to the process outlined in Annex A of the consultation paper:

a) The rationale for the two-stage application process that first requires participants to enter the DSS as a Sandbox Entrant doesn't seem entirely clear from the consultation paper. Paragraph 15 of the consultation paper provides that designation as a Sandbox Entrant will give the Sandbox Entrant "access to the temporarily modified legislation set out in the statutory instrument enacting the DSS" (stage 1). This seems to be at-odds with the requirement for applicants to additionally be designated as a DSD or authorised as an investment firm operating an MTF/OTF (stage 2) before carrying out live regulated activity. From our separate discussions, we understand the rationale is to allow firms to conduct initial small-scale testing under regulatory supervision, but this may deter firms from applying if it serves to unduly extend the timeframe to conducting live regulated activity. It would seem more straightforward for applicants to make a single application to the DSS, to act as a DSS and/or MTF/OTF. If applying as an MTF/OTF and the relevant firm is already authorised or exempt, then that application could be streamlined.

If HMT wishes to retain the two-stage application process, then we would request clarification as regards (i) the purpose and limitations of designation as a Sandbox Entrant (as firms will need certainty as to what they can expect to do as a Sandbox Entrant, before receiving separate designation/authorisation as a DSD/MTF/OTF) and (ii) the expected timeframe between designation as a Sandbox Entrant and designation or authorisation as a DSD/MTF/OTF. Otherwise, a two-stage application process may make budgeting and planning more difficult, particularly if firms are expected to conduct testing during the Sandbox Entrant phase before moving towards designation/authorisation.

b) We understand participants will meet with regulators on an ongoing basis (through 'joint regulator review points') to discuss performance against requirements, which could lead to amendments to the participant's SAN. It will be important for participants to have a clear understanding of the requirements for progressing through the DSS (both scaling-up and arriving at the completion phase) and the circumstances in which a participant's SAN may be amended. Those requirements and circumstances should be objective and transparent, ideally subject to clear regulatory guidance. A related point is that there appears to be relatively few details about the sorts of information participants would need to disclose to regulators day-to-day (in addition to any transaction reporting-type information), and whether those requirements will differ for Sandbox Entrants, DSD and MTFs/OTFs. This will need to be clarified before the DSS commences.

c) Several of the DSS processes (including but not limited to the designation and authorisation process) will likely absorb a significant amount of capacity on the part of HMT and the Bank. It is imperative that experienced HMT and Bank personnel are appointed to oversee applications etc, and that those personnel are given sufficient resources. We assume the intention is that this will be funded by the fees referenced in paragraph 3.13 of the consultation paper. While we do not object to any fees being levied on participants in principle, we would also make the point that firms' DSS projects are likely to require significant up-front investment with no guaranteed prospect of a return. Any costs imposed on participants should be seen in that light, and kept at a competitive and low level.

We have commented on other elements of the activities, authorisation and designation processes elsewhere in this response. See Q7 in relation to limits and Q17 and Q18 in relation to exiting the DSS, for instance.

Box 2.C

6. Do you agree with the approach to non-DSS activities outlined above? Please explain your answer.

We firmly support the overall aim of enabling the entire lifecycle of DSS securities to remain as similar as possible to traditional securities. We have the following three comments on the description of non-DSS activities set out in the consultation paper:

a) We think the approach to non-DSS activities should be carefully considered, otherwise there is a risk it could introduce regulatory uncertainty in certain situations. Our concern here relates to the suggestion, in paragraph 2.24 of the consultation paper, that "any activity will be permissible provided it is performed according to existing regulatory or industry frameworks, unless it is explicitly prohibited within the DSS…". While we agree with the principle, in practice market participants may want greater assurance that their non-DSS activities are permissible and therefore prefer 'positive' statements from regulators as to what is allowed, as opposed to the 'negative' approach outlined in the consultation paper (where activities are permissible unless explicitly prohibited).

One approach might be to issue regulatory guidance, which could be principles-based, perhaps including statements similar to Article 18 of the EU's DLT Pilot Regime Regulation[5] as well as illustrative examples. Possible examples to address include (i) UCITS and AIFMD, which

[5] Article 18 of the EU's DLT Pilot Regime Regulation adds the words ", including such instruments issued by means of distributed ledger technology" to the definition of "financial instruments" as set out in MiFID II. This is a helpful general clarification that allows market participants to treat references to "financial instruments" (that arise in many different rule sets) as including digital securities.

mandate the appointment of a depository to safekeep the relevant fund's assets[6], as it is unclear whether and how these requirements would apply where the fund's assets are digital securities and (ii) the EMIR Margin RTS, which sets out the types of collateral that are eligible to be posted under a derivative transaction (as it is currently unclear whether references to securities could be construed as including digital securities[7]). A Q&A facility that enables market participants to submit specific guidance requests from regulators would be helpful here, both in this context and in relation to the DSS more generally.

b) Further to our conversations with HMT, the FCA and the Bank of England, we now understand that the intention is that non-DSS activities can take place between entities that are not connected to the DSS. For example, if a digital debt security issued under the DSS is to be used as collateral for another financing transaction, neither the collateral provider nor collateral receiver would need to be Sandbox Entrants. This should be clarified.

c) Paragraph 2.24 provides that non-DSS activities are permissible "provided appropriate regulatory notification procedures are in place". We understand this refers to the regulatory notification procedures under existing frameworks, rather than a new and additional notification process. Again, it would be useful to clarify this.

Box 2.D

7. Do you agree with the broad approach to capacity and limits in the DSS described above? Please explain your answer.

We acknowledge the need for limits and agree such limits should be set by regulators rather than being fixed in legislation (owing to the greater flexibility this affords). We also welcome the proposal not to have product limits that apply at an issuance level. However:

a) The nature of the 'capacity' and 'firm-specific limits' described in paragraph 2.29 is not entirely clear. Paragraph 2.31 of the consultation paper suggests they will be set in sterling, so we assume the limits will be set by reference to the aggregate market value of securities issued or traded on a particular DSS FMI (in the case of firm-specific limits) or the aggregate market value of securities issued or traded on all DSS FMI (in the case of the capacity limit) but this should be clarified. The way the value of securities is to be calculated and reported should also be clarified.

b) The authorisation process suggests that the firm-specific limits will be set at a lower level initially and increased over time, via amendments to the SAN. We appreciate the benefits of that approach from a financial stability perspective, but would expect that some firms will be able to demonstrate adequate controls 'from day one', at the application stage. In those circumstances, we would expect higher firm-specific limits to be available, with less emphasis on scaling-up over time. Any scaling-up progression should also be possible very quickly.

c) We agree that firm-specific limits should be apportioned in a fair way and see the rationale for retaining capacity for later entrants (as explained in principles 1 and 2 of paragraph 2.32 of the consultation paper). Applicants to the DSS will nevertheless need certainty about the firm-specific limits they can expect, as this will have direct implications for the feasibility of their project proposals. Setting firm-specific limits on an overly discretionary basis may cause difficulties from a planning and budgeting perspective, so the setting of firm-specific limits should be subject to transparent steering principles. One approach could be for regulators to issue guidance which provides that applicants meeting specific regulatory, operational and/or governance requirements can expect to be subject to firm-specific limits within a stated range (with different bandings depending on the regulators' requirements). This sort of approach would result in a more objective basis for allocating firm-specific limits and give greater certainty to DSS applicants.

d) Paragraph 2.32(3) of the consultation paper provides that firm-specific limits "will be reviewed as [participants] progress, evolving as the entity's experience and business model matures, and entities are able to meet more stringent requirements and risk management standards"

[6] See for example Article 21 (*Depositary*) of AIFMD as implemented in the UK via the Investment Funds Sourcebook (FUND).

