



INNOVATION: THE EVOLUTION OF THE FCA SANDBOX



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FINTECH REGULATION - THE EU APPROACH

By Marcel Haag



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CRYPTO ASSETS AND THE CHALLENGES FOR REGULATORY DESIGN

By Andrew Godwin



A PROPOSAL FOR OVERSIGHT OF DIGITAL ASSET SPOT MARKETS IN THE U.S.

By Lee Reiners



PRIVACY IN A TECHNOLOGICAL AGE

By Susan Joseph



FINTECH & THE FEDERAL TRADE COMMISSION

By Christopher B. Leach



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01

INTRODUCTION

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The regulatory sandbox is one of the FCA's main tools to support innovation and thereby fulfil its competition mandate. The regulatory sandbox allows innovators to test new products in a live market environment in close collaboration with the regulator. In addition to being a valuable testing platform for firms, the sandbox is also a unique forum which fosters cooperation between the FCA and market participants to support innovation. This article explores how the regulatory sandbox has evolved since its introduction in 2016 and offers insights on how it has worked in practice.

02

WHAT IS THE REGULATORY SANDBOX AND HOW DOES IT WORK?

One of the key objectives of the FCA includes promoting effective competition in consumers' interests. The FCA sees innovation as an essential element of its competition mandate. Innovation enables new entrants to challenge incumbent institutions, deliver inventive products and services for consumers and potentially reduce operating costs in financial services.²

In this context, in 2014, the FCA launched a dedicated Innovation division (formerly known as "Project Innovate") with a specific focus on promoting innovation and competition in the financial services sector.³ The regulatory sandbox forms part of Project Innovate's offering. The initiative was first introduced in November 2015, with the first slot (known as a "cohort") opening for applications in June 2016.

The regulatory sandbox allows businesses to test innovative propositions in a live – but yet "controlled" – market environment with real customers. It was initially divided into two cohorts per year, each running for a six-month testing period. From August 2021, the sandbox is permanently open for applications throughout the year.

A. Not Just for Start-ups

The sandbox is addressed to a broad range of firms with a business model which is relevant to financial services. The FCA encourages participation from innovative firms from all backgrounds, with a view to accelerating "*the change needed to promote more diverse and inclusive practices across FinTech.*"⁴ Since its launch, the FCA has received over 500 applications from firms wishing to participate in the sandbox.⁵

The sandbox is not dedicated exclusively to authorized firms, or firms that require a regulatory license to operate in the UK. Rather, the sandbox is also open to firms with business models that generally fall outside the regulatory perimeter, but nevertheless wish to develop products and services which can support the financial services industry. A typical example includes technology providers that are looking to deliver solutions for the financial services market.

The sandbox is not exclusively addressed to the start-up fintech crowd. A number of incumbents have tested their own applications in the context of the sandbox, ranging from large banks (such as Barclays, Natwest, Standard Chartered Bank, Nationwide, and Experian) to market infrastructure service providers (the London Stock Exchange Group). Even the UK Post Office has participated in the sandbox to test an app relating to digital identities.⁶ Law firms have also joined the innovation arena – for example, international law firm DLA Piper tested its own RegTech application which allows firms to digitally manage regula-

2 Supporting innovation in financial services: the digital sandbox pilot, April 2021.

3 <https://www.fca.org.uk/publication/research/the-impact-and-effectiveness-of-innovate.pdf>.

4 <https://www.fca.org.uk/firms/innovation/regulatory-sandbox>.

5 <https://www.fca.org.uk/firms/innovation/regulatory-sandbox/accepted-firms>.

6 <https://www.fca.org.uk/firms/innovation/regulatory-sandbox/accepted-firms>.

tory compliance to support digitalized issuance processes.⁷

Firms that are interested to participate must submit an application explaining how they satisfy the FCA eligibility criteria, including setting out what makes their proposition “genuinely innovative” and how it is anticipated to benefit consumers, businesses or financial markets more generally.⁸

Products and services admitted for testing range from blockchain-based payment services, platforms which tokenize issuance of financial instruments to RegTech propositions, financial education platforms and sustainable finance investment platforms.

