

Emerging Trends in the Regulation of Fintech and Blockchain Technology: An Update on Regulatory Sandboxes

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According to a recent study published by PricewaterhouseCoopers (“PwC”), regulatory uncertainty is the biggest barriers to wider business adoption of blockchain technology.¹ Given this problem, it should not be surprising that one of several key recommendations made by the U.S. Treasury in its July 31, 2018 report *A Financial System That Creates Economic Opportunities-Nonbank Financials, Fintech, and Innovation* (“Treasury Fintech Report”) was the following:

Treasury recommends that federal and state financial regulators establish a unified solution that coordinates and expedites regulatory relief under applicable laws and regulations to permit meaningful experimentation for innovative products, services, and processes. Such efforts would form, in essence, a “regulatory sandbox” that can enhance and promote innovation. If financial regulators are unable to fulfill those objectives, however, Treasury recommends that Congress consider legislation to provide for a single process consistent with the principles detailed in the report, including preemption of state laws if necessary.²

Concerned that “it can take a startup several months and tens of thousands of dollars in fees, compliance costs, and legal expenses to navigate the regulatory maze in just one state,” the State of Arizona passed HB 2434 into law and launched the first “regulatory sandbox” program in the United States.³ What exactly is a “regulatory sandbox” and what kinds of financial products or services may be eligible for such a program? The following summary addresses these questions.

What is a “Regulatory Sandbox”?

A “regulatory sandbox” is a statutory or regulatory framework created by a government which allows private individuals or companies to work collaboratively with regulators in order to test, develop, and use innovative financial products and services which rely heavily on technology. If participants comply with a regulatory sandbox’s requirements, they are provided regulatory protections which can simplify regulatory compliance. According to the Arizona Attorney General, the purpose of a regulatory sandbox is to “allow entrepreneurs to give new ideas a chance in the real market without incurring the regulatory costs and burdens that would otherwise be imposed.”⁴ Regulatory sandboxes may also benefit participants by reducing the time it takes to bring a financial service or product to market by simplifying the authorization process and reducing regulatory uncertainty for market participants.

Some of the highlights of Arizona’s regulatory sandbox program include the following:

- One of the key benefits to the regulatory sandbox program is that if accepted, a participant may be allowed to operate without obtaining a license or other authorization that otherwise might be required by Arizona. ARS § 41-5602.

¹ See *Regulatory Uncertainty and Trust are Barriers to Blockchain Adoption Amongst Business*, PwC UK, August 28, 2018.

² See *Treasury Fintech Report*, at 210.

³ See 3/22/18 Press Release of Arizona Attorney General Mark Brnovich entitled *Arizona Becomes First State in U.S. to Offer Fintech Regulatory Sandbox* (AZ AG 3/22/18 PR) at <https://www.azag.gov/press-release>. A link to the bill signed into law can be found at: <https://apps.azleg.gov/BillStatus/GetDocumentPdf/459033>.

⁴ See AZ AG 3/22/18 PR.

- A sandbox participant is deemed to possess an appropriate license under the laws of Arizona for purposes of any provision of federal law requiring state licensure or authorization. ARS § 41-5605(E).
- Consistent with the recommendation of the U.S. Treasury discussed above, the Arizona Attorney General may enter into agreements with state, federal or foreign regulators that allow sandbox participants to operate in other jurisdictions and allow entities authorized to operate in other jurisdictions to be recognized as sandbox participants in this state. ARS § 41-5605(H).
- The sandbox program will be administered by the Civil Division of the Office of the Arizona Attorney General.
- Individuals or firms wishing to participate in Arizona's regulatory sandbox will be required to provide detailed information regarding their service or product on a form to be provided by the Attorney General's Office, and will have to otherwise comply with all program requirements.
- Those firms and individuals approved by the Attorney General to participate in sandbox program will have two years after their approval date to test their innovative financial product or service. The Attorney General may also grant an extension of up to one year upon request by the participant.
- The financial services or products provided are required to be provided to consumers who are Arizona residents.
- The Arizona Consumer Fraud Act applies to all products and services offered in the sandbox and any product or service offered in the sandbox is required to comply with all statutory limits and caps in Arizona law related to financial transactions.

What Types of Financial Products or Services Might Be Tested in a "Regulatory Sandbox"?

In Arizona, the Attorney General's regulatory sandbox program is limited to innovative financial products or services as those terms are defined in A.R.S. § 41-5601. According to the Arizona Attorney General, the types of products or services which may be eligible for the program include the following:

... Financial products and services eligible for entry into the Sandbox are regulated under Arizona Revised Statutes ("A.R.S.") Title 6 or Title 44, Chapters 2.1 or 13. See A.R.S. § 41-5601(3). Products or services regarding most types of credit extending services, such as peer-to-peer lending and online marketplace lending, would be eligible. Additionally, innovative products and services for money transmission and investment management also would be eligible. Certain blockchain or cryptocurrency products or services also might be eligible.⁵

Although the Arizona Attorney General only began accepting applications for its sandbox program on August 3, 2018, regulatory sandbox programs have been implemented in several other countries, including the United Kingdom through its financial services regulator the Financial Conduct Authority (FCA). Some additional examples of the types of financial services and products which have been tested in a regulatory sandbox include the following:

- An e-money platform based on distributed ledger technology that facilitates the secure transfer and holding of funds using a phone based app.

⁵ See <https://azag.gov/fintech/faq>: "What kinds of products or services can be admitted into the Sandbox?"

- A cross-border money transfer service powered by digital currencies/blockchain technology.
- A web-based software platform that streamlines the overall Initial Public Offering (IPO) distribution process for investors, issuing companies and their advisers.
- A platform that represents private companies' shares electronically on the blockchain, enabling them to manage shareholdings, conduct book building online and facilitate transfers.
- An app that helps users to build up savings by putting aside small amounts of money. These savings can then be used to pay off existing loans early.⁶

In summary, the financial services area is heavily regulated and may pose many risks for the unwary. Individuals and companies who are considering developing a business in Arizona or elsewhere based on a innovative financial service or product may well want to consider whether a regulatory sandbox is right for them.

⁶ See <https://www.fca.org.uk/firms/regulatory-sandbox/cohort-1>



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