International
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Association

ICMA's response to the Bank of England's and FCA's joint consultation on proposals to implement and operate the Digital Securities Sandbox

29 May 2024

Introduction

ICMA welcomes the opportunity to provide feedback on the Bank of England's (the "Bank") and FCA's proposals to implement and operate the Digital Securities Sandbox (hereafter referred to as "Sandbox" for ease of reference). ICMA's response follows its submission to HM Treasury's consultation on a Digital Securities Sandbox in August 2023.

ICMA promotes well-functioning cross-border capital markets, which are essential to fund sustainable economic growth. It is a not-for-profit membership association with offices in Zurich, London, Paris, Brussels, and Hong Kong, serving over 620 members in 68 jurisdictions globally. Its members include private and public sector issuers, banks and securities dealers, asset and fund managers, insurance companies, law firms, capital market infrastructure providers and central banks. ICMA provides industry-driven standards and recommendations, prioritising three core fixed income market areas: primary, secondary and repo and collateral, with cross-cutting themes of sustainable finance and FinTech and digitalisation. ICMA works with regulatory and governmental authorities, helping to ensure that financial regulation supports stable and efficient capital markets.

Fostering the development of scalable, efficient and liquid cross-border DLT bond markets is a key objective of ICMA's DLT Bonds Working Group. Notwithstanding legal and regulatory aspects, common standards play a critical role in avoiding market fragmentation and fostering interoperability. ICMA's Bond Data Taxonomy provides a common language to define both digital (DLT-based) and traditional securities in a machine-readable format and facilitates the exchange of data for issuance, trading, settlement and asset servicing.[1] To raise awareness and provide guidance, ICMA's DLT Bonds Working Group has published a set of FAQs on DLT and blockchain in bond markets (September 2022) as well as Considerations for risk factors and disclosure in DLT bond offering documents (November 2023).

ICMA's response reflects the views of a subset of its DLT Bonds Working Group, including investors, banks, market infrastructures and law firms across the international debt capital markets.

[1] The Bond Data Taxonomy has been adopted by HKSAR for the issuance of digital green bonds (February 2024), as well as various services providers in the international debt capital markets.

Executive summary

(i) ICMA members are in principle supportive of the draft guidance on the operation of the Digital Securities Sandbox, subject to: (a) adopting a more flexible approach to applying limits at Go live (Stage 3) on a firm-by-firm basis, (b) additional flexibility for Digital Security Depositories (DSDs) to scale (move to Stage 4) on a continuous basis rather than T+15-18 months into the Sandbox, and (c) flexibility to issue securities onto a platform that may be denominated in non-sterling currencies within the Sandbox.

(ii) A more tailored approach for Sandbox entrants that are regulated would be beneficial, allowing firms to bypass requirements provided they are already met outside the Sandbox. The proposed capital requirements set a high bar for participation and may restrict participation further than possibly intended.

(iii) We emphasize the importance of maintaining flexibility with regards to the end-state rules, taking into consideration learnings from the Sandbox. Indeed, due to the technical nature of the rules, firms may only identify further obstacles or potential conflicts between frameworks when progressing through the Sandbox.

(iv) Should an alternative framework for non-systemically relevant CSDs be established (outside the Sandbox), ICMA members recommend that this should be considered in the glidepath approach, allowing for choice between exit as a systemically relevant or non-systemically relevant CSD and calibrating the Sandbox rules accordingly.

(v) Activity inside the Sandbox should not preclude same or similar activity from taking place outside the Sandbox subject to different structuring choices.

(vi) We encourage close coordination between regulators with regard to permanent legislative changes made by HMT and firms graduating out of the Sandbox in order to avoid undue delays or cliff-edge risks, which would disincentivise participation in the Sandbox.

Responses to selected individual questions can be found below.

Contact

Please don't hesitate to contact Gabriel Callsen, Senior Director, FinTech and Digitalisation (gabriel.callsen@icmagroup.org) to discuss further ICMA's consultation response.

Section 1: Overview

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

ICMA Response: ICMA members are in principle supportive of the draft guidance on the operation of the Digital Securities Sandbox, subject to: (a) adopting a more flexible approach to applying limits at Go live (Stage 3) on a firm-by-firm basis, (b) additional flexibility for DSDs to scale (move to Stage 4) on a continuous basis rather than T+15-18 months into the Sandbox, and (c) flexibility to issue securities onto a platform that may be denominated in non-sterling currencies within the Sandbox. We note it is very common for UK companies to raise capital in UK capital markets in currencies other than GBP[2].

For detailed feedback on volume limits, please see ICMA's response to Question 12.

<u>Section 3: Box A: The stages of the DSS:</u>

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

ICMA Response: In principle, ICMA's members welcome the proposed approach to mitigate cliff-edge risks.

However, we encourage close coordination between regulators with regard to permanent legislative changes made by HMT and firms graduating out of the Sandbox in order to avoid undue delays or cliff-edge risks, which would disincentivise participation in the Sandbox.