[7] We see this as a more straightforward example that would not likely lead to substantive issues in practice.

Participants will require clear guidance as to the criteria they need to meet to progress through the DSS and for firm-specific limits to be increased. That criteria should be objective and transparent. If a participant does not progress after a review (and firm-specific limits are not increased), a clear explanation of the regulators' reasoning should be given.

e) The consequences of breaching the capacity and firm-specific limits are not addressed in the consultation paper. We would expect that breaching a firm-specific limit would trigger a participant's exit strategy (to the extent necessary to bring the DSS securities under that limit), but this is not referenced in the consultation paper expressly. The consequences of breaching the DSS' overall capacity limit will require closer consideration, as this would be caused by the aggregate volume of DSS securities being issued or traded exceeding the limit (rather than because of the actions of a single participant). If exit strategies are to be triggered in that context, then the way this is apportioned amongst participants will be particularly important. We generally assume the regulators will mitigate this by setting firm-specific limits so that, in aggregate, they amount to substantially less than the relevant capacity limit.

8. What size of activity does an FMI in the DSS need to reach in order to be commercially viable? Please note if there is any sensitivity in sharing information here.

We have not offered a response to this question, because we think it is more appropriately addressed by individual firms. We have encouraged UK Finance members to contact HMT directly.

Box 2.E

9. Do respondents agree with the approach to eligibility outlined above? Please explain your answer.

We broadly agree with the approach to eligibility outlined in the consultation paper. However:

a) Paragraph 2.36 provides that applications will only be accepted from "entities established in the UK". Further clarity as to what this means is needed. In particular, UK Finance strongly supports the DSS being open to applications from the UK branch of an entity incorporated in a foreign jurisdiction – if this is not the case, it could pose a significant barrier to potential applicants' preferred structures. Clarity as regards whether applications from groups that include entities incorporated in a foreign jurisdiction is also needed – we suggest this should be acceptable, as long as the 'lead entity' that submits the application is incorporated in the UK. We assume a UK-incorporated subsidiary of a parent company incorporated in a foreign jurisdiction would be permitted.

b) We suggest the requirement for a legal entity should be a condition to approval rather than something required before an application can be submitted.

c) It will be important for all DSS participants to have robust safeguards in place (which expect regulators will carefully consider during the application process) so all firms and entities that interact with that DSS FMI have assurance of its safety and soundness. Consideration should be given to whether the entity has proper consumer protections, is bankruptcy remote, complies with AML requirements, and meets minimum capitalisation requirements. The DSS will only be successful if high standards are maintained at all times.

10. Will participating entities be comfortable demarcating Sandbox from non-Sandbox business?

Yes.

Box 2.F

11. Do you agree with the approach to applications outlined above? Please explain in detail any issues or concerns.

We do not have objections to the categories of information that will be required from DSS applicants via the DSS application forms, as described in paragraphs 2.41 to 2.45 of the consultation paper. We

note this description is high-level, however. We would welcome the opportunity to comment on a specific draft of the template application forms before they are issued. See also our comments in Q13, below.

Regarding the application process more broadly, we think that:

a) Regulators should commit to specific timeframes for responding to applications, both as to whether a submitted application is complete and whether the application has been successful. This is in order to give greater timetable certainty to applicants. The same general process should apply for the stage 1 application (for designation as a Sandbox Entrant) and any stage 2 application (for designation as a DSD and/or MTF/OTF).

b) The application process should be progressive, allow for iterations and be flexible. Existing application processes for authorisations are strict and can discourage applicants. In a sandbox environment, prospective applicants must have comfort in a reasonable level of certainty of outcome, in order to encourage investment and applications. Accordingly, if an application is not successful, regulators should give clear, objective and specific reasons and allow applicants the opportunity to submit a revised application. Revised applications should be subject to shorter regulator response times.

c) The grounds on which an application may be rejected must be clear, objective and limited to regulatory, market integrity or financial stability etc concerns[8]. We would request those grounds are set out in regulatory guidance so that firms can clearly determine in advance if they have any prospect of succeeding, and therefore whether investment is justified.

12. Do you have a preference on the timeframes within which applications can be made?

Applicants should be able to submit applications at any time, until the end of the DSS – this ties-in to our response to Q17, where we suggest the DSS end date should signify the closing of the DSS to new applications. We do not think applicants should be subject to particular application time limits, assuming all application forms etc will be publicly available (in which case, potential applicants should not need to absorb regulators' capacity by raising questions before an application is submitted, although this should be expected to a degree).

Box 2.G

13. Do you agree with the approach to legislative modifications and regulator rules outlined?

We do not have objections in principle with the approach to legislative modifications and regulator rules as outlined in the consultation paper, including the use of three different methods to modify or disapply legislation (as outlined in paragraph 2.50). In this response we refer to those methods as the first, second or third methods respectively.

The most suitable method for adapting a legislative provision will vary depending on the nature of that provision. We understand the legislative provisions to be modified up front, using the first method, are best viewed as 'universal' regulatory barriers that can be addressed by non-specific drafting changes. Articles 3 and 4 of UK CSDR, for example, will need to be modified so securities recorded on DLT-based systems are permissible. Adding reference to those articles to 'securities recorded on DLT-based systems' (or similar) will be necessary for all participants, and will be straightforward from a drafting perspective. This lends itself well to the first method.

In other cases, however, we expect legislative changes will need to be more nuanced and may vary case-by-case, depending on the design proposals of the DSS applicant in question. The Government may, for example, wish to culminate its research into a digital gilt with a catalysing issuance in the DSS. In this welcome circumstance, it will likely be desirable to suspend the requirement for a "Registrar of Government Stock" in the Government Stock Regulations 2004 as a means of enabling

[8] For example, regulators should not be able to reject an application because of concerns it would not be commercially viable. See our response to Q18.

a distributed system to reduce complexity and cost.[9] As another example, Article 7 (*Measures to address settlement fails*) in UK CSDR will likely need to be disapplied or modified in order for DSDs to operate within the DSS. As all these precise modifications required will be difficult to predict before the DSS commences however, any attempt at doing so (using the first method) may not be suitable for all participants. We would therefore request that HMT considers these sorts of legislative modifications case-by-case, using the third method. A set of specific modifications may be agreed at a later date, based on the regulators' learnings from the DSS.

