

The ESA's 2019 Joint Report on Regulatory Sandboxes and Innovation Hubs

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QuickTake: timely stocktake but perhaps not nearly as transformative as many might hope for?

The European Banking Authority (**EBA**) and more recently its sister European Supervisory Authorities (**ESAs**), the European Securities and Markets Authority (**ESMA**), as well as the European Insurance and Occupational Pensions Authority (**EIOPA**) have used 2018 to accelerate their further policymaking or delivery of actions that flow from various “FinTech Action Plans” as well as their multi-annual supervisory priorities.

On January 9, 2019 the ESAs released a Joint Report “FinTech: regulatory sandboxes and innovation hubs” (the **Joint Report**), which is the most definitive policymaking recommendation to date and, as explored in this Client Alert, it calls for creating a harmonized framework for regulatory sandboxes and innovation hubs in the EU (which the Joint Report collectively refers to as “**innovation facilitators**”). This Client Alert should be read in conjunction with our dedicated coverage on the ESA's concurrent calls for creating new, as well as adapting existing, components of the EU's Single Rulebook for financial services to cater to the specifics of supervising activity relating to cryptocurrencies and digital assets.

■ The Joint Report's findings and proposed actions

The Joint Report applies to FinTech and InsurTech, regardless of the nature or size of the provider of the services and besides providing a comparative analysis of innovation facilitators established to date, related best practices regarding their design and operation, it sets out options for the European Commission's future rulemaking to promote coordination and cooperation between innovation facilitators and support for FinTechs.

The Joint Report proposes two key policy options, which, given some of their non-legislative attributes, possibly could be advanced independently of legislative action from the European Commission. This is particularly important as the ESAs, as well as the European Central Bank (**ECB**) as the super-supervisor at the head of the Eurozone and its Banking Union's Single Supervisory Mechanism (**SSM**) are cognizant that “forum shopping” exists both at the FinTech firm level seeking a favorable regulatory environment but also amongst supervisory authorities and their various types of innovation facilitators themselves.

The Joint Report dedicates a number of pages to this issue and concern amongst various authorities. In the bid to avoid an uneven playing field which could stifle innovation, especially in the event that there is a consumer protection failing, the ESA's options include ensuring that innovation facilitators do not discriminate against a particular business model, sector or how it uses technology and instead focus, at the EU level on the:

- Development of a Joint ESA “own-initiative” guidance, presumably in the form of a Guideline covering cooperation and coordination between innovation facilitators; and/or
- Creation of an EU network to “bridge” innovation facilitators established at the EU Member State level – which, possibly following in the footsteps of the EU financial services’ passport seems the more politically palatable alternative to a centralized EU regulatory sandbox.

It will remain to be seen whether the ESA's proposed options, which are very likely to be deliverable without legislative action are enough to deliver what many market participants and some, perhaps more established, financial services authorities as well as the EU Commission generally have identified as pressing i.e., a single “European” framework for FinTech access to innovation facilitators and on-going supervision of FinTech firms regardless of sector, business model, technology use or jurisdictions. The ESAs point to the national divergences in how measures affecting FinTech have been implemented into national law and mention that supervisory convergence – itself an overriding regulatory priority of each ESAs – requires a “multi-pronged approach”. This is a known issue that goes back to the first steps on FinTech at the EU and ESA level, and if no action is taken, then this most recent effort of the ESA's could kick the can further down the long regulatory road.

■ Innovation hubs, sandboxes and best practices

The Joint Report defines innovation facilitators and differentiates between their attributes:

- “**Innovation hubs**” – that provide a dedicated point of contact for firms to raise enquiries on FinTech-related issues with the national competent authorities (**NCA**s), which are usually the financial services supervisory authorities in the relevant jurisdiction. Questions may also be accompanied by requests for non-binding guidance on the conformity of innovative financial products or services and business models with applicable licensing and/or registration requirements as well as the regulatory and supervisory expectations of the relevant NCA. The Joint Report observed that innovation hubs can either be standalone or alternatively operate on a “hub and spoke” model with the hub being the centralized contact point for firms and queries and drawing on expertise from the various teams in the authority; or
- “**Regulatory sandboxes**” which provide a scheme to enable firms to test, pursuant to a specific testing plan agreed and monitored by a dedicated function of the NCA the innovative financial products or services and business models. Sandboxes may also imply the use of discretions that the NCA is permitted to apply without disapplying EU legal and regulatory requirements.

While 21 EU Member States have established innovation hubs, a much smaller fraction (5 – Denmark, Latvia, the Netherlands, Poland and the UK) have established sandboxes – the first and most successful being the UK's program run by Financial Conduct Authority (**FCA**). A number of other EU Member States have copied and applied lessons learned from the UK, and there are perhaps other lessons that could be applied. Both Norway and Spain have announced steps to launch their own sandboxes and introduced legislative changes to support that. One area where the relevant EU-27 authorities have, regardless of type of innovation facilitator, embraced the FCA's own approach is the use of existing supervisory memorandums of understanding (MoUs) to share data amongst various authorities or, where necessary, for the authorities to establish FinTech specific cooperation channels – and these are points upon which the ESA are likely to form a “network” and a “bridge.”