In 2018, Deloitte in collaboration with Innovate Finance (which is an industry body representing the UK FinTech sector) undertook a survey⁹ interviewing several sandbox participants from the first four cohorts. According to the report findings, “the unequivocal message” was that sandbox experience was a valuable one for participants who benefited in a variety of ways, from receiving regulatory guidance to helping them “kicking the tires” on the risks involved in their business model.¹⁰ The report also found that the sandbox also resulted in certain “unexpected benefits” for firms, noting in particular that:

“While the FCA has emphasised strongly that it does not “pick winners”¹¹, the feedback from our interviews is that being accepted into the sandbox, and proving the underlying technology in a live environment, increased the credibility of firms with both investors and customers alike.”¹²

B. What Should Firms Expect from Participating in the Sandbox?

The sandbox provides firms with access to regulatory expertise and facilitates testing through a variety of available “tools.” Firms admitted in the sandbox are assigned a dedi-

cated FCA case officer, who is responsible for supporting the firm in their sandbox journey. This includes helping them navigate the various regulatory requirements, getting clarity around their test parameters and objectives and ensuring that the test is undertaken effectively.¹³ The case officer can also act as a link between the firm and other departments within the FCA, which may be relevant for the particular test in question.

“The sandbox provides firms with access to regulatory expertise and facilitates testing through a variety of available “tools.”

Generally speaking, undertaking regulated activities in the UK requires authorization or registration, unless an exemption applies. This means that a number of businesses operating in the financial services space will require authorization just to be able to test their application with real customers. This can be a significant barrier to entry, particularly for smaller firms with limited resources to access legal support. A tool available to sandbox firms is that they can apply for “restricted authorization.” This is a fast-track process which allows firms to obtain authorization quickly in order to test their Minimum Viable Product (“MVP”), but subject to specific parameters and limitations tailored around the test (for example limitations around the types and number of customers they can take on or volume of transaction they are allowed to undertake). Firms can then decide, based on the outcome of the test, if they wish to go for full authorization.

Other firms may be providing services which are at the fringes of the regulatory perimeter and may require guidance on how to avoid triggering any regulatory requirements. For example, this may apply to technology firms that want to know whether they act as a simple (unregulated) technology provider or whether their business model means that they require authorization to operate in the UK.

7 <https://www.dlapiperintelligence.com/investmentrules/blog/articles/2020/two-of-our-projects-accepted-into-the-fca-sandbox.html>.

8 <https://www.fca.org.uk/firms/innovation/regulatory-sandbox/eligibility-criteria>.

9 <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fca-regulatory-sandbox-project-innovate-finance-journey.pdf>.

10 <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fca-regulatory-sandbox-project-innovate-finance-journey.pdf>.

11 <https://www.fca.org.uk/news/speeches/uk-fintech-regulating-innovation>.

12 <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fca-regulatory-sandbox-project-innovate-finance-journey.pdf>.

13 <https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf>.

Equally, a proposition may push the boundaries of the regulatory perimeter in novel ways and may, therefore, not fit squarely within existing regulations and guidance. In those cases, there are tools available that aim to help firms navigate the various FCA rules. For example, this ranges from helping firms identify the rules and guidance that may be applicable to their business model (known as “signposting”) to providing “informal steers” on potential regulatory implications of the proposed project. In certain cases, it may even involve providing individual guidance, setting out how the FCA would interpret the requirements in that particular case.

The FCA is given extensive powers under the sandbox, including the ability to waive or modify certain of its rules for the purposes of a test, if deemed to be unduly burdensome, or even issuing a “no enforcement action” letter for the duration of the test.

03 BEYOND THE UK: THE GLOBAL SANDBOX

The Global Financial Innovation Network (“GFIN”) – an international network of financial services regulators and relevant organizations – was launched in January 2019, building on the FCA’s earlier proposal for the creation of a “global sandbox.”¹⁴ The GFIN is led by the FCA, which also acts as chair.

