

The Sandbox Paradox

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An Overview of Regulatory Sandboxes

- Regulatory Sandboxes are closed testing environments where specific firms are able to experiment with new and innovative business models or products
- These are most common in the area of “FinTech”
- The goal is to promote entrepreneurialism and innovation
- Each regulatory sandbox differs in its design and the relief it offers



MAP OF EMERGING AND ESTABLISHED REGULATORY SANDBOXES



Source: **INNOVATE|FINANCE**

Existing Regulatory Sandboxes

- The U.K. launched the first Sandbox in June 2016
- Shortly thereafter, Singapore and Australia created their own sandboxes
- In 2018, Arizona became the first U.S. jurisdiction to create a sandbox
- On September 10, 2019, the CFPB launched its own “Compliance Assistance Sandbox”





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Attributes of Sandboxes (Generally)

- Gated access that requires regulator approval
- Limited time duration and number/type of customer who can be served
- Type of relief depends on authorities and jurisdiction of administering regulator
- Relief frequently involves allowing limited access to market without full licensure (learners' permit licensing)
- Frequently includes information sharing requirement



LEARNER'S PERMIT SOUTH AUSTRALIA

Licence No. Date Of Birth Expiry Date Conditions

L41136 ← 01/01/1959 09/01/2016

CLASS C

JOHN SAMPLE
2 SECOND ST
ADELAIDE 5000

John Sample

ORGAN
DONOR

MUST BE CARRIED WHEN DRIVING

Attributes of Sandboxes (Aussie edition)

- Qualifying firms can notify ASIC that they are taking advantage of Fintech Licensing Exemption
- Grants two year exemption from licensing
- Highly proscriptive requirements and limited eligibility
- Requires report at end of term
- Extensions and other relief available via process similar to other sandboxes



Attributes of Sandboxes (CFPB edition)

- Requires application
- Provides regulatory “approval” for acts the CFPB deems to be lawful under ECOA, TILA, EFTA
- Approval provides safe harbor from CFPB enforcement
- May provide safe harbor from state and private action

