



GBBC Global Blockchain
Business Council

About us:

GBBC is the largest leading industry association for the blockchain technology and digital assets community. Launched in Davos in 2017, GBBC is a Swiss-based non-profit, with more than 500 institutional members, and 301 Ambassadors across 117 jurisdictions and disciplines. The organisation is dedicated to furthering the adoption of blockchain technology by convening regulators, business leaders, and global changemakers to foster collaboration and advance dialogue to create more secure, equitable, and functional societies.

To whom it may concern,

Re: Digital Securities Sandbox joint Bank of England and FCA consultation paper (GBBC Response)

We welcome the efforts of the Bank of England and the FCA in fostering an innovative financial landscape through the Digital Securities Sandbox. While we acknowledge the regulation's aim to safeguard market stability and integrity, we also highlight the importance of the DSS in the creation of a competitive ecosystem for new digital market structures. In its current form, the DSS poses several inhibitors to this end.

Below, we outline recommendations developed by GBBC's members throughout a series of roundtables and discussions as part of the GBBC DSS Working Group. Our response addresses six key themes for the regulators to consider, focusing on inclusiveness, a systemic support framework for innovative emerging business models, and the development of clearer guidelines for communication and negotiations between regulators and Sandbox participants.

We're grateful to our members for their input and would welcome a meeting with the Bank of England and FCA with our members to discuss further.

Themes:

1. Eligibility for Sandbox Participation: is the current framework inclusive enough?
2. Scope of asset classes: is the current range sufficient, or are additions needed?
3. Entry thresholds
4. On-chain settlement and the last-leg problem
5. Alternatives to traditional bid/ask matchmaking
6. Insights on necessary regulatory adjustments (prospectus, listing, CSDR, market abuse, MiFID)

Please find the cross-referenced list of the original Consultation Paper's Questions at the end of this document). Additionally, each theme elaborated by the GBBC Working Group is preceded by direct references to questions posed in the consultation.

Yours faithfully,

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Theme 1: Eligibility for Sandbox Participation

Cross-reference to DSS CP:

- *Question 1: Do you have any comments on the draft Guidance on the Operation of the Digital Securities Sandbox (Appendix A)?*
- *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?*
- *Question 9: Do you agree with the proposed approach to managing potential interactions between Bank, FCA, and PRA requirements?*

Summary: To foster innovation, we recommend the DSS adopt a more inclusive framework that allows tech providers and startups to participate in the Sandbox directly. This would expand the innovation base and aid new business models. Adjusting the fee structure and easing the glide path would help smaller firms comply more feasibly. We argue for a collaborative compliance/negotiations approach which would facilitate dynamic dialogue between regulators and participants, promoting a diverse ecosystem and preventing market stagnation.

A. Relationships between entrants and non-entrants:

Recognition that the relationships between technology providers and traditional systemic actors like CSDs are becoming ever more intertwined is crucial in the context of DLTs. Therefore, we emphasise the need to create a regulatory environment permitting optimal collaboration between third parties, and systemic market participants. While we welcome DSS's emphasis to allow for interactions between DSS entrants and non-entrants, additional guidance and principles stipulating burdens and responsibilities of non-entrants engaging with DSDs are required, beyond what is currently outlined in *Regulation 3(4) of the DSS Regulations*.

B. Inclusive participatory framework:

In its current form, *DSS Regulation 3(2)* excludes non-CSD and non-MTF entities like technology providers from the Sandbox. However, these entities need to fulfil legal requirements which might prohibit them from doing so in practice. Specifically, as outlined in Appendix A (p.10), DSS's current scope requires that potential participants demonstrate that their intended solutions could more appropriately be pursued in the DSS due to regulatory, legal or technical obstacles, particularly around securities registration and digital ledger technology.

We appreciate the regulators' attention to the conclusions of HMT's consultation of July 2023, which stated that key barriers to the adoption of DLT in FMIs should be approached by addressing the activities of CSDs. However, GBBC believes that there are wider potential ecosystem benefits which can be facilitated through DSS, primarily, by extending the participatory framework.

The current DSS structure prioritises incumbent financial institutions providing traditional CSD services, thus potentially side-lining innovative technology providers and small firms due to high

entry barriers, particularly the stringent CCSD and MTF compliance requirements, high costs of CCSD and MTF licensing, and inequitable fee structure.