In this context we make two further comments:

a) First, the application process will need to allow participants to specify the sorts of legislative provisions they need to modify or disapply (in addition to the universal regulatory barriers already modified by HMT via the first method). This is already contemplated in paragraph 2.42 of the consultation. Ideally, applicants would be able to specify *any* relevant law or regulation, rather than selecting legislative provisions from a pre-defined list. However, we recognise HMT would first need to have specified the relevant legislation as a 'relevant enactment' in a statutory instrument, per Section 17(6) of the FSMA 2023. As such, it will be imperative that HMT is expansive when specifying the list of relevant enactments in the statutory instrument – if it is not, then regulators may not have the requisite powers to grant derogations on a case-by-case basis without passing a further statutory instrument that expands the list of relevant enactments (which would be time consuming).

   Generally, we see few disadvantages in specifying a very long list of legislation that might need to be varied, as regulators are under no obligation to automatically grant derogations under the DSS in any event.

b) Second, if legislative barriers are identified by applicants on a case-by-case basis, we do not think those applicants should need to propose specific drafting modifications to the legislation. Applicants should instead be able to request those provisions are disapplied, subject to the regulators agreeing to specific operational mitigants, to be proposed by the relevant applicant, to the risks that the relevant legislation was designed to guard against. Specific legislative modifications should follow at a later stage, led by regulators after having identified which sorts of operational mitigants best satisfy their requirements.

We assume the second method would only be used at a later stage, to codify the legislative modifications identified by regulators during the DSS.

14. What other specific regulatory barriers have you identified to the use of digital securities within markets, either in relation to the legislation above or generally?

We have not generally sought to analyse the specific regulatory barriers set out in the legislation identified in the consultation paper. That said, we note that the list of regulatory barriers under CSDR (see paragraph 2.58 of the consultation paper) does not include an exemption regarding the provision of ancillary banking services under Article 54 of CSDR and specifically the requirement to set up a standalone bank. It should be possible to modify or disapply these requirements under the DSS, as they would otherwise be a major barrier for the development of DLT FMIs, due to the high associated costs. Consideration should be given to the proportionality of those requirements, given the limits that will be imposed on such infrastructures.

Further, while it is important for DSS participants to be able to benefit from settlement finality, they should be able to do so without the full burden of authorisation or designation intended for systemic FMIs. We would also note that even after exiting the DSS, subjecting firms to the full set of settlement finality regulations could still be disproportionate given these are meant for systemic entities, and a phased approach would be more appropriate.

Please also see our response to Q13, and in particular our request that legislative modifications are made via the third method (i.e. on a case-by-case basis) unless the nature of the changes is obvious and unequivocal (in which case they could be made using the first or second methods).

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[9] We would also recommend that HMT and the FCA take further actions beyond the issuance of a digital gilt (including public statements) that encourage experimentation with digital securities and further participation in the DSS.

15. Are there any pieces of legislation in addition to the above that should be brought into scope of the DSS (either listed in the FSMA 2023 as "relevant enactments" or outside of this)?

We agree that the legislation listed in paragraph 2.48 of the consultation paper is the main legislation that needs adapting. However, we would also request that HMT considers certain additional legislation including (for example) the following:

a) The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, as amended (the "MLRs"), which provide that it is an offence for a person to carry on business in the United Kingdom as a "cryptoasset exchange provider" or "custodian wallet provider" without first registering with the FCA, regardless of whether that person is already FCA-regulated for other reasons. We believe there are circumstances in which certain DSS structures would fall within the definition of cryptoasset exchange provider and/or custodian wallet provider, and assume HMT do not intended for all DSS participants to first register with the FCA under the MLRs.

b) The UCITS Regulations 2011 and AIFM Regulations 2013, which (as alluded to in our response to Q6) should both be included to allow for amendments to the rules on custody and depositaries.

The above list is clearly not exhaustive and we expect further legislation to be identified during HMT's review. Indeed, there is an argument that the list of relevant enactments should be as long as possible to ensure that the regulators have the flexibility required to manage unanticipated and innovative uses under the DSS (as we reference in our response to Q13). There appears to be few disadvantages with taking this sort of approach, as listing legislation as a relevant enactment does not require the regulators to grant specific modifications or derogations, but does give them the option to do so when they deem it appropriate on a case-by-case basis. Otherwise, HMT would be required to return to Parliament repeatedly to extend the list via a new statutory instrument, which would be time consuming.

UK Finance welcomes the opportunity to discuss this further with HMT.

Box 2.H

16. How long are participating entities likely to need in the DSS?

We do not offer a response to this question, as we expect the time needed by a particular participant will vary depending on a multitude of factors (e.g. whether the applicant has already conducted proof of concept transactions).

17. Is five years an appropriate timeline? Should it be longer or shorter if not? (note that we anticipate entities exiting the DSS before the overall timeline expires)

We agree with the proposed five year duration for the DSS in principle, on the understanding there will be flexibility for the DSS to be extended and for temporarily modified legislation to be made permanent before the end of the DSS (as the consultation paper suggests). However, it would be useful for market participants to better understand:

a) Precisely what the end of the five year duration (the "DSS end date") will mean for participants that haven't yet transitioned out of the DSS. We assume those participants would need to wind down their activities, but it is unclear whether this would need to be completed in full before the DSS end date or not. It would be preferable if the occurrence of the DSS end date only resulted in the DSS being closed for new applications, with existing participants being given the opportunity to wind down their activities after the DSS cut-off date as required. This would lead to a more orderly transition, which would likely be preferable from a financial stability perspective.

b) The conditions under which an extension of the DSS would be sought and granted, and precisely when this decision would be taken. This is to ensure market participants are given clear signals as to the likelihood of an extension in advance of the DSS end date. We would expect this could

be appropriately addressed in the report contemplated by Section 14 of the FSMA 2023[10], although we note the timing and specific contents of that report are not described in the consultation paper. Clarification on this would be helpful.

c) Whether the regulators will commit to processing applications within a certain timeframe (see our response to Q11). This is important, as standard authorisations can take six to twelve months, and if much of the five year duration is taken up with the application process then this limits the amount of time participants will have for testing. This ties-in with the point we make in sub-paragraph (a) above: if the five year duration relates to time period the DSS remains open to new *applications*, then this will provide comfort.

Generally, in order for firms to properly create a DSS project with sufficient capital backing, risk controls and operational resilience, firms must expend significant resources. Thus, in order for the DSS to be successful, firms must know that they will be given sufficient runway for their DSS projects to succeed. We request that HMT remains mindful of those considerations.

