

INNOVATION IN THE UK CAPITAL MARKETS – THE FMI SANDBOX TAKES SHAPE

Following the introduction of the UK Financial Services and Markets Bill 2022 (the "**FSMA Bill**") to Parliament in July 2022, the FMI sandbox (as defined below), first announced by the then-UK Chancellor of the Exchequer Rishi Sunak on 19 April 2021 and part of a series of ambitious plans to stimulate private sector investment in FinTech, is starting to take shape.

The FSMA Bill proposes amendments to existing legislation pursuant to which HM Treasury would be empowered to issue statutory instruments allowing the creation of a sandbox (or sandboxes¹) in which financial market infrastructures ("**FMI**") such as domestic investment exchanges, multilateral or organised trading facilities, central securities depositories and any other person as may be specified will be allowed to temporarily test the efficiency and effectiveness of their activities in a particular way, including through new technology or by adopting different practices (the "**FMI sandbox**"). According to the FSMA Bill, the FMI sandbox, which appears to have been inspired by the sandbox of the Financial Conduct Authority ("**FCA**") launched back in 2016, may be regulated by the FCA and the Bank of England.² This will be determined in due course.

In summary, FMI Sandboxes would enable firms designated to participate in them to test and adopt new technologies and practices (such as distributed ledger technology ("**DLT**") by temporarily disapplying, modifying or even applying certain legislation for specific purposes.

Once the FMI sandbox has been in place for the period of time to be specified by HM Treasury in due course, a report will be prepared by HM Treasury (in consultation with the FCA and the Bank of England) describing the FMI sandbox arrangements, the efficiency or effectiveness of the arrangements and whether or not HM Treasury proposes that the arrangements under the FMI Sandbox should be made permanent.³ The outcome of the FMI sandbox initiative may therefore be the permanent modification of the UK legislative or regulatory framework in such a way that financial market infrastructures will be able to fully embrace technological innovation and ultimately make the UK financial system, including capital markets, an attractive option for the full

Key issues

- The FSMA Bill proposed amendments to existing UK legislation pursuant to which HM Treasury would be empowered to create sandboxes in which financial market infrastructure providers and certain designated persons can test the efficiency and effectiveness of their activities in a particular way, including through new technology or by adopting different practices while being subject to a bespoke legislative and regulatory framework.
- The FMI sandbox(es) would be in place for a limited period with the aim to learn from the experiments, foster innovation and potentially permanently adopt the framework into UK legislation.
- There are parallels with the EU Pilot Regime, but the FMI sandbox may actually go further to encourage innovation by financial market infrastructures.

¹ Pursuant to Clause 13(9) of the FSMA Bill, there may be more than one FMI sandbox. They may be successive or existing in parallel.

² Clause 13(5) of the FSMA Bill

³ Clause 16 of the FSMA Bill

spectrum of market actors (e.g. FMI operators, technology developers, issuers, investors and financial intermediaries).

The FMI sandbox has widely been dubbed the UK equivalent to the EU Pilot Regime.⁴ The EU Pilot Regime will allow regulated investment firms, market operators and central securities depositaries to operate DLT-based market infrastructures in Europe for a limited period from 23 March 2023.⁵ This will be achieved by allowing such entities to apply to be temporarily exempted from some of the specific requirements of EU financial services legislation that the European Union feels are incompatible with DLT and are widely regarded as stifling the adoption of trading and settlement of financial instruments that are issued, recorded, transferred and stored using DLT ("**DLT Financial Instruments**"). The objective is that initiatives under the EU Pilot Regime would give sufficient data and information so that a market for DLT Financial Instruments could be made permanent. We expect that if the EU Pilot is successful, it would offer not only an additional source of capital to issuers, but a range of further advantages due to the use of DLT and smart contracts, such as a reduced settlement cycle as well as other efficiencies, potentially including the automation of payments of principal and interest, a simpler ownership and custody structure, greater security and transparency and the possibility of paying for DLT Financial Instruments using crypto-currencies such as central bank digital currencies.

In our view, the proposals in the FSMA Bill create a strong parallel to the EU Pilot Regime. Not least because when the UK government announced the FMI sandbox back in April 2021, DLT was mentioned as an example of the technology which could be tested under the FMI sandbox. This is consistent with the FSMA Bill which in Schedule 4 includes examples of the types of provisions that FMI sandboxes may make including that FMI sandboxes could describe particular "*practices adopted in the issuance, trading or settlement of financial instruments in a way not otherwise possible or practicable as a result of requirements imposed by relevant enactments*". This demonstrates that the intention is to ensure that actors in the UK capital markets can benefit from the advantages of new technologies such as DLT as much as possible and one of the direct consequences of this could be the creation of a market for DLT Financial Instruments in the UK.