Furthermore, an inclusive participatory framework can be advanced by revisiting the fee structure. In its current form, Article 47 of the UK CSDR stipulates strict requirements for the calculation of going-concern capital and wind-down costs. GBBC welcomes the Bank's flexible approach to the calculation of capital levels at Gate 2. However, we highlight that the proposed minimum criteria:

- (a) the amount of resources needed to cover all their going concern risks and the cost of wind down or,
- (b) resources equivalent to at least nine months' of operating expenses for their DSS activities at all times, to cover the risks from these activities,

may not be suitable for smaller entrants and startups whose capital structures and operational models significantly differ from those of established CSDS. These smaller entities often operate with leaner capital reserves and a focus on rapid innovation, making it challenging to meet such stringent financial requirements. These criteria may lead to an inequitable distribution of costs, particularly when these costs are not proportionate to the scale of the company's activities. This disparity can create accessibility barriers in practice, hindering the participation of smaller firms in the DSS.

Especially for non-incumbents, might prove too high of a cost to test innovative business models within the Sandbox as they may be paying for:

- a) licences required by FCA and BoE to operate as a CSD or trading venue (or both),
- b) covering regulator's costs of oversight which are divided equally across all participants
- c) other costs of compliance compounded across different gates.

Recommendations:

- We recommend a more inclusive framework that allows various entities, including tech providers and start-ups to participate directly in the DSS. This approach will not only broaden the innovation base but also enrich the sandbox with diverse technological insights facilitating the creation of new business models. While the BoE and FCA recognise that non-CSDs can still provide technology without needing to comply with CSD-specific requirements, GBBC encourages the introduction of a separate dimension to the glide path for such non-systemic providers, allowing them to benefit from the regulatory innovation more directly and overcome barriers stemming from *i.a.* Regulation No. 909/2014 (UK CSDR), FSMA 2000, Uncertificated Securities Regulations 2001 (USRs 2001) and Companies Act 2006 (CA 2006). To reduce entry barriers, we propose that the steepness of the glide path be lessened, enabling smaller firms to ramp up and become compliant more feasibly. Such flexibility would allow entities to experiment with various business models and apply for additional necessary licences in a progressive manner.
- Allowing entities to enter the sandbox and then applying controls is a more feasible approach than requiring adherence to stringent, harmonised standards from the outset. This shift could mitigate the dominance of incumbents and foster more competitive entries into the market. To manage risk while enhancing market access, a variety of tools could be utilised. For example, limiting participation to institutional clients or restricting the number of retail clients could effectively control exposure. Additionally, adjusting the types of permitted investments, such as specific share portfolios, could further safeguard investor interests and market integrity.
- Technology providers and start-ups could identify barriers preventing digital ledgers from operating within the current legal framework, using the sandbox for testing and understanding these limitations. Given the smaller scale of such actors' activity, the risks which they pose for market integrity and stability are limited, which can be reflected in a different set of regulatory mechanisms applied to them. Direct participation can help to improve not only innovation but also information flows between sandbox entrants and non-entrants, facilitating the end-state integration between technology providers and systemic CSD actors, therefore addressing regulatory edge cliff challenges.
- Regarding the fee structure, we recommend that it be sensitive to the financial capacities of smaller new entrants. Especially from Stage 3, the equal sharing of supervision costs and chargeable policy work equally across all DSDs should be revisited, adopting an approach relative to the size and liquidity of participants. Resourcing requirements can be managed through restrictions on the scalability of the business to ensure that financial and other resources are always commensurate to regulatory and financial stability risks. Moreover, the FCA and PRA capital requirements can exclude some types of entrants from applying into the sandbox. Therefore, adjusting the framework recognising the regulatory compliance capacities of non-systemic, non-CSD or non-MTF entrants can enhance inclusivity by easing some licencing requirements and, consequently, associated rules

concerning capital within the DSS. Finally, while not feasible as a general fee model, the alternative approach considered by the Bank to levy a flat, one-off fee to recover Gate 1 & 2 costs only at the point of issuance of the DSD licence could be considered for smaller entities which are most vulnerable to being deterred by the high initial costs.