Box 2.I

18. Do you agree with the approaches to exiting the DSS outlined above?

As a general comment, it is imperative that participating firms are able to transition from the DSS to operating in the wider market outside the DSS (without limits etc) as quickly as is safely possible. While we understand the regulators' preference is to scale-up limits within the DSS, this should not be used as a mechanism to delay a participant's exit. For the DSS to be successful, firms need to know their substantial time and cost investments will result in a real, viable and scalable offering. If this is not assured, or if the process for exiting the DSS is uncertain or subject to delays or the continued imposition of limitations, then this will reduce the attractiveness of the DSS.

We make the following more specific observations in relation to the approaches for exiting the DSS and participants' exist strategies outlined in paragraphs 2.72 to 2.82 of the consultation paper:

a) As noted in paragraph 2.75, permanent legislative changes must be made before a participant exits the DSS, to ensure there is no "legislative gap" that affects a participants' ongoing operations. The consultation paper suggests these permanent changes would be made by statutory instrument, and reference is made to the possibility of changes being made via statutory instruments more than once. It is not currently clear, however, how this process will be managed and we do not think it is realistic for a separate statutory instrument to be made whenever an individual participant seeks to exit the DSS.

b) Paragraph 2.80 suggests a wind down could be triggered where the project is commercially unviable. We do not think this is an appropriate reason to trigger a participant's exit strategy, as we think decisions about whether the project is commercially viable should be taken by the participant (who will be incurring an expense in continuing the project) rather than regulators. If this sort of factor is retained, we think the threshold should be set at a very high level (e.g. "no realistic prospect of becoming commercially viable" or similar). Participants should be given the opportunity to remedy any issues before the decision to trigger a participant's exit strategy is taken, as already envisaged in paragraph 2.84 of the consultation paper.

   We do not have objections in principle to an exit strategy being triggered where regulatory requirements are not being met (again assuming participants will be given opportunities to remedy any regulatory issues beforehand).

c) Paragraph 2.81 of the consultation paper seems to assume participants will be able to transition securities from DSS FMI to traditional (non-DSS) FMI as part of their exit strategy. However, we do not expect all participants will themselves operate a traditional FMI. The DSS should therefore allow participants to rely on commercial arrangements put in place between the DSS and a

[10] Financial Services and Markets Act 2023.

traditional FMI operator[11]. We assume this is what's anticipated, given the reference in bullet four of paragraph 2.44 of the consultation paper.

d) Any remaining SAN limits applicable to the FMI would need to be lifted when exiting the DSS, and have been substantially raised before then in any event (to avoid any sudden changes).

Box 2.J

19. Do you agree with the approach to supervision and enforcement outlined above? Please explain your answer.

Yes, we agree with the approach to supervision and enforcement. Our only comments are that it will be important for the FCA and Bank to co-operate closely to avoid duplication in supervision, and for any enforcement actions to be taken on a predictable, consistent basis (and only after participants are given forewarning and a change to remedy and concerns). These factors are already referenced in the consultation paper.

20. Is there any information that will be sensitive to share with the government regarding the operation of a DSS FMI?

We understand the rationale for requiring firms to share information with the Government and regulators. As a general point, we request that HMT appreciates that DSS participants will need flexibility as to adapting their DSS projects. In an information sharing context, this means that advanced notice of certain changes may prove difficult. In the EU DLT Pilot Regime, for instance, firms are required to give at least four months' notice where certain changes are made to their business plans[12] – we think this may prove challenging, so request HMT does not include something similar.

Save for the above, we do not offer a response to this question as we have not received a clear indication from UK Finance members as to the sorts of information that are likely to be sensitive for DSS entities to share with the UK Government.

Box 2.K

21. What features do industry require from a money settlement asset in the DSS and why?

We firmly support the maximum possible flexibility in relation to cash settlement assets. This should include "on-chain" payment assets backed by commercial bank money (such as deposit tokens) or central bank money, as well as "off-chain" solutions. The DSS should allow sufficient flexibility for participants to determine which solution to use for the payment leg, as long as that is properly regulated and clearly established up front and disclosed in a transparent way to all participants in the system. Regulators should be cognisant of the possibility that changes to the DSS will be required over time in order to properly accommodate new cash settlement assets as they develop.

It would be helpful to clarify that any relevant CBDC may be used as a money settlement asset, and this would not be limited to CBDC issued by the Bank of England. As a general point, we would urge HMT and the Bank of England to continue their support for the development of digital cash solutions to enable the settlement of transactions.[13]

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[11] As contemplated in Articles 7(8) – (10) of the EU's DLT Pilot Regime Regulation (Regulation (EU) 2022/858).

[12] See Article 11(1) of the EU DLT Pilot Regime Regulation.

[13] Please note that in Summer 2023, UK Finance and a number of their members and interested parties, supported by EY, worked on a discovery phase for the Regulated Liability Network ("RLN") concept. The RLN has the potential to be a regulated FMI that would operate a shared ledger that records, transfers, and settles regulated liabilities of central banks, commercial banks, and regulated non-banks. UK Finance is publishing on 4 September 2023, its report UK RLN Discovery Phase and trusts that it will be useful to UK government and key stakeholders.

Consultation questions set out in Chapter 3 – Further policy Issues

Box 3.A

22. What type of DLT system are you planning to use (permissioned or permissionless), and what trade-offs have you considered in your decision?

We do not offer a response to this question as it is intended for firms intending to apply to the DSS, with a specific project in mind.

23. How can settlement systems based on permissionless DLT be designed in a manner that would meet the PFMIs?

We agree that DLT-based systems for the settlement and trading of securities must not create financial stability concerns. We also acknowledge that permissionless DLT does not easily reconcile with existing regulatory standards such as the PFMIs, given their decentralised nature. Generally, though, we see the DSS as an opportunity to test all technological design options, alongside regulators, to better assess the strengths and weaknesses of each. We suggest this assessment should include considering whether and how existing regulatory standards (such as the PFMIs, which are now over 10 years old), and the risks they are designed to mitigate, could be addressed by permissionless systems.

We think regulators should therefore allow firms to answer this Q23 on a case-by-case basis, as part of their applications, by reference to the specific design features and mitigants of their particular project. The decision as to whether permissionless systems are acceptable from a regulatory and financial stability perspective would then be taken during or after the DSS, having taken into account the performance of permissionless DSS FMI and the risks they pose.

By including this response, UK Finance does not seek to advocate for permissionless DLT generally and acknowledges that financial stability and regulatory issues must be considered carefully by regulators. Moreover, for full transparency, the UK Finance members consulted during the preparation of this response are expecting to utilise private/permissioned systems at present.