Moreover, the Joint Report clarifies that innovation hubs' responses to routine questions such as "does this activity need authorization?", "are anti-money laundering, consumer protection or disclosure rules applicable?" or "are there any exemptions or is proportionate treatment available?" is moving increasingly to dialogue. That dialogue focuses on how policymakers might improve existing legislation to facilitate more innovative business or on how to close gaps. While most of the sandboxes surveyed demonstrate similar processes in the phases from application, preparation, testing through to evaluation and having to maintain regulatory licenses throughout the process, the entry standards as part of application phase to participate in the sandbox often differ.

The Joint Report also consolidates what the ESAs consider to constitute challenges, opportunities along with a range of recommendations that are framed as "best practices" (see Annex B to the Joint Report). The challenges are comparably detailed and range from how innovation facilitators deal with IT and technical challenges to the pressures of keeping pace with industry and retaining appropriately knowledgeable staff.

By contrast, some of the content and tone of the 19+ "best practices" are rather self-evident – like conducting appropriate due diligence prior on available resources and demand prior to establishing an innovation facilitator and making sure innovation facilitators are suitably visible with clearly defined points of contact, defined objectives and defined access policies as to "entry conditions". Other areas that Annex B looks at are also not exactly evident of innovative "blue sky thinking" by the supervisors – like communicating lessons learned to relevant stakeholders in NCAs, grounds for improvement should be reviewed and regulatory sandboxes should apply the law. Perhaps the last statement is the clearest given the issues around forum shopping.

■ Outlook and next steps

Whilst the Joint Report does aim to advance the debate on the future of FinTech in the EU and how it is supervised it misses some of the concrete aims for deliverables and desired spillover effects that the individual "Proposed way forward" action points might have set out in both the EU and EBA's own Action Plans. The first conclusion that is clear from the Joint Report is that there will not be a single EU regulatory sandbox in the short term. The second conclusion is that the ESAs reserve the right to step-in to take charge of supervisory convergence using soft-law instruments such as Guidelines rather than wait upon EU legislative action, which remains somewhat behind where some in the market might hope to have it. It may be up to the market to express what they would like to have ESAs do to deliver on the two policy objectives of creating a network of innovation facilitators.

Even if over the longer term the process of getting the regulatory and supervisory framework on FinTech supervision in the EU is likely to remain a continuous a "work in progress", and even if the ESAs are occupied with a range of demanding workstreams during 2019 and beyond, some of the solutions might be geographical closer to home. The ESAs may wish to follow the lead of many EU FinTech firms and find inspiration from how the FCA delivered, embedded and now uses its own Sandbox Regime to achieve domestic and international aims.

It is also conceivable that longer term any network of EU innovation facilitators might be clear that certain centers of expertise sit in certain jurisdictions and that those resources should be made available to the wider set of FinTech firms regardless of where they engage with the supervisory participants that make of this EU FinTech network. Failing to do so might be a missed opportunity especially if EU FinTech is to be a facilitator of the wider-reaching Single Market integration project that is the Capital Markets Union.

If you would like to discuss any of the items mentioned above, in particular how to choose, engage or graduate from an innovation hub and/or sandbox in the EU or how the EU's future FinTech policy framework may affect your business or your clients more generally, please contact our Eurozone Hub and EU FinTech key contacts.

Key contacts:



Michael Huertas

Partner, Financial Regulation and Funds; Eurozone Hub Leader
D +49 69 45 00 12 330
M +49 162 2997 674
E michael.huertas@dentons.com

Michael Huertas is a partner in our Frankfurt office and a member of our Financial Regulation and Funds practice as well as our Banking and Finance practice. Michael leads our Eurozone Hub and the wider Eurozone Group. His structured finance practice focuses on derivatives, securities financing transactions and securitizations. Michael also has experience advising on conduct of business and governance arrangements (in particular, the managing of non-performing assets) and financial market infrastructure, collateral and custody arrangements.



Robert Michels

Office Managing Partner Frankfurt
D +49 69 45 00 12 395
M +49 162 24 43 577
E robert.michels@dentons.com

Robert Michels is Managing Partner of Dentons' Frankfurt office and co-heads the European and Global Capital Markets groups at Dentons. Robert specialises in capital markets, banking and securities law. He advises national and international clients in connection with listings/IPOs/SPOs on European and US Stock Exchanges as well as with corporate bonds. Another focus is the legal advice of Fintech companies as well as crowdfunding and crowdlending platforms.



Valeria Hoffmann

Senior Associate
D +49 69 45 00 12 198
M +49 17 35 87 82 54
E valeria.hoffmann@dentons.com

Valeria Hoffmann is a senior associate in Dentons' Frankfurt office. She advises national and international clients, in particular foreign issuers in connection with listings/IPOs on European Stock Exchanges and corporate bonds regarding compliance and post-listing obligations. Valeria further advises crowdfunding and crowdlending platforms as well as Fintech companies in particular with regard to Initial Coin and Token Offerings and overall cryptocurrency compliance issues.