C. Detailed guidance regarding hybrid models.

GBBC welcomes that the DSS recognizes the potential of comingled CSD and MTF systems leveraging DLT. This integrated hybrid approach is vital for alternative providers who are likely to emerge within the sandbox. The potential competitive advantages of hybrid entities operating in financial markets raise the tension between the Treasury's support for these innovations, which aim to circumvent current market constraints, and the Bank's concerns about the systemic implications. Utilizing competition as a strategic lever could be effective. However, attention needs to be directed towards regulatory trends elsewhere, where regulations meant to enhance competition often solidified dominant firms' dominance. Therefore, focusing on competition through the facilitation of hybrid entities could ensure that DSS contributes to genuine market diversity and innovation, rather than the entrenchment of the status quo.

That said, GBBC highlights that those current proposals of oversight, requiring both FCA and BoE's compliance, impose undue burdens on such hybrid setups, restraining potential advancements in financial technologies. Achieving dual compliance from the onset is a considerable challenge, especially given the entity's financial stability risks linked to the merging of CDS and MTFs functions. The reality is that such a high compliance threshold may only be attainable by a limited number of well-established market participants initially. Nonetheless, there is significant interest among smaller or emerging firms in adopting these hybrid models. To avoid setting too high a barrier to entry, and support innovation while maintaining market stability, mechanisms that allow these firms to incrementally meet regulatory standards are crucial and will broaden participation in the sector, diversifying the market infrastructure.

Ignoring those limitations risks mirroring the EU experience where the entities most eager to participate often lack the qualifications to do so, while the larger, qualified entities show little interest, often due to the risks of reinforcing the position of the incumbent. To foster innovation and inclusivity in the market, it may be advantageous to consider frameworks that allow emerging firms to scale up their compliance incrementally, thus encouraging broader participation and preventing market stagnation.

- **Barriers for small firms:** Even with Gate 2 measures, and the glide-path approach, small firms may still struggle to comply with the full set of MTF and CSD regulations. The high cost and complexity of meeting CSD or MTF requirements and obtaining licences create significant barriers to entry into the Sandbox as a hybrid entity. We suggest lessening the steepness of the glide path, enabling smaller firms to ramp up and become compliant more feasibly.
- **Authorization burdens:** Operating both a CSD and a trading venue involves significant authorization burdens, making it challenging for hybrid models to achieve compliance, and

- consequently, move further in the glide path. GBBC argues that these stringent requirements may be unfair to some entities. We recommend that the regulators publish detailed principles which will be employed in business-model-specific assessments along the glide path, exploring mechanisms that allow firms to incrementally meet regulatory standards, thus broadening participation in the sector and diversifying the market infrastructure.

Recommendations:

- To fully address the above-mentioned challenges likely to be encountered by hybrid entities within the Sandbox, we propose that the regulators adopt a ‘collaborative compliance/negotiations approach’ for smaller entities like start-ups and new entrants. This reflects the principles implicit in the glide path process, embracing a dialogue between sandbox entrants and regulators, which should be dynamic, accommodating different rates of progress and unique needs. This entails publishing detailed conditions and criteria which are taken into consideration when individual hybrid business models are assessed for regulatory oversight and progression within the glide path. Hybrid models introduce a different subset of regulations that need encouragement in the regulatory approach. FCA and BoE should clearly articulate their positions on these models, anticipating potential cross- and intra-institutional frictions, rather than merely encouraging the approach.
- Moreover, defined guidelines are important given the systemic risks involved in the conversion of CSD and MTF operations under one functional hybrid model. Outlining the consequences and implications of converged regulatory frameworks for CSDs, MFTs, OTFs and RMs is critical for entities to manage systemic risks effectively.
 - For example, regulators should address the implications of a scenario where a CSD also becomes an MTF. Such merging will raise questions about how MTF regulations apply when the platform transitions from a non-systemic to a systemic function.
 - Additionally, the Bank and FCA should outline what additional obligations can be imposed on an MTF that also fulfils CSD functions, recognizing that this would create fundamentally different layers of regulatory considerations. We acknowledge that such a structural change requires the FCA and the Bank of England to undertake a thorough review of the resulting regulatory landscape, ensuring that all potential impacts are addressed.
- Furthermore, the ‘negotiations approach’ to compliance would allow Sandbox participants and regulators to engage in case-specific dialogue facilitating innovation and emergence of new market solutions, at the same time ensuring feedback and communication channels allowing for amendments and improvements in the DSS regime. Such an approach would enhance the DSS's risk-management framework, allowing for regulatory pressures to be eased where appropriate without compromising market stability. At the same time, it would provide a more tangible incentive mechanism for hybrid models to develop, addressing the lack of specific mechanisms encouraging that process within current DSS regulations.

