



Regulatory Sandboxes for Innovation in Financial Products and Services

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Regulatory Sandboxes

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Initiatives by Federal Banking Agencies to Promote “Innovation”

Bank regulatory agencies launch various initiatives for “innovation”

- Efforts to promote “responsible” innovations
- Most initiatives focus on consumer financial products or services
- “Financial inclusion” appears as a common theme
 - Federal Reserve Vice Chairman for Supervision, Randal K. Quarles: innovation that targets financial inclusion can address “unequal or insufficient access to financial products and services”
 - Available at <https://www.federalreserve.gov/newsevents/speech/quarles20180326a.htm>
 - FDIC Chairman Jelena McWilliams: in the United States, 8 million households with “no relationship” to the banking system, and 24 million households are “underbanked,” *i.e.*, some financial services *outside* the banking system
 - Available at <https://www.fdic.gov/news/news/speeches/spnov1318.pdf>



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Initiatives for “Innovation”



- **Board of Governors of the Federal Reserve System: Payment system improvement initiative**
- **Federal Deposit Insurance Corporation: Office of Innovation**
- **FinCEN:** Acting jointly with the prudential banking agencies, has issued a statement to “encourage depository institutions to consider, evaluate, and, where appropriate, responsibly implement innovative approaches to meet their Bank Secrecy Act/anti-money laundering (BSA/AML) compliance obligations”
 - **Joint Statement on Innovative Efforts to Combat Money Laundering and Terrorist Financing (Dec. 2018)**, available at <https://www.fdic.gov/news/news/press/2018/pr18091a.pdf>



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Initiatives for “Innovation”

- **Office of the Comptroller of the Currency: Office of Innovation**
- **“Responsible Innovation”** [is] the use of new or improved financial products, services and processes to meet the evolving needs of consumers, businesses, and communities in a manner that is consistent with sound risk management and is aligned with the bank’s overall business strategy.”
 - Available at <https://www.occ.gov/topics/responsible-innovation/index-innovation.html>
- **OCC accepts national bank charter applications from fintech companies**
 - **Special Purpose National Bank charter**, based on the OCC’s policies and procedures established in its regulations (e.g., 12 C.F.R. part 5) and the *Comptroller’s Licensing Manual*
 - **“Core” banking activities:** (i) paying checks and (ii) lending money
 - Available at <https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-occ-policy-statement-fintech.pdf>



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State Regulators: “Vision 2020” Initiative

- **Conference of State Bank Supervisors (CSBS)** aims to “modernize state regulation of non-banks”
 - “State regulators, who are the primary regulators of non-bank and fintech firms, are committed to fostering the innovation of fintech companies while protecting consumers from predatory products and services.”
 - Available at <https://www.csbs.org/vision2020>
- **Six elements of Vision 2020:**
 1. The Fintech Industry Advisory Panel
 2. Redesigned Nationwide Multistate Licensing System (NMLS)
 3. Harmonize Multi-State Supervision
 4. Assist State Banking Departments
 5. Enable Banks to Service Non-Banks, through enhanced industry awareness campaigns to address de-risking practices
 6. Improve Third-Party Supervision through CSBS



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An Origin Story: Born British

- **In 2014, UK Financial Conduct Authority (FCA) formally adopts its “Innovation Hub”**
- **FCA’s regulatory sandbox is rooted in two key observations about regulation of financial products and services:**
 1. Regulatory uncertainty creates “delays” that “disproportionately affect first- movers and discourage innovators;” and
 2. Some innovations are “abandoned” because of “regulatory uncertainty”
See FCA, Regulatory sandbox (Nov. 2015), available at <https://www.fca.org.uk/publication/research/regulatory-sandbox.pdf>
- **Benefits for established (“authorised”) banking organizations:** regulatory sandbox could help manage a bank’s exposure to risks or costs (*e.g.*, due to an examination or sanction) associated with “outsourcing arrangements” involving novel technologies or newly established fintech companies



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UK FCA Regulatory Sandbox

- **Options for Unauthorised Firms:**
 - Testing by a firm that is approved by the FCA to be “authorised with restrictions”
 - Once the firm can meet the “full” regulatory (*i.e.*, licensing) requirement, then the restrictions would be lifted
 - Only a firm that (i) offers a product or service designed for the “financial services industry” (*i.e.*, not generally applicable for commercial uses (?)) and (ii) needs to test a “new” product or service
 - “Genuine innovation” is described in terms of offering a “new solution” that is “novel or significantly different to existing offerings”
- **Constraints under EU legislation**
- **Examples of Sandbox Firms (June 2017):** (i) app for claims processing for travel insurance; (ii) advisory tool to help a consumer lower costs of debt; (iii) savings tool to round up on a consumer’s spending activities



