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A FINTECH REGULATORY SANDBOX: THE TREASURY'S MODEST PROPOSAL

The U.S. Department of the Treasury (the "**Treasury**") has released a fourth report in a series of reports produced in response to Executive Order 13772, available here, which sets out the Administration's seven core principles for regulating the U.S. financial system (the "**Core Principles**"). This report, entitled "A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation" (the "**Fourth Report**", available here) analyzes and provides recommendations for the regulation of nonbank financial companies, the financial technology ("**fintech**") sector and other forms of financial market innovation through the lens of the Core Principles. Thematically, the Fourth Report primarily addresses the following two Core Principles: (1) making regulation efficient, effective, and appropriately tailored and (2) enabling American companies to be competitive with foreign firms in domestic and foreign markets.

This briefing will discuss the Treasury's "regulatory sandbox" proposal in the Fourth Report. Although short on specifics, the Fourth Report affirms Treasury's commitment in principle to the establishment of a regulatory sandbox for innovative fintech companies, in coordination with other federal and state regulators, and it goes so far as to recommend that if voluntary efforts to persuade state regulators to join are unavailing, Congress should legislatively override such resistance through federal preemption.

The Clifford Chance fintech team has previously distributed briefings discussing the Fourth Report's marketplace lending recommendations, available here, and the related proposal by the Office of the Comptroller of the Currency ("**OCC**") to begin accepting applications for special-purpose national bank charters from fintech companies, available here.

Regulatory Sandboxes

In the Fourth Report, the Treasury observes that many countries around the globe have established so-called "regulatory sandboxes". According to the Treasury, a regulatory sandbox is "a unified solution that coordinates and expedites regulatory relief under applicable laws and regulations to permit meaningful experimentation for innovative products, services, and processes."[1] Regulatory sandboxes tend to be designed around a framework of common principles, including the desire to promote the adoption and growth of innovation in financial services, or to provide

1 Fourth Report, at 168.

varying degrees of regulatory relief to companies in various stages of the business lifecycle (from startups to established incumbents) while maintaining consumer protections, as well as improving the timeliness of regulatory feedback.[2] The Fourth Report surveys a number of international regulatory sandbox initiatives, such as the Hong Kong Fintech Supervisory Sandbox, and those conducted under the auspices of the Monetary Authority of Singapore and the UK's Financial Conduct Authority.[3]

The Treasury notes, however, that replicating the regulatory sandbox approach in the United States is complicated by the fragmentation inherent in the U.S. financial regulatory system: the sheer number of disparate regulatory actors, at both the federal and state levels, compounds the difficulty of implementing a single, comprehensive sandbox-style solution. A no-action letter or exemptive relief granted by one regulator does not bind others. Fintech innovators, particularly smaller firms, report that merely identifying which regulators have jurisdiction is a difficult task in itself. Navigating this complex maze takes time, money, and a willingness to bear the opportunity costs. These practical hurdles make it difficult for fintech innovators – which tend to be companies in the early stages of the corporate lifecycle – to compete with established financial institutions.

In addition, the Treasury notes that there is uncertainty about what form a coordinated regulatory sandbox would actually take. In particular, "establishing a formal sandbox overseen by a single regulator would require preemption of a firm's other regulators... *it is also very unclear who that single regulator would be*."[4] Even at the federal level, there are both prudential regulators – such as the OCC, Federal Reserve Board, and Federal Deposit Insurance Corporation ("**FDIC**"), who supervise certain *institutions*, in this case banks, across the full range of their underlying activities – and functional regulators, like the Securities and Exchange Commission ("**SEC**") or Commodity Futures Trading Commission ("**CFTC**"), whose authority is limited to particular financial products (securities and derivatives, respectively) and activities in connection therewith (*e.g.*, providing investment advice). When contemplated activities would cross jurisdictional boundaries and implicate the potential authority of more than one federal regulatory agency, it is unclear which such agency would – or should – be designated as the regulatory lead.

Layered on top of the uncertainty of which federal agency should supervise a fintech regulatory sandbox, is the federal-state fault line. Most states have securities commissioners and banking regulators of their own. The Treasury suggestion that authority for administering a fintech regulatory sandbox should be vested in a single federal agency may be controversial among state regulators, particularly with the securities commissioner or banking authority in the state under whose laws a fintech company seeking to participate in the regulatory sandbox is organized, or where its principal business office is located. In reaction to the release of the Fourth Report, Maria Vullo, the head of the New York State Department of Financial Services ("**DFS**"), observed that the sandbox approach threatens harm to consumers and stated that: "Toddlers play in sandboxes….

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[2] Fourth Report, at 13-14.
[3] Fourth Report, at 169-70.
[4] Fourth Report, at 169 (emphasis added).

Adults play by the rules."[5] If state regulators are unwilling to voluntarily acquiesce to a predominant federal role in supervising the Treasury's proposed sandbox, then Treasury "recommends that Congress consider legislation to provide for a single process… *including preemption of state laws if necessary.*"[6]

For its part, the Treasury asserts that it is ready to "wor[k] with federal and state financial regulators to establish a unified solution."[7] This appears to imply that the Treasury would prefer a more voluntary model based on collaboration in the first instance, although the Fourth Report is vague on what organizational form such voluntary collaboration should take, or how the inevitable jurisdictional disputes would be sorted out. If voluntary efforts are unavailing or prove too messy, however, the Treasury recommends that Congress proceed with involuntary and unilateral federal preemption – a measure of just how strongly it believes in the advisability of a fintech regulatory sandbox.