- GBBC recognises the facilitation of hybrid entities as one of the key achievements of the Sandbox, providing innovation in market efficiency without compromising market integrity. Due to the novelty of hybrid models specific to the Sandbox, and the concurrent need to comply with each relevant function of CSDR, OTF and MFT, and CCPs, Sandbox participants require more fine-grained guidelines on how such models will be treated by the regulators. The proposed negotiatory approach would introduce more transparency and flexibility of treatment regarding hybrid entities, facilitating their cultivation within the DSS.
- The approach of systemic negotiations between startups and regulators, as could be practised in the UK, is both innovative and advantageous. It does not limit sandbox access to specific types of firms and potentially provides the UK with a competitive edge in fostering financial innovation.

D. Transparency Process and Regulatory Adaptation

Considering the importance of the DSS for the UK's financial innovation, its long timeline and a limited number of participants, the market must be kept fully informed about the activities and regulatory conditions within the sandbox to ensure clarity and maintain trust in the evolving financial landscape. Transparency is therefore not only important for DSS participants but also for non-participating market players and wider stakeholders, who can adjust their strategies according to the developments arising from the Sandbox. Given the regulators' mandate to safeguard market integrity and financial stability, establishing robust informational flows within and outside of the Sandbox should be considered beforehand, and included as a systematic part of the oversight processes of both regulators.

- The consultation has sparked important discussions around the transparency of regulatory processes, particularly how amendments are communicated across different stages of the glide path and as the ecosystem matures. GBBC highlights a significant need for mechanisms that not only notify but also adequately inform all market participants about regulatory updates and incoming changes at different gates, specific to participants' business models. This ensures that entities at varying levels of regulatory alignment or developmental stages are equally prepared to adapt to new Sandbox regulations.
- Moreover, to ensure trust for the DSS, and facilitate non-sandbox DLT developments, transparency should take the form of adequate reporting to non-entrants, ensuring that lessons and conclusions developed within the ecosystem are circulated to the markets. This is particularly important in the regulations of relations between entrants and collaborating non-entrants.

Recommendations:

- We urge the FCA and the Bank of England to enhance the transparency of their regulatory processes, establishing reporting regimes both within and outside of the Sandbox, with a clear framework of informational flows within the Sandbox and its participants as well as between participants and non-participants. Moreover, GBBC supports the regulators' position on a continuous, adaptive reassessment of DSS evolution and the principle of

adapting individual regulations to business models. However, transparency processes regarding the new ‘tranches’ of regulations need to be shared in a timely and accessible manner, to reduce frictions between participants at different stages of the Sandbox.

Theme 2: Scope of asset classes

Cross-reference to DSS CP:

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

Summary: Integrating a broader scope of digital assets, including future UK stablecoins, into the DSS is essential for aligning with technological advancements and maintaining the UK's leadership in financial innovation. A more inclusive approach to stablecoins, permitting broader testing and development, would support back-office solutions and comprehensive technological growth, allowing the DSS ecosystem to produce more dynamic and comprehensive end-state results and lessons.

GBBC considers that the digital securities system would be facilitated if it also covered the use of unregulated stablecoins or other forms of private or government-issued money for the settlement process. While it is not an asset form that is going to be traded, it is necessary to include it for the viability of the securities systems the DSS aims to encourage. These will be fundamental for future innovations within the financial sector, particularly in enhancing transaction efficiency, fraud detection, reducing costs, and enabling new business models through decentralised finance and blockchain technology. We embrace the consideration of central bank-regulated digital assets within the DSS as an important step towards the integration of DLT to achieve such improvements. The consultation paper opens the possibility of using stablecoins within the DSS, specifying that only systemic stablecoins, which would presumably be backed by central bank reserves, are permissible.

- This restriction presents a significant limitation, as the current market for such systemic stablecoins does not exist, and the regulatory framework required to govern these stablecoins is not yet developed. The DSS framework should explicitly consider the integration of regulated digital assets, including future UK stablecoins, into the sandbox.