Among other things, a key objective of GFIN is to facilitate cross-border testing of innovative solutions with an international element, and in particular *“to provide a more efficient way for innovative firms to interact with regulators, helping them navigate between countries as they look to scale new ideas,”* including *“the ability to conduct a cross-border test – a solution for firms wishing to test innovative products, services or business models across more than one jurisdiction.”*¹⁵

The idea of a global testing platform appears as a natural continuation of national sandbox initiatives, particularly in the context of markets which are inherently global. In practice, however, its implementation has not been without its challenges. Following the first testing pilot phase in 2019, GFIN published a lessons learned report reflecting on the pilot outcomes and feedback.¹⁶

“*The idea of a global testing platform appears as a natural continuation of national sandbox initiatives, particularly in the context of markets which are inherently global. In practice, however, its implementation has not been without its challenges*”

Even though the concept of “cross-border testing” appeared to be “self-explanatory” for participating regulators, the report found that firms had varying interpretations of what constituted a cross-border test.¹⁷ This meant that GFIN received applications which did not necessarily have “inherent” cross-border characteristics as originally expected. Rather it appeared that a number of firms were hoping to use the global sandbox as an opportunity to be introduced by one national regulator to another national regulator, with a view to exploring market entry opportunities in the relevant jurisdiction.¹⁸ The result was that firms applied to more jurisdictions than originally anticipated. Coupled with the fact that firms were expected to submit applications in all jurisdictions where they were interested to undertake testing, in practice this meant that, in certain cases, firms submitted up to 14 applications for the same test (with most firms filing 4 to 6 applications on average).¹⁹

In addition, according to the report, although GFIN expected to receive more interest from larger and international institutions with cross-border operations, there was “a noticeable lack of applications” from this type of firms. This may have been due to the short application window (which was only one month), but it may also indicate that the value

14 <https://www.fca.org.uk/firms/innovation/global-financial-innovation-network>.

15 <https://www.fca.org.uk/firms/innovation/global-financial-innovation-network>.

16 <https://www.thegfin.com/s/GFIN-CBT-Pilot-lessons-Learned-publication-09012020-FINAL-8247.pdf>.

17 <https://www.thegfin.com/s/GFIN-CBT-Pilot-lessons-Learned-publication-09012020-FINAL-8247.pdf>.

18 <https://www.thegfin.com/s/GFIN-CBT-Pilot-lessons-Learned-publication-09012020-FINAL-8247.pdf>.

19 <https://www.thegfin.com/s/GFIN-CBT-Pilot-lessons-Learned-publication-09012020-FINAL-8247.pdf>.

of participating in the global sandbox was not made sufficiently clear for firms.

Overall, among 44 applicants, only eight firms were initially admitted for cross-border testing as part of the pilot. However, following six months of working with the respective national regulators to set out joint testing plans, only two firms managed to proceed to the actual testing phase.²⁰ The remaining six were not ready to meet all the relevant regulators' expectations. This was partly due to the fact that, in some jurisdictions, firms cannot be admitted in the sandbox unless they are already authorized to provide financial services or have partnered with an authorized firm for the purposes of the sandbox. This meant that some firms could not appropriate local partners in time.

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THE POWER OF DATA: THE DIGITAL SANDBOX

As the UK financial services sector is becoming increasingly more digital, the FCA has seen heightened demand for support services focusing on data and data access.²¹ The emergence of new market participants, on the one hand, coupled with extensive digital transformation efforts among incumbent institutions, on the other hand, means that data is playing an increasingly more prominent in financial services. At the same time, market participants, and especially new market entrants, require access to more comprehensive consumer and market data in order to develop innovative technological solutions.²²

Against this backdrop, in 2021, the FCA in collaboration with the City of London Corporation (“CoLC”) launched a pilot of the “Digital Sandbox” – a digital testing environment for technology solutions.