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Bureau of Consumer Financial Protection

- In 2018, the Bureau issued two proposals:

1. **Disclosure Sandbox**

Policy to Encourage Trial Disclosure Programs, 83 Fed. Reg. 45,574 (Sept. 10, 2018), *available at* <https://www.govinfo.gov/content/pkg/FR-2018-09-10/pdf/2018-19385.pdf#page=1>

2. **Product Sandbox**

Policy on No-Action Letters and the BCFP Product Sandbox, 83 Fed. Reg. 64,036 (Dec. 13, 2018), *available at* <https://www.govinfo.gov/content/pkg/FR-2018-12-13/pdf/2018-26873.pdf#page=1>

- **Declaring its 2013 policy for promoting trial disclosures as “failed”**

- Similarly, in revising the 2016 policy for no-action letters, the Bureau explains: “[B]oth the process required to obtain a No-Action Letter and the relief available under the 2016 Policy have not provided firms with sufficient incentives to seek No-Action Letters from Bureau staff.”



Bureau: Disclosure Sandbox

Section 1032(e) of the Consumer Financial Protection Act of 2010

authorizes the Bureau to conduct trial programs to improve disclosures:

“ . . . trial program that is limited in time and scope, subject to specified standards and procedures, for the purpose of providing trial disclosures to consumers that are designed to improve upon any model form issued pursuant to subsection (b)(1) [*i.e.*, new disclosures developed by the Bureau], or any other model form issued to implement an enumerated statute, as applicable.” 12 U.S.C. § 5532(e)(1)

Trial program –

- Must be “limited in time and scope;” but
- Bureau has discretion to tailor “standards and procedures” for the particular program



Bureau: Disclosure Sandbox

- For a particular disclosure requirement pertaining to a model form, a covered person may be granted a “waiver,” which could be:
 - (i) Safe harbor for compliance (*i.e.*, subject to prescribed conditions or restrictions); or
 - (ii) Exemption83 Fed. Reg. at 45,575, fn. 8.
- Bureau’s discretion to grant relief extends to any requirement under an enumerated consumer law prescribing the language, form, or other condition of a model disclosure which a covered person may (or must) provide to comply with that law



Bureau: Disclosure Sandbox

Policy for Disclosure Sandbox:

Section A— Application

Section B— Bureau’s assessment

Section C— Bureau’s procedures to grant a waiver

Section D— Bureau’s procedures to act on request for extension of time for a program

Section E— Standards for Bureau to coordinate with other federal agencies or state regulators

Section F— Bureau’s disclosure of information about an approved program

Bureau: Disclosure Sandbox

Key Elements of Application:

- A.2— Description of how the new disclosure or method of delivery will be tested, including expected improvements
- A.3— Parameters for the trial, including metrics and data to measure whether improvements occur
- ❖ Improvements may include savings of the *covered person's costs*
- A.5— Potential risks to consumers, as well as steps the covered person will take to mitigate the risks



Terms and Conditions of Waiver

- Bureau's approval for a program is expected to:
 - Specify the new disclosure or delivery method to be used
 - Describe the "test population(s)" of consumers
 - Specify scope of the waiver
 - Describe the Bureau's exercise of discretion to take no action, including for a potential UDAAP, for use of trial disclosure(s) during the "waiver period"
- Bureau reserves the authority of revocation, including on its own assessment of risks to consumers, but subject to procedures allowing the covered person to respond or to cure



Comment by CSBS

- “We appreciate the proposed addition of a new section to the Policy regarding the Bureau’s plans to coordinate with state regulators who provide similar programs that encourage consumer-beneficial innovation. Some states have chosen to create a ‘sandbox’ within their state in order to encourage more companies to test out innovative products and services within a limited scope environment with tailored regulatory expectations and consumer protections. Other states have objections with the concept of regulatory sandboxes as a matter of regulatory policy. It is critical for the Bureau to recognize and respect differences in the views of each state as to the propriety of establishing sandboxes within their state. . . .”
- **Ultimately, to be effective in facilitating innovation, the Bureau’s TDP Policy should avoid creating unrealistic expectations or confusion on the part of regulated financial institutions.**
 - Available at <https://www.csbs.org/policy-encourage-trial-disclosure-programs>



Bureau: Product Sandbox

- **Two types of “relief” available: (1) “approval” or (2) “exemption,” and an exemption may be issued from (i) statutory provision or (ii) regulatory provision**
- **For approvals**, Bureau cites its authorities to grant exemptions under three laws: (1) Truth in Lending Act (15 U.S.C. § 1640(f)); (2) Equal Credit Opportunity Act; or (3) Electronic Fund Transfer Act
- **For exemptions**, Bureau will cite to relevant “statutory exemption-by-order provisions” or from applicable regulatory provisions
 - “An exemption issued to a particular entity or entities will include (a) a statement that, subject to good faith compliance with specified terms and conditions, the Bureau exempts the recipient(s) from complying with or deems it to be in compliance with specified statutory or regulatory provisions in connection with its offering or providing the described aspects of the product or service” 83 Fed. Reg. at 64,042
 - The Bureau’s “specified terms and conditions” are the rails around the sandbox