Recommendations

- We encourage the Bank and the FCA to anticipate regulatory synergies and implications raised by the ongoing development of HMT and FCA's stablecoin regime and address them directly outlining regulatory strategy and potential integration/boundaries. The framework should emphasise the need for regulatory adaptation to include comprehensive guidelines for crypto assets, facilitating their potential use in innovative trading and settlement models within the DSS. This approach would align the sandbox's regulatory environment with technological advancements and ensure that the UK remains at the forefront of financial innovation. As the DSS evolves, it should progressively incorporate clear and supportive policies for crypto assets and other forms of private money, particularly in how they are used for securities settlement in a regulated context. Such a strategy would enhance the

DSS's applicability and effectiveness in fostering innovation, at the same time maintaining controlled oversight and risk management capacities.

- Furthermore, we recommend that the DSS consider a more inclusive approach that allows for the use of a broader range of stablecoins, not just those backed by central bank reserves. This would enable more practical and immediate testing and development within the DSS.
- The Sandbox's effectiveness hinges on fostering a comprehensive ecosystem that encourages technological competition, not just monetary. We think it is important that the sandbox supports proofs of concept that may not necessarily involve direct trading of cryptocurrencies like Bitcoin or Ethereum but focus on backend solutions like quick settlement fixes using dummy tokens or similar innovations. This approach focuses on back-office functions rather than front-office trading, aiming to solve real industry challenges in a controlled environment.
- The current regulatory framework, particularly concerning the narrow interpretation that restricts the use of non-traditional assets for settlement processes, should be more flexible. This flexibility will allow firms to experiment with and refine new technologies without the pressure of immediate full compliance with existing MTF rules, thus encouraging a more comprehensive technological development within the sector. For some innovative business models, the MLR registration requirement is a considerable material barrier. Therefore, having the ability to conduct limited activities on a test basis with a glide path for compliance would promote inclusion raised in Section 2 of this response.
- Given this anticipated development of regulated systemic stablecoins, it is crucial that the timing of regulatory and market readiness is considered in advance by the DSS framework. Otherwise, the current regulatory frameworks for such assets may expire before such coins are fully operational. Therefore, we recommend that the process for developing and approving systemic stablecoins be synergised with the DSS. This would allow for testing of the settlement processes using stablecoins within the Sandbox directly. By doing so, the Sandbox would allow for verification of the practicality and robustness of the settlement mechanisms involving systemic stablecoins, which are poised to play a critical role in the future financial infrastructure. A potential approach to addressing legislative barriers for new business models, which may arise with the introduction of stablecoin legislation, is to consider the creation of additional sandboxes.
- By restricting the DSS to systemic stablecoins only, we potentially preclude the use of more readily available stablecoins that are regulated by bodies such as the FCA. This could limit the sandbox's utility and slow innovation in financial technologies that leverage stable digital currencies. While we acknowledge that this approach was made to stop firms from becoming a systemic risk to the banking and the monetary system, we recommend that the consultation considers a more inclusive approach that allows for the use of a broader range of stablecoins, not just those backed by central bank reserves, at the same time retaining controlled environment.

Theme 3: Entry thresholds

Cross-reference to DSS CP:

- *Question 6: Do you have any feedback on the Bank's approach to creating the Gate 2 rules or the Gate 2 rules themselves?*
- *Question 7: Are there any specific features of technology and/or business models that would be incompatible with the proposed Gate 2 rules?*

Summary: We advocate for flexible volume thresholds within the DSS to include a diverse range of participants. Incorporating exchange functions can streamline digital securities' progression. By balancing thresholds, the DSS can attract both major financial institutions and innovative startups, ensuring a rich diversity of insights.

We believe that to ensure the glide path approach is fit for purpose, amendments are needed in the value chain, particularly concerning the role of exchanges and the potential integration of exchange functions. To achieve that, digital securities exchanges should be incorporated within the DSS framework to streamline the overall process of progression within each Gate. By integrating exchange functions, the DSS can provide a more cohesive environment for the issuance, trading, and settlement of digital securities.

Drawing lessons from the EU DLT pilot, where merging trading and clearing functions was a significant achievement, we believe it is important to evaluate the volume thresholds in the DSS framework. The integration of trading and clearing in the EU DLT pilot demonstrated how such mergers could lead to streamlined processes and reduced operational complexities.

The volume thresholds will be pivotal in determining the types of participants the DSS attracts. Some blockchains cannot handle high transaction volumes per volume/day, so it is essential to balance the thresholds to accommodate a diverse range of participants. On one hand, setting higher thresholds might attract major banks and financial institutions capable of handling substantial transaction volumes. On the other hand, lower thresholds could encourage participation from innovative smaller entities such as startups, which might not have the capacity to handle high transaction volumes but can offer valuable insights and innovations.