This initiative aims, among other things, to fill a gap in the early-stage “proof of concept” phase of product de-

velopment by providing participants with access to synthetic and publicly available data in order to facilitate testing of prototype technology solutions. In addition, the Digital Sandbox pilot aims to support innovators by offering a “market-place” for application programming interface (“API”) solutions, where digital service providers can list and grant access to services using APIs, as well as a coding development environment. It is also intended to operate as a collaboration platform between sandbox participants and mentors and an “observation deck” for regulators to “observe in-flight testing at a technical level” and “inform policy thinking” in a controlled environment.²³

The pilot was focused on three areas – preventing scams and fraud, supporting vulnerable consumers and promoting SME financing. Feedback²⁴ on the pilot suggested that the Digital Sandbox generally delivered value for firms and overall helped them accelerate product development. That being said, however, ensuring sufficient data quality across numerous topics proved more challenging than expected. In particular, the pilot evaluation report noted that:

“It is important to recognise that synthetic data is a nascent and enormously complex field. Even with world-leading expertise contributed by the Turing Institute, the Working Group was unable to create the required richness across so many data sets.”

The second phase of the Digital Sandbox, which was launched in November 2021, was dedicated exclusively to the topic of environmental, social, and governance (“ESG”) data and disclosure and associated new products and services.²⁵ In an effort to keep the scope narrow, and thereby ensure sufficient data quality, this “sustainability cohort” was focused on addressing specific market challenges in the chosen subject area. This included, for example, exploring how technology can be used in order to promote transparency in disclosure and reporting in relation to sustainability and how technological solutions can increase consumer understanding around the ESG features of products and providers and provide visibility around potential alternative solutions which may be more aligned with their needs and preferences.²⁶

20 <https://www.thefin.com/s/GFIN-CBT-Pilot-lessons-Learned-publication-09012020-FINAL-8247.pdf>.

21 <https://www.fca.org.uk/firms/innovation/digital-sandbox>.

22 <https://www.fca.org.uk/publication/corporate/digital-sandbox-joint-report.pdf>.

23 <https://www.fca.org.uk/firms/innovation/digital-sandbox>.

24 <https://www.fca.org.uk/publication/corporate/digital-sandbox-joint-report.pdf>.

25 <https://www.fca.org.uk/firms/innovation/digital-sandbox>.

26 <https://www.fca.org.uk/firms/innovation/digital-sandbox>.

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THE FUTURE OF THE SANDBOX

As part of the 2020 Budget, the Chancellor asked Ron Kalifa OBE to undertake an independent review regarding the development of the UK fintech sector in the years ahead. This is commonly known as the “Kalifa Review.”²⁷ The Kalifa Review “sets out a series of proposals for how the UK can build on its existing strengths, create the right framework for continued innovation, and support UK firms to scale,” in order to support fintech growth and “extend the UK’s competitive edge over other leading fintech hubs.”²⁸

Interestingly, the review’s findings suggest that “FCA’s regulatory sandbox is already the busiest sandbox facility in the world.”²⁹ With a view to ensuring, among other things, that the UK retains its competitive edge in fintech, the Kalifa Review explores how sandbox initiatives can help to further promote the UK fintech sector and what steps must be taken to “enhance” the regulatory sandbox going forward. This includes, for example, making the regulatory sandbox permanently open for applications (rather than operating on a cohort basis), creating a dedicated space for identified “priority fintech areas” and introducing a “scalebox” to support fintech companies at the growth stage. In addition, the Kalifa Review recommended that the digital sandbox should be made permanent and that, in the longer term, it may be housed with an independent, non-regulatory body, with the participation of the FCA.

Overall, this demonstrates the UK’s commitment to further develop and support sandbox initiatives going forward, with a view to fostering competition and innovation in the financial services sector and promoting the UK as a global hub for fintech. It also shows that this form of collaboration between public sector bodies and market participants can deliver value for both the regulator and firms, by enhancing the understanding of emerging regulatory issues and providing a hub to explore how technology and innovation can help build more inclusive, progressive and potentially safer financial markets. ■

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27 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/978396/KalifaReviewofUKFintech01.pdf.

28 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/978396/KalifaReviewofUKFintech01.pdf.

29 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/978396/KalifaReviewofUKFintech01.pdf.

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