Box 3.B

24. What benefits could entities using digital asset technology offer when meeting regulatory reporting requirements?

Paragraph 3.8 of the consultation paper already references some of the potential benefits of DLT in a regulatory reporting context – e.g. streamlining and automating regulatory reporting, which will ease burdens (particularly the cost burden) and improve efficiency. These benefits are generally expected to arise because DLT-systems can potentially use the distributed ledger as a ‘single source of truth’ for reporting purposes. This should enable a more integrated system, where data can be drawn from the same system rather than being relayed through a series of separate but interconnected reporting systems. More specific potential benefits include:

a) Real-time availability of data, as data recorded on the distributed ledger is continually updated and is accessible at any time.

b) Greater data consistency, as information can be drawn directly from the distributed ledger (where it is verified by parties through the relevant consensus mechanism) without the need for periodic reconciliation.

c) Lower costs, as regulatory reporting can be carried out automatically by passing-on data from the DLT system. In contrast, current systems often require information to be reported separately, by each transaction party by reference to their own data sets.

25. Are there any aspects of the existing regime that would prevent effective reporting in the context of digital securities?

We do not offer a response to this question, as we have not received a clear indication from UK Finance members as to whether effective reporting would be ineffective under the existing regime.

Box 3.C

26. How do potential DSS entities intend to carry out custody functions in relation to activities in the DSS?

We do not offer a response to this question as it is intended for firms intending to apply to the DSS, with a specific project in mind. Please refer to the Law Commission's consultation and report on digital assets for a more detailed description of how different custodial arrangements can be structured under English law.

27. Are there any changes to the existing custody regulatory framework (including FCA rules, Article 40 of the RAO and CASS) that would facilitate the safe operation of these functions?

The existing regulatory framework set out primarily in Article 40 of the RAO and CASS (the "existing framework") is designed to regulate the safeguarding and administration of traditional investments. FCA guidance[14] has, however, stated that the existing framework also applies in relation to digital securities that qualify as specified investments. As such, firms that safeguard and administer digital securities issued under the DSS will be subject to the existing framework, including the requirements set out in CASS. This means participants would need to be authorised by the FCA, unless an exemption or exclusion applies.

We support this approach in principle, which we believe is aligned with the principle of "same activity, same risk, same regulatory outcome". Applying the existing framework to the custody of digital securities, however, creates some uncertainty, stemming from the technical and operational differences between digital asset custody and traditional custody. Many of those differences were referenced in HMT's recent consultation on potential reforms to the regulatory regime for cryptoassets[15]. Custodians that safekeep digital securities, for example, are generally responsible for holding a private key that allows access and usage of the digital security in question, and may deploy a range of different technological solutions when doing so, including cold (offline) storage or multi-signature hot (online) wallets. These concepts do not apply to traditional custody arrangements, nor do they readily correspond to the requirements set out in the existing framework. We note the FCA separately expect to consult on replacing the existing framework in the context of security tokens[16].

For these reasons, we think the regulators ought to clarify how the existing framework will apply where securities issued under the DSS are safekept and administered. In particular, regulators should clarify:

a) How the rules on segregation and commingling apply to digital securities. For example, CASS 6.2.5R of the existing framework generally provides that firms are not permitted to record their own proprietary assets in the same account as client assets. Digital assets are, however, typically recorded in a wallet under the control of the custodian, rather than in a traditional securities account. This causes some uncertainty, as it is arguable that, under the exiting framework, digital securities may be co-mingled with the custodian's own digital securities in a single underlying wallet, provided they are segregated within the custodian's own books and records from its own assets. This should be clarified. Custodians should still be permitted to offer omnibus segregation at a wallet level (i.e. allowing clients' digital securities to be recorded in the same wallet as the digital securities of the custodian's other clients,) provided this is disclosed to investors.

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[14] FCA Policy Statement PS19/22.

[15] See Chapter 8 (*Regulatory outcomes for cryptoasset custody*) of HMT's "Consultation and call for evidence: Future financial services regulatory regime for cryptoassets".

[16] Ibid., paragraph 8.6.

b) The safeguards and controls required for the safekeeping of private keys (which are not contemplated in the existing framework), particularly if specific operational mitigants will be required.

c) That new strict liability standards will not be imposed on firms that custody digital securities issued under the DSS on behalf of investors. Instead, custodian liability should continue to be fault-based such that liability is only imposed when acting in a negligent manner or when failing to maintain acceptable systems and processes.

d) Whether the existing framework will only apply where firms are offering administration services as well as custody services. We understand this to be the position under the existing framework, but acknowledge there is an argument that firms safeguarding private keys that provide access to digital securities (without 'administering' those digital securities) are performing a critical role which should be subject to certain minimum standards.

e) How regulators will determine whether a custodian is carrying on the regulated activity of safeguarding and administering 'in the UK' (which may not be straightforward in DLT-based systems).

f) Whether there will be any other differences in the regulation of safekeeping and administering activities in a digital securities context as compared to a conventional securities context.

As explained further in our response to Q15, we also suggest the MLRs are modified or disapplied in relation to custody activities conducted within the DSS. If it is not, the requirement to register with the FCA before carrying on business in the UK as a "custodian wallet provider" (irrespective of any other regulatory authorisations already obtained) would likely deter potential applicants to the DSS.

Finally, while we acknowledge that the future development of prudential rules for the custody of tokenised securities is a separate workstream (to be dealt with outside the DSS), we request that UK policymakers take an off-balance sheet approach to custody of tokenised securities, as set out in the Basel Committee's standards on the prudential treatment for banks' exposures to cryptoassets. It is essential that any capital and liquidity requirements associated with cryptoasset custody do not make custody unfeasible at scale for regulated financial institutions.

Box 3.D

28. If you envisage retail investors interacting with investments traded on DSS entities, how would this differ from more traditional models?

We do not offer a response to this question, as we have not received a clear indication from UK Finance members as to the potential interaction between retail investors and DSS entities.

29. Do you see any UK rules or requirements as obstacles to this model?

See our response to Q28, above.

Box 3.E

30. How would an entity operating an FMI in the DSS ensure that the tax obligations of its users are being fulfilled?

In most respects UK digital securities should (and would under most existing UK tax rules) be treated similarly to conventional securities in the more conventional forms of definitive registered securities, dematerialised securities settled through CREST and global securities held and settled through clearing systems. Stamp taxes are, however, an exception whose transactional nature and collection processes entwined with legal form will cause the introduction of digital securities to interact more substantially with them.

Accordingly, we think it is important to view the DSS proposals in conjunction with HMRC's current proposals to modernise the operation of stamp taxes on shares and securities (commonly referred

to as "STS")[17]. This consultation closed on 22 June 2023 and is currently awaiting HMRC's publication of the conclusions of the consultation. In essence, HMRC's proposal is to replace the existing two STS systems with a single modern STS system which operates by self-assessment through an online portal. Such an approach would make it considerably simpler to dovetail the STS system with digital securities in a manner that makes it easier for FMIs to process. This is particularly important in relation to UK digital equities, as UK equities attract the bulk of STS collected. In principle, it could also be relevant to UK digital debt securities, for which the current STS rules are very complex. In commercial practice, however, most UK debt securities are structured to be exempt from STS, as debt securities subject to STS frictions are not normally commercially viable.