Recommendations:

- We recommend setting flexible volume thresholds within the DSS to enable an inclusive and broad spectrum of participants. This will ensure that the DSS incubates the insights and innovations from both established financial institutions and emerging fintech startups. Setting participant-specific entry thresholds, reflective of the efficiencies gained by merging exchange functions, will allow for a more diverse ecosystem, providing more lessons and insights from the cohort.

Theme 4: Chain Settlement and the Last-Leg Problem

Cross-reference to DSS CP:

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

Summary: Addressing the "last-leg" settlement issue is critical for integrating digital securities within the UK framework. Accepting stablecoins issued by FCA-regulated entities can expand permissible use within the sandbox.

GBBC believes that, in its current form, the DSS must address the "last-leg" settlement issue, which is crucial for the successful integration of digital securities within the UK regulatory framework. Currently, UK regulations, akin to those in the EU, require that financial transaction settlements be conducted in funds.

However, under the EU's regulatory frameworks, including MiCA and PSR, stablecoins issued by private entities are classified as funds under the Electronic Money Directive (EMD). Therefore, under EMD, CBDCs are not necessary for on-chain settlements, as stablecoins can be sufficient to address the final stage of the settlement of transactions. A similar approach could be adopted by the DSS which, in its scope, includes mainstream securities but excludes crypto assets and stablecoins as fiat settlement forms. GBBC members point out that this exclusion might hinder models that require digital forms of money for settlement in digital securities. This reduces the sandbox's capacity to drive responsible innovation forward, limiting the scope of DLT uses in the settlement of transactions.

In terms of regulatory competition, the UK is trailing behind the EU in stablecoins' legislation. The government is prioritising updates to align with the EU's MiCA framework, which is set to be implemented in January. This delay affects the UK's ability to fully integrate stablecoins into the DSS for on-chain settlement.

Specifically, under the DSS, transactions can be initiated, traded, and cleared on-chain but must be moved off-chain to conclude settlement with fiat funds because of the current regulatory constraints on stablecoins. This could be resolved by representing (tokenising) fiat currency on a DLT platform, but this would require a legal framework that qualifies a tokenized form of money (stablecoin denominating a fiat currency) as a fund. DSS currently only foresees the use of central bank money for settlements, making it unlikely that privately issued eMoney or stablecoins will meet the necessary standards even after relevant legislation is introduced.

Recommendations:

- An intermediate solution might involve the acceptance of stablecoins issued by FCA-regulated entities. This could ease existing constraints and expand permissible stablecoin use within the sandbox framework. In doing so, the sandbox should adopt a flexible and

forward-looking approach, ensuring that its framework can accommodate innovative financial models. We believe that this goes beyond the issue of transactions of securities, holding profound implications for the UK's regulatory and financial competitiveness.

- We recognize the Bank's commitment to the CPMI-IOSCO Principles for Financial Market Infrastructures which minimises the use of money with credit or liquidity risk, as presented in Appendix A (p.22). However, we think that to fully leverage the sandbox's potential for the implementation of DLT in financial infrastructures, these standards should be widened to account for some forms of commercial bank money *before* the permanent settlement regime, precisely to have insights and lessons from the integration of these assets in a more systemic setting.

Theme 5: Alternatives to Traditional Bid/Ask Matchmaking

Cross-reference to DSS CP:

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

Summary: The DSS should explore alternatives to traditional bid/ask frameworks, like automated market makers (AMMs) and liquidity pools. These can enhance liquidity and market efficiency. Clear regulatory guidance and pilot programs are essential for its secure implementation. This approach promotes a resilient trading environment, improving the liquidity of tokenized securities.

GBBC believes that the Sandbox should explore alternatives to the traditional bid/ask matchmaking framework outlined in MiFID. While the regulations do not explicitly prevent alternative methods, there is a lack of guidance or encouragement for exploring these models. The limitations of the current bid/ask system could be addressed through the adoption of DeFi mechanisms, such as pooled funds, which have shown potential benefits in enhancing liquidity and market efficiency.

Traditional bid/ask matchmaking relies on direct buy and sell orders to establish market prices. This approach can be limiting, especially in low-liquidity contexts. The inherent latency and friction in matching individual buy and sell orders can result in wider bid/ask spreads and reduced market efficiency.