However, compared to the EU Pilot Regime, the proposals in the FSMA Bill would enable the FMI sandbox to actually go further than the test environment under the EU Pilot Regime to encourage innovation by financial market infrastructures. This is the case even without having an indication from HM Treasury as to how they propose to exercise these powers. For example:

- the FSMA Bill permits HM Treasury to allow a broad participation in FMI sandboxes which in practice could include FMI providers, and participants in these systems as well as, conceivably, unregulated service providers such as technology companies and any other person that HM Treasury specifies. This is a much broader category of participants than in the EU Pilot Regime, which is limited to multilateral trading facilities and securities settlement systems and

⁴ Regulation (EU) 2022/858 of the European Parliament and of the Council on a pilot regime for market infrastructures based on distributed ledger technology (the "**EU Pilot Regime**"). See our [client briefing](#) on this subject.

⁵ The initial term is three years, but it may be extended another three years (Article 14(2) of the EU Pilot Regime)

makes no mention of recognised investment exchanges or any other person⁶;

- the FSMA Bill envisages the disapplication of a wider range of legislation,⁷ beyond the EU financial services legislation cited by the EU Pilot Regime (e.g. MiFID II and the CSDR) and, unlike the EU Pilot Regime, it is envisaged that the FMI sandbox may go further than simply disapplying legislation, allowing for the modification of legislation⁸ or even the application of specific legislation (with or without modification) in certain scenarios⁹ and in particular enabling the modification, amendment and creation of rules by the Bank of England and the FCA, thus creating the opportunity to create a bespoke regulatory framework in respect of each FMI sandbox¹⁰; and
- the FSMA Bill suggests that the FMI sandbox is not focused solely on promoting the use of DLT, contrary to the EU Pilot Regime. It refers instead to the use of 'developing technology' in a broader sense and the adoption of new or different practices in the carrying on of FMI activities.¹¹ The FSMA Bill does not set out specific categories of activities at the outset, contrary to the EU Pilot Regime which envisages the creation of DLT multilateral trading facilities, DLT settlement systems or DLT trading and settlement systems.

Unlike the EU Pilot regime, the powers under the FSMA Bill enable HM Treasury to permanently implement successful FMI sandboxes even before their expiry. Essentially this would allow HM Treasury to convert into general law those legislative provisions which have been subject to temporary modification and disapplication within an FMI sandbox. This would enable the legislative provisions to apply to entities that either did not participate or were ineligible to participate in an FMI sandbox, such as overseas operators of FMI entities, subject to the entities being authorised by the appropriate regulator.¹²

It is however too early to carry out a full analysis of the differences with the EU Pilot Regime as, assuming the FSMA Bill becomes law, it would be at HM Treasury's discretion to exercise its powers and what the exact terms of any FMI sandboxes to be put in place should be. Each FMI sandbox will need to specify activities to which the FMI sandbox will relate, the specific FMIs or other person(s) that may participate, the duration of the FMI sandbox, which legislation may be disappplied, modified or applied and how such FMI sandbox should be regulated.¹³ The FSMA Bill even sets out further provisions which may need to be determined at the outset, including the particular kinds of technology that may be used under the FMI sandbox arrangements for the purposes of assessing their efficiency or effectiveness¹⁴ and the particular kinds of practices that may be adopted under the FMI sandbox arrangements for the purposes of assessing their efficiency or effectiveness,¹⁵ as well as the

⁶ See the wide discretion awarded to HM Treasury to specify FMI entities and other persons who may participate in an FMI Sandbox in Clause 13(4)(b) of the FSMA Bill

⁷ See Clauses 13 and 17(3) of the FSMA Bill

⁸ Clause 13(6)(b) of the FSMA Bill

⁹ Clause 13(6)(c) of the FSMA Bill

¹⁰ Clause 16(1) of the FSMA Bill

¹¹ Clause 13(2) of the FSMA Bill

¹² Clause 15 of the FSMA Bill

¹³ See Clauses 13(4) to 13(7) of the FSMA Bill

¹⁴ Paragraph 2 of Schedule 4 of the FSMA Bill

¹⁵ Paragraph 3 of Schedule 4 of the FSMA Bill

scope of financial instruments¹⁶ and provisions for the settlement of payments.¹⁷

To this end, in August 2022, the HM Treasury launched an industry consultation pursuant to Clause 16(2)(b) of the UK Financial Markets and Services Bill which will end in October 2022. The HM Treasury is seeking input on a number of specific points, including the scope of financial instruments, the thresholds for issuance and recording of securities, eligibility criteria for participants and the application process and exit routes, as well as difficult legal issues such as how to resolve conflict of law issues if in the DLT context participants operate nodes outside of the UK.

HM Treasury will also consult with the FCA and the Bank of England before any regulations are passed in relation to the creation of FMI sandbox(es),¹⁸ but the intention appears to be to move quickly so that the first FMI sandbox(es) can be created in the second half of 2023, in the wake of the launch of the EU Pilot Regime on 23 March 2023.

¹⁶ Paragraph 4 of Schedule 4 of the FSMA Bill

¹⁷ Paragraph 5 of Schedule 4 of the FSMA Bill

¹⁸ Clause 16(2)(a) of the FSMA Bill

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