One foreseeable DSS activity would have digital equity and debt securities held and settled outside the CREST system (through which the majority of STS is currently collected). In such circumstance, and absent a DSD with analogous capabilities, the digitised system of STS self-assessment via an online portal proposed in the HMRC consultation might usefully be capable of being applied to digital securities. This would mean purchasers of UK digital securities could be required to file STS returns via the proposed online portal and manually pay any relevant STS in the same manner as envisaged for purchases of conventional registered UK securities outside of CREST. If this approach were adopted, then it would be the responsibility of purchasers of UK digital securities to file STS returns and pay the relevant STS to HMRC, rather than a responsibility of DSS participants to monitor, police and enforce – though it would be practical to require FMIs to systemically report to HMRC on the transactions in UK digital securities entered into through them, to enable HMRC to undertake any necessary compliance checks that purchasers are making the required STS filings and payments.

Alternatively, DSS participants could be required to administer and collect STS through their systems – in similar manner to that envisaged under the reformed STS system (and indeed already existent in the current STS system) for conventional UK securities settled through CREST. This could be achieved through a system which, upon entering a transaction within the FMI system, flags the STS status of the transaction and then automatically collects the STS on the transaction and remits it to HMRC. In the event UK digital securities are envisaged to be capable of settlement through CREST, or similar DSD system with analogous capabilities, then any such securities within the CREST system should by necessity be subject to the same STS collections processes applicable to CREST.

Finally, in respect of non-UK securities, the interaction of digital securities with stamp taxes in the relevant issuer jurisdictions also needs to be considered. In particular, while many jurisdictions do not impose stamp taxes on transactions in shares and securities, several EU jurisdictions (including France, Italy and Spain) apply a Financial Transactions Tax ("FTT") on certain equities and equity derivatives. This would need to be taken into account in digitising securities in other jurisdictions which apply a FTT.

31. What issues could be created by the application of existing tax procedures to assets settled via FMIs in the DSS?

As indicated above, aside from stamp taxes, the UK's existing tax rules could generally continue to apply to digital securities in the same way they apply to conventional forms of shares and securities, without requiring any material adjustment. The UK's stamp tax system is, however, not well suited for digital securities, because of the complexities of the current 'dual' stamp tax system, which exist for largely historical reasons. This system comprises (i) UK stamp duty, which is a tax on certain written instruments transferring UK stock and marketable securities (and dates back to the 19th century) but generally has no personal liability or directly enforceable obligation to pay the duty and (ii) UK stamp duty reserve tax ("SDRT"), which is a more conventional self-assessed tax on transactions in UK shares and securities. We address each element in turn below. See our response to Q30 above regarding the current HMRC proposals to modernise the UK stamp tax rules and procedures.

UK stamp duty is applied in relation to instruments that transfer UK stock and marketable securities (which are not exempt). The current process involves electronically submitting the relevant instrument to HMRC and confirming that stamp duty has been paid (or identifying any relief claimed). HMRC then issues a letter confirming that duty has been paid or a claim for relief adjudicated. However, many UK debt securities are exempt from UK stamp taxes. Transactions in debt securities are also

[17] See HMRC's consultation "Stamp Taxes on Shares Modernisation" published 27 April 2023.

typically settled through book-entries within settlement systems such as Euroclear and Clearstream which are paperless, so do not involve an instrument of transfer to which stamp duty can apply. And, since CREST is a fully digital system through which share ownership is transferred electronically, without an instrument of transfer, stamp duty does not apply to such uncertificated transfers of UK shares through CREST.

While it might be theoretically possible to design DLT-based FMI which requires the production and execution of an instrument of transfer that attracts stamp duty (equivalent to a stock transfer form used to transfer unlisted UK paper shares outside of CREST), requiring physical documentation and execution would introduce significant procedural inefficiencies and run contrary to the intended frictionless nature of DLT-based systems, potentially rendering the DSS uncommercial for most transactions in UK equities. There would also be no benefit to the Exchequer from taking such measures, since the effect of requiring the creation of a stampable document would merely be to collect the relevant stamp tax in the form of stamp duty rather than SDRT.

The UK's parallel system of SDRT could apply in relation to UK digital securities in similar manner to its existing application within CREST (as an "operator" for SDRT purposes) and within certain clearing systems. Under current SDRT rules, unless DSS participants are able to constitute "operators" or clearing systems for SDRT purposes, purchasers of UK digital securities would be required to file SDRT returns and process and effect SDRT payments. This would be procedurally unusual as, in practice, most electronic transfers of UK shares operate within the well-established CREST system under existing arrangements and practices, so would likely require some adaptation of existing systems and processes to achieve – i.e. purchasers of UK digital securities would need to develop systems to file the necessary SDRT returns and pay the SDRT.

Alternatively, DSS participants could potentially be structured to qualify as "operators" (i.e. equivalent to CREST) or as clearing systems for SDRT purposes. If so, that would place responsibility for operating, collecting and remitting STS onto the DSS participants which operate the FMIs, which may be better placed to collect and remit the stamp tax on transactions within the FMIs.

In any event, it would be preferable to legislate for the introduction of digital securities concurrently with the modernisation of the STS system, so that market participants can effect one single change to adapt their systems to both digital securities and STS modernisation at the same time

Box 3.F

32. How should information regarding DSS activity be shared with the wider financial services sector?

We believe it would be helpful if a list of legislative exemptions and modifications that have been granted to DSS applicants is made publicly available. This should include details on how the DSS FMI will ensure any risks arising from the exemption or modification are appropriately mitigated. We do not offer a view at this stage as regards the nature of other information that might be shared, or the best process for co-ordinating information sharing amongst DSS participants. UK Finance would be happy to discuss this with HMT further.

33. What information will be sensitive for a DSS entity to share with others across the FS sector?

We do not offer a response to this question, as we have not received a clear indication from UK Finance members as to the sorts of information that are likely to be sensitive for DSS entities to share publicly or with other DSS participants.

34. Would a cross-industry body, set up to scrutinise DSS activity and provide policy recommendations, be appropriate? If so, how should this be set up, and who should participate?

In our report entitled "Unlocking the Power of Securities Tokenisation"[18], UK Finance called on HMT, the PRA, and the FCA to support further two-way engagement between industry participants (including firms' own legal experts), regulatory representatives, and other legal experts specialising

[18] Available at www.ukfinance.org.uk/policy-and-guidance/reports-and-publications/unlocking-power-securities-tokenisation

in digital assets and securities tokenisation. UK Finance further called on the Government and regulators to support industry participants as they convene and develop voluntary standards for tokenised securities.

