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World-First Regulatory Sandbox Open for Play in the UK

Innovative businesses in the financial services industry looking to test exciting new financial products and services will be able to apply to the UK's regulatory sandbox beginning May 9.

The “regulatory sandbox” is the next step for the Financial Conduct Authority (FCA) as part of Project Innovate, a programme that commenced in October 2014 aiming to remove unnecessary barriers to innovation for businesses involved in banking and finance in the United Kingdom. The sandbox marks a significant leap forward in financial services regulation and is the first of its kind, globally. With the launch of Project Innovate, and now the sandbox, the FCA has positioned itself as a forward-thinking regulator keen to promote and support so-called disruptive financial technologies and position the UK as an attractive market for emerging technology companies. Not surprisingly, other regulators have already started to take notice of the FCA's activities, for example the Australian Securities and Investment Commission has recently announced their own plans to launch a sandbox. We expect that the success of the first cohort of participants in the FCA's sandbox will be monitored very closely both by the UK financial services industry itself as well as peers and regulators in other jurisdictions.

About the Sandbox

The FCA's sandbox will allow businesses to test disruptive technologies and new ideas in a live environment without immediately incurring all of the normal regulatory consequences.¹ From 9 May 2016, potential users can submit an application to the FCA for one of what the FCA calls a “small number”² of spaces in the sandbox. The application must detail the specific product, service or methodology that the applicant wants to test and should anticipate the regulatory flexibility or clarity the applicant needs in order to conduct the test in accordance with the FCA's rules. The application process is open to (i) authorised firms wanting to test an innovative product or service outside of the restrictive reigns of the regulations; (ii) technology businesses supporting the financial services industry; and (iii) on a limited basis, unauthorised businesses seeking to test products and services without the need to obtain full FCA authorisation. As a result of the FCA's inclusive approach to defining potential users, anyone from a start-up to a multi-national can benefit from the sandbox.

Unauthorised businesses will use the sandbox predominantly to facilitate testing without the need for full authorisation from the FCA. For authorised users and suppliers, the FCA has identified and will offer three key tools to businesses, on a case-by-case basis, which will allow those users to operate without fear of enforcement action.³ Within the sandbox, the FCA may offer authorised firms any of the following:

- **Individual Guidance.** The FCA may issue guidance on its interpretation of specific rules in relation to the product or service being tested. If the firm acts in accordance with the guidance, the firm shall be deemed compliant with the rules and safe from regulatory action.
- **Waivers.** In limited circumstances, the FCA may make a decision to waive or modify particular rules for the sandbox business. However, this option is limited to the remit of the FCA's powers under the Financial Services and Markets Act 2000 and cannot be used by the FCA to waive any EU legislative requirements.⁴
- **No Enforcement Letters.** The FCA also anticipates “edge cases” where the technology challenges the assumptions that underpin the existing regulatory framework and, in such cases, the FCA may go as far as issuing “no enforcement action” letters.⁵ These would preclude FCA disciplinary action for the duration of the test.

These tools will be exercised at the FCA's discretion. The FCA has noted that in exercising this discretion, consumer protection will be a significant focus. As the FCA has acknowledged that the sandbox poses potential adverse risks for consumers and, accordingly, the FCA will be considering appropriate consumer safeguards, such as disclosure, protection and compensation, on a case-by-case basis.

Applying to the Sandbox

A firm must meet five key eligibility criteria to use the sandbox. The firm must:

- Be an in-scope business
- Demonstrate a genuine innovation
- Deliver a consumer benefit
- Demonstrate a need for the sandbox
- Be ready for testing (*i.e.* the business has already invested sufficient background resources to ensure that the product is ready for a live environment)

The details for each criteria are available [here](#).⁶ The most important issue in differentiating the applications seems to be the last criterion — whether a business is ready for testing. Christopher Woolard, the FCA's Director of Strategy and Competition, has gone so far as to say that “we will choose firms with the most *doable tests* for the first cohorts”.⁷

The FCA will be looking for firms to demonstrate that they have a detailed testing plan in place setting out, among other specifics, test duration, key milestones, a risk analysis, an investigation of potential exposure for customers, measurement metrics and an exit plan.⁸ The FCA has ultimate authority with respect to approving the test plan. Businesses should therefore encourage dialogue between their product development team and regulatory team from the earliest stages of development, so that the regulatory strategy informs, rather than impacts, the development and testing of the product.

Applications for the sandbox are open from 9 May 2016 until 8 July 2016 and can be made via the FCA [website](#). The FCA anticipates that applications for a second cohort will open prior to January 2017.

Impact and Next Steps

The regulatory sandbox represents more than simply a co-operative approach to regulation of financial products and services. It presents an opportunity for banking and financial institutions in the UK, as well as start-ups, to test emerging technologies and ideas that have the power to reshape the way customers consume financial services — from innovative payment methods to custom cryptocurrencies and everything in between. Until now, many businesses have struggled to find a safe way to implement these technologies given the unknowns in the regulatory environment and the risk of public scrutiny. For businesses fortunate enough to obtain sandbox approval, there is now an exciting opportunity to see how their new technologies can be deployed in the real world and test whether the sandbox approach validates the optimism that has pervaded Project Innovate up until now.

For the FCA, this model sandbox is just the beginning. Although the initial number of spaces in the sandbox are limited, the FCA views this as an opportunity to engage with the industry more broadly and has recently announced that an industry working group has been created to explore the potential for industry-led, rather than FCA-led, sandboxes as well.⁹ With the convergence of new technology and new initiatives gathering pace, undoubtedly the use of disruptive innovation in the financial services industry will see a tectonic shift. In a world-first, the UK regulator appears to be taking centre stage to help drive that innovation and keep it on course.

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Endnotes

- ¹ Financial Conduct Authority, Regulatory Sandbox (November 2015) available at <https://www.fca.org.uk/your-fca/documents/regulatory-sandbox>
- ² Financial Conduct Authority. Regulatory Sandbox (Accessed 4 May 2016) available at <https://innovate.fca.org.uk/innovation-hub/regulatory-sandbox>
- ³ Financial Conduct Authority. Regulatory Sandbox (Accessed 4 May 2016) available at <https://innovate.fca.org.uk/innovation-hub/regulatory-sandbox>
- ⁴ Cf. Waiver Test, Section 138A Financial Services and Markets Act 2000
- ⁵ For global firms with a US presence, this is similar to the US Consumer Financial Protection Bureau's (CFPB) No Action Letters
- ⁶ Financial Conduct Authority. Regulatory Sandbox (Accessed 4 May 2016) available at <http://www.fca.org.uk/your-fca/documents/sandbox-eligibility-criteria>
- ⁷ Innovate Finance Global Summit - Speech. Woolard, C. (11 April 2016) available at <http://www.fca.org.uk/news/innovate-finance-global-summit>
- ⁸ Financial Conduct Authority. Default standards for sandbox testing parameters (20 April 2016) available at <http://www.fca.org.uk/your-fca/documents/default-standards-for-sandbox-testing-parameters>
- ⁹ Innovate Finance Global Summit - Speech. Woolard, C. (11 April 2016) available at <http://www.fca.org.uk/news/innovate-finance-global-summit>