Bureau: Product Sandbox

Policy for Product Sandbox:

- Section A— Types of Relief Available
- Section B— Application
- Section C— Bureau’s assessment
- Section D— Bureau’s procedures to grant the form(s) of relief
- Section E— Bureau’s procedures to act on request for extension of time
- Section F— Standards for Bureau to coordinate with other federal agencies or state regulators
- Section G— Bureau’s disclosure of information about an approved program



Bureau: Product Sandbox

Key Elements of Application:

- B.2— Description of the consumer financial product or service to be offered, including (a) how it functions and its terms and (b) the manner in which it would be offered (*e.g.*, any disclosures)
- B.4— Explanation of the potential benefits to consumers and the metrics and data to measure whether improvements occur
- B.6— Identification of the specific statutory provision(s) or regulations from which the applicant seeks relief, as well as the a description of “the potential uncertainty, ambiguity or barrier that such relief would address”



Terms and Conditions of Relief

Key Elements of the “Terms and Conditions” Order:

- D.3— Relief is limited to the “described aspects of the product or service,” and not to the whole consumer financial product or service or other manner by which it would be offered or delivered
- D.5— Requires the fintech company to “report information about the effects,” including complaint patterns, and default rates, so that the Bureau can make its own assessment of the potential harms to consumers
- D.7— Extent to which the Bureau may publicly disclose information about the fintech company’s participation in the Product Sandbox
- D.10 — Conditions for revocation, including that the “Bureau would not pursue an action to impose retroactive liability”

83 Fed. Reg. at 64,043-44



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Comment by State Attorneys General

Twenty-Two State Attorneys General Oppose the Bureau’s Product Sandbox

▪ Available at <https://www.regulations.gov/document?D=CFPB-2018-0042-0031>

- “[P]rocess [is] designed to value speed over careful decision-making”
- “These safe harbor provisions do not authorize the CFPB to grant the approval relief contemplated by the Proposed Sandbox Policy. . . . Importantly, this affirmative defense [afforded in the statute] is only available when companies can demonstrate they acted in good faith and in conformity with the CFPB’s *official* guidance.” (Emphasis in original.)



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New York CLE Verification Code

To obtain CLE credit in New York, the verification code is:
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Arizona Regulatory Sandbox: Attorney General's Office

In 2018, Arizona enacted a law for its “Regulatory Sandbox,” and the Attorney General’s Office has implemented the program (codified at Ariz. Rev. Stat. Ann. § 41-5601-5612)

Key conditions to participate in the Regulatory Sandbox:

1. **Qualifying Financial Activities:** Must fit within one of three regulated areas:
 - (i) Banking (including transmitting money);
 - (ii) Business of a sales finance company; or
 - (iii) Investment advisory services (including regulated financial planning)

❖ **Insurance products or services are not eligible**
2. **Oversight:** Attorney General’s Office monitors the fintech company
3. **Exit Strategy:** If the testing fails, the fintech company must address potential risks of harm to affected consumers—and that possibility puts the company in the position of preparing in advance with a remediation strategy



Arizona Regulatory Sandbox

- **Core Benefit:** Certain licensing requirements are suspended temporarily so that a fintech company can evaluate, in a live environment, whether the innovative financial product or service actually works or could work on a larger scale
- **Innovation:**

[T]he use or incorporation of new or emerging technology or the reimagination of uses for existing technology to address a problem, provide a benefit or otherwise offer a product, service, business model or delivery mechanism that is not known by the Attorney General to have a comparable widespread offering in this state

Ariz. Rev. Stat. Ann. § 41-5601(4)



- Each innovative financial product or financial service to be tested in the sandbox requires a separate application



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Arizona Regulatory Sandbox

- **General Rule:** “Except as otherwise provided [in the law], a sandbox participant is not subject to state laws that regulate a financial product or service” (§ 41-5605(F))
- **Product-Specific Requirements:** Section 41-5605 contains clawback provisions for particular state laws that apply each type of eligible financial product or service
- **No Relief for Potential UDAAP Violation:**

Arizona’s Consumer Fraud Act applies (see § 41-5611(E))



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Arizona Attorney General's Office