Accordingly, UK Finance strongly commends the proposal to form an industry committee to consider jointly the experience and desired outcomes of participating in the DSS and provide cross-industry recommendations. UK Finance agrees that the body should include entities directly participating in the DSS, law firms, academics, the regulators and HMT (and potentially other government departments). More widely, it is important that key communities within the financial services industry are represented, such as wholesale and investment banks, investors and financial markets infrastructure. UK Finance stands ready to assist with convening this cross-industry body.

Box 3.G

35. What frictions might hinder the use of digital assets on a cross-border basis?

Examples of issues that might hinder the use of digital assets cross-border include the different approaches taken by regulators and legal systems as regards digital assets, difficulties associated with interoperability (both as between DLT-based systems and between DLT and conventional systems) and the absence of common data standards, amongst other things.

We agree with the points made in paragraph 3.21 of the consultation paper, however, concerning the importance of the UK co-operating closely with other jurisdictions and maintaining high international standards.

Consultation questions set out in Chapter 4 – Legal considerations

Box 4.A

36. Following the conclusions of the UKJT statement, what further action (either public or private sector led) needs to be taken to provide clarity regarding use of digital securities, as well as digital assets more generally?

One point that would be helpful to clarify is whether the BCBS standards on the prudential treatment of cryptoasset exposures[19] will be applied to DSS participants, particularly the PRA's expected approach to the infrastructure risk add-on. This is likely to be of particular concern to participants to the DSS and (if activated) may render their investments economically unviable. We acknowledge the statements made in paragraph 3.5 and 3.6 of the consultation paper, but think DSS participants would benefit from some form of preliminary guidance as to the circumstances in which the PRA would activate the infrastructure risk add-on as a minimum – this will inform investment and application decisions. The same applies in relation to whether the UK plans to 'gold-plate' the BCBS standards. See also our thoughts on the prudential aspects of custody service provision in Q27.

Aside from this, we note that the Law Commission's consultation and final report on digital assets marks various recommendations for further action (having considered the UK Jurisdiction Taskforce's legal statement on digital securities, amongst many other things). As set out on pages 18 and 19 of the summary paper[20], this includes recommendations that:

a) Legislation is introduced confirming that a thing will not be deprived of legal status as an object of personal property rights merely by reason of the fact that it is neither a thing in action nor a thing in possession.

b) The Government creates or nominates a panel of industry-specific technical experts, legal practitioners, academics and judges to provide non-binding guidance on the complex and evolving issues relating to control (and other issues involving digital objects more broadly).

[19] Basel Committee on Banking Supervision: Prudential treatment of cryptoasset exposures (December 2022)

[20] Available at www.lawcom.gov.uk/project/digital-assets/.

c) Legislation amending the FCARs[21] is introduced, which: (i) clarifies the extent to which and under what holding arrangements crypto-tokens, cryptoassets (including CBDCs and fiat currency-linked stablecoins) and/or mere record/register tokens can satisfy the definition of cash, including potentially by providing additional guidance as to the interpretation of "money in any currency", "account" and "similar claim to the repayment of money" and (ii) confirms that the characterisation of an asset that by itself satisfies the definition of a financial instrument or a credit claim will be unaffected by that asset being merely recorded or registered by a crypto-token within a blockchain or DLT-based system (where the underlying asset is not "linked" or "stapled" by any legal mechanism to the crypto-token that records them) and (iii) confirms that, where an asset that satisfies the definition of a financial instrument or a credit claim is tokenised and effectively linked or stapled to a crypto-token that constitutes a distinct object of personal property rights from the perspective of and vested in the person that controls it, the linked or stapled token itself will similarly satisfy the relevant definition.

d) The laws applicable to UK companies are reviewed, to assess the merits of reforms that would confirm the validity of and/or expand the use of crypto-token networks for the issuance and transfer of equity and other registered corporate securities. In particular, the Law Commission recommend that any such review should consider the extent to which applicable laws could and should support the use of public permissionless ledgers for the issuance and transfer of legal interests in equity and other registered corporate securities.

e) As a matter of priority, the Government sets up a multi-disciplinary project to formulate and put in place a bespoke statutory legal framework that better and more clearly facilitates the entering into, operation and enforcement of (certain) crypto-token and (certain) cryptoasset collateral arrangements.

UK Finance supports these recommendations and requests they are taken forward by the Government as a matter of priority, and expect the panel of technical experts would serve as a useful sounding-board for the Government in developing further guidance or reforms in this area. We look forward to seeing how the Law Commission's other projects[22] develop and commend its valuable efforts to date.

Finally, UK Finance is mindful of various related ongoing consultation and reform processes in the UK, particularly HMT's "Future financial services regulatory reform for cryptoassets" but also the various Edinburgh Reform initiatives. The industry will continue to engage and provide feedback on these processes, but would generally request continued close co-operation between different regulators and the industry, to ensure no barriers or areas of uncertainty are inadvertently introduced.

Box 4.B

37. Do you agree with the categories above?

We broadly agree that digital securities are likely to fall within the two categories outlined in paragraph 4.8 of the consultation paper (namely, digitally native securities or digital representations of traditional securities held at a CSD). We note, however, that the description of 'digitally native securities' could be clarified, as it only seems to cover digital securities recorded in a DLT-based register ('digital registered securities') and not structures involving the issuance of tokens to which rights against the issuer are stapled ('digital bearer securities'). Both of these variants can be considered 'digitally native' as they do not seek to evidence rights in a traditional immobilised or dematerialised security. There are several possible design implementations for these structures, as explained in the UKJT legal statement on digital securities[23].

We assume the two categories are the subject of a consultation question to ensure digital securities are being conceptualised consistently. We do not express a view on whether the categories would be appropriate to codify in legislation, regulator rulebooks or guidance.

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[21] Financial Collateral Arrangements (No 2) Regulations 2003.

[22] For example, the Law Commission's forthcoming consultation papers on conflict of laws (referenced in footnote 29 below) and decentralised autonomous organisations.

[23] For more detail, refer to Appendix 1 (*Illustrative examples*) of the UK Jurisdiction Taskforce's Legal Statement on the issuance and transfer of digital securities under English private law.

38. Into which category will your proposed use-case sit?

We do not offer a response to this question as it is intended for firms intending to apply to the DSS, with a specific project in mind.