Despite the considerable practical hurdles and uncertainty as to the specifics, the Treasury has nonetheless made clear that it is committed in principle to working with both federal and state financial regulators toward making a coordinated regulatory sandbox a reality, the implementation of which it believes should be guided by the following principles:

- Promoting innovation in financial services;
- Providing equal access to both startups and established incumbents;
- Delineating transparent, publicly-known processes and procedures, including both for entry as well as exit;
- Providing targeted relief across multiple regulatory frameworks;
- Cooperating with, or showing deference toward, international regulators, presumably with a view toward achieving a harmonized regulatory framework across borders for firms to comply with;
- Maintaining consumer and investor protections commensurate with the project's scope; and
- Increasing the timeliness of regulator feedback offered throughout the product or service development lifecycle.

Innovation: Moving Away from a "Binary" Regulatory Approach

Although not all efforts to innovate will succeed, the Treasury believes that new ideas and fresh thinking can nevertheless enhance market efficiency and improve the delivery of important products and services. Therefore, as a policy matter, innovation should be encouraged. While it is appropriate for regulators to aim to mitigate the negative externalities associated with the innovation process, the Treasury is of the view that the process should ideally be designed to eschew a purely binary model – centered on granting or withholding approval, with the threat

5 Statement by DFS Superintendent Maria T. Vullo on Treasury's Endorsement of Regulatory Sandboxes for Fintech Companies and the OCC's Decision to Accept Fintech Charter Applications, (Jul. 31, 2018), available here.

6 Fourth Report, at 210 (emphasis added).

7 Fourth Report, at 14.

of enforcement action lurking in the background. Instead, the Treasury expresses support for a more flexible, tempered give-and-take with firms as they attempt to innovate. The Fourth Report highlights existing initiatives that are representative of this flexible, non-binary approach and encourages U.S. regulators to build on these efforts, including:

- Geographically-diffuse outreach campaigns for meeting face-to-face with innovative firms;
- Creating an innovation office to serve as a single point of contact for innovators;
- Promulgating guidance, exemptive orders, or no-action letters to give innovators the space to innovate within legacy administrative structures;
- Creating agency-wide working groups to address emerging technologies in consolidated fashion;
- Publishing white papers and speeches to address new technologies and trends in the marketplace; and
- Engaging with foreign regulators, presumably with a view toward harmonizing cross-border frameworks.

Conclusion

The Fourth Report is long on broad statements of policy and short on specifics. Implementing a coordinated regulatory sandbox will be a difficult and profoundly complex endeavor, fraught with practical barriers to implementation. The Treasury's call for Congress to take legislative action if need be to forcibly preempt state law is, however, a powerful testament to the ardency of its belief in the benefits for the promotion of innovation that the regulatory sandbox concept offers. It remains to be seen whether other federal and state regulators share the Treasury's views in that respect. Even if the full extent of the Treasury's regulatory sandbox recommendations is not implemented, we would expect other financial regulators – at both state and federal levels – to continue to conduct outreach campaigns, create innovation offices, form working groups, and promulgate administrative guidance as part of an attempt to promote fintech innovation within their respective jurisdictional bailiwicks.

CLIFFORD CHANCE

AUTHORS

Celeste Koeleveld
Partner

T +1 212 878 3051
E celeste.koeleveld@cliffordchance.com

Jesse Overall
Associate

T +1 212 878 8289
E jesse.overall@cliffordchance.com

KEY FINTECH CONTACTS

Jeff Berman
Partner, Financial Services Regulatory

T +1 212 878 3460
E jeffrey.berman@cliffordchance.com

Jay Bernstein
Partner, Capital Markets

T +1 212 878 8527
E jay.bernstein@cliffordchance.com

Gary Boss
Partner, M&A/Insurance

T +1 212 878 8063
E gary.boss@cliffordchance.com

David Felsenthal
Partner, Capital Markets

T +1 212 878 3452
E david.felsenthal@cliffordchance.com

Steven Gatti
Partner, Financial Services Regulatory

T +1 202 912 5095
E steven.gatti@cliffordchance.com

Megan Gordon
Partner, Financial Services Regulatory

T +1 202 912 5021
E megan.gordon@cliffordchance.com

Anand Saha
Partner, Corporate

T +1 212 878 8301
E anand.saha@cliffordchance.com

Robert Villani
Partner, Capital Markets

T +1 212 878 8214
E robert.villani@cliffordchance.com

Philip Angeloff
Counsel, Financial Services Regulatory

T +1 202 912 5111
E philip.angeloff@cliffordchance.com

Alistair Dunlop
Counsel, Capital Markets

T +1 212 878 3259
E alistair.dunlop@cliffordchance.com

Alice Kane
Counsel, M&A/Insurance

T +1 212 878 8110
E alice.kane@cliffordchance.com

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

Clifford Chance US LLP

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