General Considerations for the Application to the Regulatory Sandbox

- **Innovation Is Not Sufficient:** Fintech company also must demonstrate to the satisfaction of the Attorney General's Office that the specific financial product or service will satisfy other criteria of the regulatory sandbox law, including:
 - **Factors for assessing whether the Test is successful or unsuccessful**
 - **Why the fintech company is "not able to proceed with the Test outside the Sandbox" (emphasis added)**
 - **How the fintech company will wind down the test and protect consumers if the test were to fail**
- In its FAQs, the Attorney General's Office states that an application will be evaluated "holistically to determine the applicant's ability to conduct a test that does not place undue risk on consumers"



Arizona Attorney General's Office

- **Recordkeeping:** In the application, the fintech company must describe the records to be kept, such as "advertising materials, accounting workbooks, drafts of model contracts and forms, signed contracts and forms, communications between the business and consumers, data in its native format, and any metadata"
- Collecting relevant data and records could serve various objectives:
 - Respond to oversight by the Attorney General's Office
 - Demonstrate compliance with disclosure requirements (*see* § 41-5606)
 - When the company exits the sandbox, the maintenance of books and records could prove useful in an application for the relevant license
- **Confidentiality and limited disclosures by the Attorney General's Office:** Materials submitted by the fintech company generally are not subject to the Arizona law governing public records



Common Themes

- **Novelty:** The fintech company is expected to provide an innovation
 - There's no pass on a required license or waiver on compliance with a regulatory requirement unless the company can deliver an innovative product, service, or method of delivery
- **Metrics and Data:** To track success—and guard against challenges due to potential risks to consumers—the fintech company needs to (i) establish parameters for its trial program and (ii) collect and keep data relating to its activities
- **Timeline for Success:** The regulatory sandbox is designed to be exceptional—
 - In Arizona, the fintech company needs to plan for transition to engage in financial activities with appropriate license(s), compliance management systems, etc.; or
 - For the Bureau's programs, the trial program should provide an appropriate starting point to urge reform of the relevant law or regulation so that the new type or method of disclosure or innovative consumer financial product or service achieve "widespread" acceptance by consumers and regulatory agencies (*i.e.*, would no longer be innovative)



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Looking Ahead

- **Challenges to the Bureau's Product Sandbox:**
 - State Attorneys General and State Banking Agencies
 - Administrative Procedure Act—Bureau acknowledges that, when issuing relief, the agency is making "(a) Approvals by order under three statutory safe harbor provisions and (b) exemptions by order [from statutory or regulatory provisions]"
 - ❖ Either action may be a type of rule (*see* 5 U.S.C. § 553) and could be subject to review by a court
 - Freedom of Information Act (FOIA) and the Bureau's Disclosure Rule (12 C.F.R. part 1070)
- **Different Types of Applicants:** None is restricted to a startup
 - Anticipate applications to be filed by established financial institutions—such as banks, credit unions, payments processors (online or in-person payments)—as well as by small- or large fintech companies



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Comparison of Sandbox Programs

Should a Fintech Company Apply to Play (or Play for Keeps)?

	BCFP Disclosure Sandbox	BCFP Product Sandbox	Arizona Regulatory Sandbox
Limited Types of Innovations?	Yes: model disclosures	Yes: product or service subject to certain rules	Yes: three defined financial activities
Prior Assessment of Benefits to Consumers?	No	Yes (see B.3)	No
Data Collection?	Yes (see A.3 and A.7)	Yes (see B.7)	Yes
Fintech Company Subject to Supervision?	Yes (at least indirectly)	Yes (at least indirectly)	Yes
Limited Disclosure of Fintech Company's Data?	Yes	Unclear: depends on FOIA and Bureau's Disclosure Rule	Yes



Speaker Biography



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Tom Scanlon is experienced in counseling clients on ways to adapt financial products or services to changing rules, advising on transactions, and helping to address supervisory actions by the bank regulatory agencies, including the Consumer Financial Protection Bureau.

In both private practice and government service, Tom has worked on a range of bank regulatory issues and on projects relating to payments systems. He also has advised fintech companies on compliance with federal and state laws that apply to a money transmitter.

While serving at the Federal Reserve Board, Tom worked on a series of interagency rules; while serving at the Department of the Treasury, Tom worked as the principal attorney of the Department's team to help draft the Consumer Financial Protection Act of 2010 (Title X of the Dodd-Frank Act). He has worked with several types of clients to help shape public policy for financial regulation, such as by drafting legislative proposals and preparing comment letters for proposed rules.

Tom has extensive experience advising on issues that involve the Federal Reserve's regulations, the Federal Deposit Insurance Act, the National Bank Act, the Electronic Fund Transfer Act, the privacy rule (the Bureau's Regulation P), the Fair Credit Reporting Act, the Military Lending Act, financial data aggregation, and vendor-management standards.