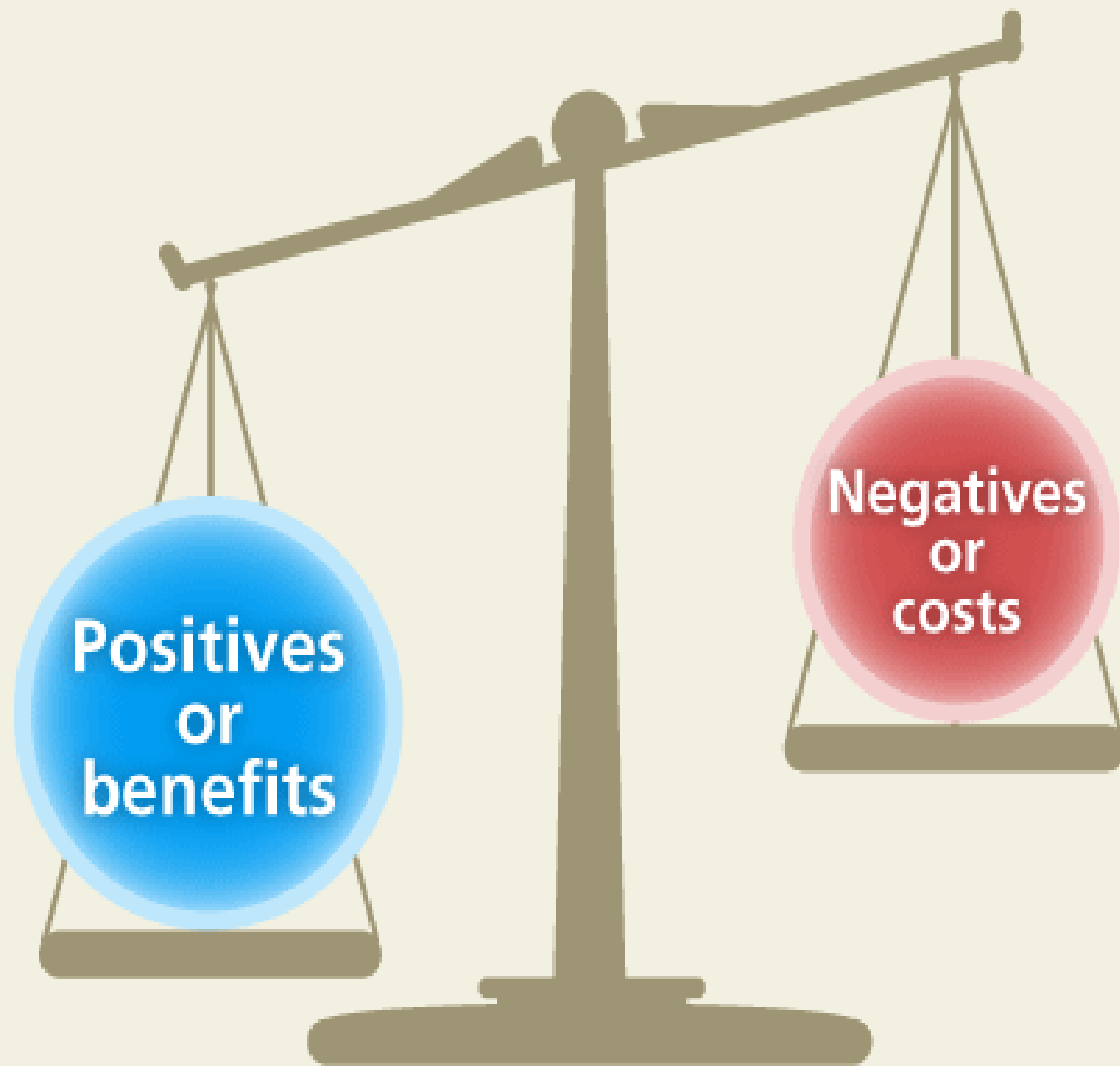




Sandbox by no-action letter?

- SEC recently provided Paxos with no-action relief for a two-year trial period
- Does not appear to waive SEC authority or determine that Paxos is exempt from law
- Requires limited duration and limited number of customers/transactions
- Appears to rely on prosecutorial discretion
- Is this effectively a sandbox





The Rewards and Risks of Regulatory Sandboxes

- Rewards:
 - Increased entrepreneurialism and innovation.
 - More legal certainty
 - Heightened regulatory oversight
 - Lower barriers to entry
 - Faster access to markets
- Risks:
 - Potential for consumer harm
 - Safety and soundness issues
 - Systemic instability
 - Decreased regulatory control





Another Possible Risk Associated with Regulatory Sandboxes

- While regulatory sandboxes have may promote entrepreneurialism and innovation, they also have the potential to create a form of governmentally granted economic privilege if not everyone gets to play in the sandbox
- This is not to say the cost associated with firm specific economic privilege outweighs the benefits created by sandboxes, just that this cost should be acknowledged and addressed





Potential Sources of Firm Specific Economic Privilege

- Sandbox firms may get easier access to the market as well as first-mover advantages through a streamlined approval process
- Sandbox firms may have lower regulatory burdens or decreased legal liability
- Sandbox firms may have access to informal guidance from the regulators
- Sandbox firms may gain increased access to capital because of the signaling function provided by sandboxes






The Potential Costs of Firm Specific Economic Privilege

- Economic privilege feels intuitively unjust and violates the generality principle underling the “rule of law”
- Economic privilege distorts the market and can actually end up harming competition and innovation
- Economic privilege opens the door for cronyism and regulatory capture





Ways to Mitigate the Cost of Firm Specific Economic Privilege

- Lower or eliminate restrictions on entry
 - Decrease regulatory discretion in granting entry
 - Apart from the intended benefits, do not treat sandbox firms in a substantively different way from non-sandbox firms
 - Make it clear that acceptance into the sandbox is not mandatory (or *de-facto* mandatory), nor is it an endorsement of the admitted firms
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