DLT offers alternatives to such traditional bid/ask systems. These include automated market makers (AMMs) using liquidity pools, which aggregate liquidity from multiple participants and use algorithms to facilitate trades. These mechanisms can significantly affect market abuse prevention, reduce spreads, improve liquidity, and enable continuous trading without the need for direct order matching. AMMs, which are widely used in DeFi platforms, use smart contracts to create liquidity pools where prices are determined algorithmically based on the ratio of assets in the pool. This provides a more resilient trading environment less susceptible to market manipulation and volatility.

Incorporating these alternative mechanisms within the DSS could improve the liquidity of tokenized securities, making the market more attractive to both institutional and retail investors. However, this requires regulatory support, explicit incentives/recommendations, and clear guidelines to ensure these systems operate within a compliant and secure framework. The DSS could set the stage for broader adoption by actively testing and refining these mechanisms, with benefits particularly important for the liquidity of tokenized securities.

Recommendations:

- Mechanisms promoting exploration and implementation

- The DSS should explicitly encourage business models leveraging alternative liquidity mechanisms, such as AMMs and liquidity pools, within its framework.
- Regulatory support
 - Clear regulatory guidance should be provided to ensure these new mechanisms can be implemented securely and compliantly.
- Pilot programs and testing
 - The DSS should include pilot programs to test these alternatives, gathering data and insights to inform the permanent regime.

Theme 6: Insights on Necessary Regulatory Adjustments (e.g., Prospectus Directive, Listing Directive, CSDR, Market Abuse Directive, MiFID2)

Cross-reference to DSS CP:

- *Question 1: Do you have any comments on the draft Guidance on the Operation of the Digital Securities Sandbox (Appendix A)?*
- *Question 5: Is the full set of rules set out in Appendix B consistent with the objectives and design principles of the DSS?*
- *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?*

Summary: Adapting regulatory frameworks to support the technological conversion of existing securities into DLT formats and the creation of new digitised securities is essential. Incorporating advanced technologies like tokenization, smart contracts, oracles, and machine learning can transform the utilisation of regulated capital. Evolving regulatory frameworks to accommodate these instruments will streamline the innovation base of the DSS and enhance market efficiency. Our Working Groups have shown that there is a series of regulatory changes needed to address the digitisation of new types of securities. GBBC recognises that the technological conversion of existing securities into a DLT format or accommodation of entirely new types of digitised securities will require the updating of the public offering regulations and prospectus obligations under frameworks like MiFID or MiCA.

The development of "smart assets" and management of "dumb liabilities" represent a significant innovation in banking. These concepts involve the integration of advanced technologies such as tokenization, smart contracts, oracles, and machine learning to create highly efficient assets. These assets can transform the utilisation of regulated capital for enhanced economic activities.

- Tokenization and smart contracts allow for the creation of programmable financial instruments that can automate and streamline various processes, from settlement to compliance.
- Oracles and Machine Learning: Integrating real-world data through oracles and applying machine learning can enhance the functionality and efficiency of smart assets, providing real-time data validation and predictive analytics.

Despite the potential for these innovations, they remain unaddressed within current DLT pilot regimes. The regulatory framework needs to evolve to accommodate these instruments.

Consultation Paper Questions referenced to GBBC Response Themes:

Question 1:

- **Theme 1:** Eligibility for Sandbox Participation
- **Theme 2:** Scope of Asset Classes
- **Theme 4:** On-Chain Settlement and the Last-Leg Problem
- **Theme 5:** Alternatives to Traditional Bid/Ask Matchmaking
- **Theme 6:** Insights on Necessary Regulatory Adjustments

Question 4:

- **Theme 1:** Eligibility for Sandbox Participation

Question 5:

- **Theme 6:** Insights on Necessary Regulatory Adjustments

Question 6:

- **Theme 3:** Entry Thresholds

Question 7:

- **Theme 3:** Entry Thresholds

Question 9:

- **Theme 1:** Eligibility for Sandbox Participation

Question 12:

- **Theme 2:** Scope of Asset Classes
- **Theme 4:** On-Chain Settlement and the Last-Leg Problem
- **Theme 5:** Alternatives to Traditional Bid/Ask Matchmaking
- **Theme 6:** Insights on Necessary Regulatory Adjustments