Box 4.C

39. What conflicts of law issues are likely to arise in the DSS? How should these be mitigated?

English conflict of laws rules traditionally provide that questions relating to the rights or entitlement to property should be governed by the law of the place in which the property is situated (the *lex situs*). The lex situs of an object of property is straightforward to determine in the case of things in possession (tangible property), but more difficult in the case of things in action (intangible property, although the position is relatively settled for traditional assets) and even more so for digital assets recorded on DLT-based systems that are unconnected to any particular jurisdiction. The overarching issue that may arise in relation to the DSS is the uncertainty about how lex situs should be determined in relation to digital securities. There are a range of different viewpoints that could be adopted by the courts, but no consensus as to which should prevail. For instance, a court could take the view that the lex situs in respect of a digital security should be determined by reference to:

a) The location of the owner, which was the approach adopted by Butcher J in *Ion Sciences*[24], where the lex situs of a cryptocurrency (Bitcoin) was determined to be "the place where the person or company who owns it is domiciled". Other cases have adopted a similar approach, but preferred to focus on the jurisdiction in which an individual is "resident"[25].

b) The law of the jurisdiction specified in the terms of the digital security, or (failing that) the system on which the digital security is recorded, or (failing that) the domestic law of the jurisdiction where the issuer has its publicly ascertainable statutory seat. This is the approach set out in Principle 5 (*Applicable law*) of the UNIDROIT Principles on Digital Assets and Private Law[26], noting that this is starting point in a waterfall of different alternatives.

c) For digital securities that evidence rights in a security that exists in conventional form elsewhere, the lex situs of that underlying security. For intermediated securities, this is usually determined by reference to the jurisdiction in which the underlying securities account or register of the most immediate intermediary is held. This is the so-called PRIMA principle[27] and is reflected in the UK's implementation of certain EU legislation[28].

d) The location of the private key (or the person who has control of the private key, which may be the ultimate beneficial owner or its custodian) or the location where centralised control may be exercised. These were referenced as relevant factors by the UK Jurisdiction Taskforce in its legal statement on cryptoassets and smart contracts.

In addition to the analytical approach taken by a court to determine lex situs, the lex situs will also depend on the fact pattern in question. The HMT proposal described in paragraph 4.10 of the consultation paper suggests the intention is to narrow the range of different fact patterns that might emerge in the DSS, so that English law will be determined as the applicable law under most, if not all, of the analytical approaches that could potentially be applied. This is by requiring certain variables to all point to England or English law, by requiring each DSS FMI (or the "nodes controlling that FMI") to be controlled and operated by a UK-based entity and by requiring England and Wales to be specified in the governing law and jurisdiction provisions. We have the following three comments to make in relation to this proposal:

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24 *Ion Sciences vs Persons Unknown and Others* (unreported), 21 December 2020 (Commercial Court).

25 See *Tulip Trading Ltd v Bitcoin Association for BSV* [2022] EWHC 667 (ch) and *LMN v Bitflyer* [2022] EWHC 2954 (Comm). A similar approach is taken by HMRC in its Cryptoassets Manual, which treats exchange tokens as sited in the jurisdiction in which the beneficial owner is tax resident.

26 Available at www.unidroit.org/work-in-progress/digital-assets-and-private-law/.

27 PRIMA refers to the 'place of the relevant intermediary account', as codified by the Hague Securities Convention (2006).

28 For example, Regulation 23 of The Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979), which implements Article 9(2) of the Settlement Finality Directive (98/26/EC).

a) First, requiring nodes controlling DSS FMI to be ‘controlled and operated by a UK-based entity’ effectively rules-out permissionless systems, where there are typically no restrictions placed in relation to the geographic location of validator nodes. The same applies by virtue of the requirement to specify a particular governing law and jurisdiction, as permissionless systems do not feature a set of contractual documents in which such specifications can be made. See our response to Q23 for further comments on permissionless systems.

b) Second, participants would need greater clarity as regards the contracts in which the governing law and jurisdiction provisions would have to be included. Indeed, the contractual documentation associated with a particular DSS FMI and the issuance or trading of securities will include the terms of the relevant digital security, but also various rulebooks, operating manuals, custody documentation and so on. If the intention is to require England and Wales to be specified in the governing law and jurisdiction provisions in *all* relevant documentation, then this may prove problematic – particularly for applicants with operations in several jurisdictions, where there may be sound commercial or legal reasons for choosing an alternative jurisdiction in the governing law and/or choice of law provisions.

c) Third, even if these requirements were cast broadly and adhered to, it would not rule out the possibility that an English court would find the lex situs of a digital security to be the laws of another jurisdiction altogether. This is because, as explained above, certain analytical approaches determine lex situs by reference to the location of the owner (see sub-paragraph (a) further above), the location of the intermediary account (see sub-paragraph (c) above), the location of the private key or person who has control of the private key (see sub-paragraph (d) above) and so on. It will therefore be difficult, and perhaps impossible, to fully mitigate conflict of laws issues through the design of the DSS – particularly if HMT intend (as stated in paragraph 4.10) to allow users to be based in foreign jurisdictions. This issue may accordingly be more appropriately dealt with through the development of English common law principles. We expect the forthcoming work of the Law Commission to be helpful in this regard[29].

Finally, we should also note that English conflict of laws rules apply a different approach for questions relating to tortious claims, which are traditionally determined by the laws of the place where the damage occurred. This could lead to claims being sought in a non-UK jurisdiction, e.g. where an investor in a digital security is domiciled or incorporated in a foreign jurisdiction (and claims they have suffered damage in that jurisdiction). We expect, however, that many of the same issues described above will arise in relation to those claims.

40. We intend that applicants to the DSS should be required to confirm English and Welsh law as the choice of law. Applicants should also agree that England and Wales will be the choice of jurisdiction in the event of a dispute. Do you agree? If you disagree, please explain why.

Please refer to our response to Q39 above, particularly sub-paragraphs (y) and (z).

Consultation questions set out in Chapter 5 – Expressions of interest and next steps

Box 5.A

41. Are you, or a firm you represent, interested in applying to operate an FMI using digital asset technology as part of the DSS?

We do not offer a response to this question as it is intended for firms intending to apply to the DSS, with a specific project in mind.

42. If so, what activities are you, or the firms you represent, interested in undertaking as part of the DSS, and what assets would be in scope?

Per our response to Q41 above.

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[29] See the Law Commission’s “*Digital assets: which law, which court?*” project, the consultation paper for which is expected in the second half of 2023.

43. What non-DSS activities (i.e. activities beyond notary, settlement, maintenance and operating a trading venue) are likely to be performed (with sandbox and/or non-sandbox assets)?

Per our response to Q41 above.

44. Do you have an indicative development timeline that you wish to share? How soon do you intend to apply?

Per our response to Q41 above.

45. Please include any further details you think relevant for informing HMT, the Bank of England and FCA about your use of the DSS.

Per our response to Q41 above.

We remain at your disposal should you have any questions or wish to discuss anything further.

About UK Finance

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms across the industry, it seeks to enhance competitiveness, support customers and facilitate innovation. Our primary role is to help our members ensure that the UK retains its position as a global leader in financial services. To do this, we facilitate industry-wide collaboration, provide data and evidence-backed representation with policy makers and regulators, and promote the actions necessary to protect the financial system.

UK Finance's operational activity enhances members' own services in situations where collective industry action adds value. Our members include both large and small firms, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks.

Further information is available at **www.ukfinance.org.uk**.

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