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

ICMA Response: ICMA members welcome the clear criteria for exit from the Sandbox set out in the end-state rules, whilst also expressing the importance of flexibility within the glidepath approach. Where market stakeholders that are already regulated (such as financial market infrastructures (FMIs) and PRA-authorised banks) enter the Sandbox, a more tailored approach with regard to timelines, initial limits, and end-state rules would be beneficial, allowing Sandbox entrants to bypass requirements already met under an existing authorisation outside the Sandbox (if applicable). More broadly, ICMA members recommend that the regulators remain open to amending the rules (at Gate 2, Gate 3 or exit) in response to learnings in the Sandbox and alternative proposals that prove to satisfy regulatory objectives.

The existing CSDR framework is designed for systemically relevant CSDs. We understand that HMT and regulators are considering developing an alternative framework for non-systemic CSDs. ICMA members recommend that this alternative framework should be considered as a potential exit route from the Sandbox and reflected in the glidepath approach, allowing for choice between exit as a systemically relevant or non-systemically relevant CSD and calibrating the Sandbox rules accordingly.

The draft guidance of the Sandbox also proposes to bring across a limited number of the requirements within the CSDR Regulatory Technical Standards (RTS), including the RTS for CSD links, into the end-state rules. The RTS for CSD links will need to be carefully considered to manage potential risks between CSDs graduating from the Sandbox and existing CSDs.

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[2] Bank data shows that well over half of debt issued by UK corporates is in currencies other than GBP. For example, in Q 1 2024, 74% of the gross capital raised through bonds by UK issuers was denominated in currencies other than GBP. See https://www.bankofengland.co.uk/statistics/details/capital-issuance.

Additionally, further guidance under specific scenarios may be required when firms are progressing through the Sandbox, for instance, with regard to contingency plans and flexibility for amendments in case a Sandbox experiment ends prematurely, as well as interaction with retail clients.

Section 4: Proposed approach to rules in the DSS:

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

ICMA Response: While the proposed end-state rules include a broad range of modifications, additional regulatory barriers and/or risks to/from the technology or business models may only be identified by firms whilst progressing through the Sandbox. As highlighted in our response to Question 1, a more flexible and tailored approach to individual participants' requirements taking into account different business models would be welcome.

At the same time, it is equally important to acknowledge that activity inside the Sandbox should not preclude same or similar activity from taking place outside the Sandbox subject to different structuring choices in compliance with the existing regulatory framework.[3]

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

ICMA Response: ICMA members support the regulators' aims to facilitate innovation, protect financial stability, and protect market integrity. However, we emphasize the importance of maintaining flexibility with regards to the end-state rules, taking into consideration learnings from the Sandbox. While guidance on the anticipated end-state rules is in principle welcome, the Bank's draft DSS rules should not preclude relevant in-scope legislation from being modified at a later stage, if required.

Furthermore, while we appreciate that the above objectives need to be balanced carefully, the proposed capital requirements set a high bar for participation and may restrict participation further than possibly intended.

As far as the rules in scope of the DSS regulations are concerned, some members have suggested that further legislative amendments by HMT might be helpful, for example of the Government Stock Regulations 2004 (GSRs) – subject to structuring choices – to support different models of digital (DLT-based) Gilt issuances within the Sandbox.

[3] See ICMA's FinTech tracker for latest announcements and transactions of DLT-based securities, amongst others, across global capital markets.

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

ICMA Response: See response to Question 4.

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

ICMA Response: See response to Question 4.

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

ICMA Response: ICMA members emphasize that due to the technical nature of the rules, firms may only identify potential conflicts between frameworks they are subject to at a later stage once they have been admitted to the Sandbox.

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

ICMA Response: See response to Question 8.

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

ICMA Response: As highlighted in our response to question 5, ICMA members appreciate that the objectives of the Sandbox need to be balanced carefully. However, the proposed capital requirements set a high bar for participation and may restrict participation further than possibly intended.

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

ICMA Response: See response to question 10.

Section 5: The Bank's methodology for setting DSS capacity:

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

ICMA Response: ICMA members are in principle supportive of the regime's approach, providing flexibility to facilitate innovation while seeking to protect financial stability.

However, we note that the proposed Go live (Stage 3) limits per DSD, coupled with the proposed fixed review points for DSDs to apply to proceed through Gate 3, are too low and are likely to disincentivise participation in the Sandbox and inhibit the UK's competitiveness.

For example, several members deem it highly likely that firms entering the Sandbox will reach the initial limits early into the Sandbox, potentially with only one issuance/transaction. According to the draft rules, the Sandbox entrant then would need to wait until one of the two fixed review points (potentially up to 15-18 months later) to seek to apply to support further issuances/transactions within the Sandbox. This would effectively suspend further activity until a later date, and several members have suggested this could make participating in the Sandbox, at least at an early stage, commercially unviable.

As a result, ICMA members propose that the Bank modifies its approach to applying limits at Go live (Stage 3) by calibrating limits on a firm-by-firm basis, with additional flexibility for DSDs to scale (move to Stage 4) on a continuous basis.

This approach will also mitigate the risk that volume limits applied evenly at entity level will further decrease if the number of participants is higher than expected.

Section 7: Box C: FMI fees and Bank's powers to levy fees for the DSS:

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

ICMA Response: ICMA members have not raised any objections to the proposed fee regime.

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