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The Sandbox Paradox

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Table of Contents

I.	What are regulatory sandboxes and how do they work?	3
a.	What is a regulatory sandbox?	3
b.	How do regulatory sandboxes work	3
i.	Sandbox purpose	3
ii.	Entry criteria and process	6
iii.	Relief offered.....	9
c.	Potential costs of a regulatory sandbox	10
i.	Taxing scarce regulatory resources	10
ii.	Consumer protection	11
II.	The risk of economic privilege in regulatory sandboxes	11
III.	The cost of economic privilege.....	14
a.	Governmentally granted economic privilege is unjust.	15
b.	Governmentally granted economic privilege distorts the market	15
c.	Governmentally granted economic privilege could lead to regulatory capture	16
IV.	How to mitigate the risk of sandbox privilege.....	18
a.	Lack of access	18
b.	Differential treatment.....	19
V.	Conclusion	20

Introduction

In recent years, a new regulatory concept commonly referred to as a “regulatory sandbox” has gained a great deal of attention from regulators, regulatory scholars, and those engaged in the provision of financial services. While these experimental regimes can vary significantly in their design, regulatory sandboxes can generally be defined as a legal construct that allows firms to offer products or services for a limited time to a limited number of customers in a modified regulatory environment in order to allow the firm to test out a product or service before it is broadly offered. Firms within these sandboxes usually receive some combination of reduced regulatory burdens, limitations on regulatory liability, increased communication with and advice from regulators, and expedited regulatory decisions. These sandboxes are perhaps most prevalent in the field of financial technology, often referred to as “FinTech.”

The United Kingdom’s Financial Conduct Authority (FCA) launched the first regulatory sandbox centered around FinTech in June 2016, as part of an initiative known as Project Innovate.¹ Shortly thereafter, Singapore and Australia implemented their own regulatory sandboxes aimed at promoting the creation and development of FinTech within their jurisdictions.² Singapore has even recently proposed implementing new regulatory sandboxes focused on fast tracking the approval process for experimental products as a way to complement their existing sandbox.³ In 2018, Arizona became the first jurisdiction or regulatory body within the United States to create a financial regulatory sandbox.⁴ Wyoming and Utah followed suit in 2019.⁵ Finally, in 2019 the Consumer Financial Protection Bureau (CFPB)⁶ finalized its own proposal for the first federal regulatory sandbox within the United States.⁷ More and more, legislative and regulatory bodies are considering the adoption of regulatory sandboxes as a way to gain a competitive advantage for their jurisdiction when it comes to entrepreneurialism and innovation within the financial sphere.

¹ *Regulatory Sandbox*, Financial Conduct Authority, <https://www.fca.org.uk/firms/regulatory-sandbox>.

² *FinTech Regulatory Sandbox*, Monetary Authority of Singapore, <http://www.mas.gov.sg/Singapore-Financial-Centre/Smart-Financial-Centre/FinTech-Regulatory-Sandbox.aspx>; *Regulatory Sandbox*, Australian Securities & Investments Commission, <https://asic.gov.au/for-business/your-business/innovation-hub/regulatory-sandbox/>.

³ *MAS Proposes New Regulatory Sandbox with Fast-Track Approvals*, Monetary Authority of Singapore, <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2018/MAS-Proposes-New-Regulatory-Sandbox-with-FastTrack-Approvals.aspx>.

⁴ *Arizona Becomes First State in U.S. to Offer Fintech Regulatory Sandbox*, Arizona Attorney General, <https://www.azag.gov/press-release/arizona-becomes-first-state-us-offer-fintech-regulatory-sandbox>.

⁵ Anthony C. Kaye, *Wyoming Creates Fintech Sandbox*, NATIONAL LAW REVIEW, Jun. 6, 2019, <https://www.natlawreview.com/article/wyoming-creates-fintech-sandbox>; Allen S. Li, *Utah Passes the Third State-Run “Sandbox” for Innovative Financial Products and Services*, NATIONAL LAW REVIEW, Aug. 1, 2019, <https://www.natlawreview.com/article/utah-passes-third-state-run-sandbox-innovative-financial-products-and-services>.

⁶ There has been debate within the Bureau over whether it is the Consumer Financial Protection Bureau (CFPB) or the Bureau of Consumer Financial Protection (BCFP), but both of these refer to the same entity. We will refer to it as the CFPB in this paper.

⁷ Policy on the Compliance Assistance Sandbox, 84 Fed. Reg. 48,246 (Sept. 13, 2019).

While regulatory sandboxes have generated considerable excitement among some policy scholars as a way to promote entrepreneurship and innovation within a segment of the economy burdened by heavily restrictive regulation while keeping comprehensive consumer protection and regulatory oversight mechanisms in place, there are concerns as well. The most obvious concern is that sandboxes may pose a risk to consumers or reflect a “race to the bottom.”⁸ The concern is that firms faced with reduced liability or regulatory burden may be more likely to make riskier decisions in the pursuit of profit that could ultimately harm consumers. This is where most of the criticism levied against regulatory sandboxes has been focused.

However, these sandboxes also pose another risk that has not received the same level of attention within the literature or public discourse. In addition to promoting innovation within the financial sphere, regulatory sandboxes have the potential to give certain economic privileges to specific firms without extending those same privileges to other, similarly situated, firms. Typically, only certain firms, or types of firms, are approved by regulators and allowed to participate in the sandbox. Because regulatory sandboxes, by design, reduce the regulatory costs that an admitted firm incurs, firms approved to participate in the sandbox may receive an advantage over their non-approved competitors. This governmentally granted economic privilege is an aspect of regulatory sandboxes that has been underdeveloped by regulatory and policy scholars.

Critical analysis of regulatory sandboxes are almost always based around a concern for consumer protection. The goal of this paper is to look at the structure of regulatory sandboxes and examine the possible sources of governmentally granted economic privilege as well as the potential costs associated with this privilege. This paper will then propose best practices that policy makers can use to reduce the potential for economic privilege and mitigate the costs associated with it. This paper should not be construed as arguing that the risk of this economic privilege outweighs the benefits created by regulatory sandboxes, only that this risk exists and should be thoroughly considered as regulatory sandboxes become more and more prevalent.

Part I of this paper provides an overview of the current regulatory sandboxes that exist in various jurisdictions, both in and outside the United States, and the aspects of their design that have an impact on the potential for government-granted privilege. Specifically we will focus on the regulatory sandboxes already established in the United Kingdom, Australia, Arizona, Utah, and the CFPB. Part II of this paper analyzes the ways in which these regulatory sandboxes have the potential to create economic privileges for certain firms or industries. Part III discusses the potential costs associated with this economic privilege including notions of fairness and justice, the effect of economic privilege on market signals and competition, and the potential it creates for cronyism and favoritism. Part IV of this paper considers some of the ways in which regulators might mitigate these potential costs and the risk of cronyism. It also details best practices that regulators could follow to minimize this risk as much as possible. Part V concludes.

⁸ One public comment filed by a collection of consumer advocacy groups referred to the CFPB's proposal as “a Sahara desert parched of consumer protections.” Linda Jun, *NAL Product Sandbox Comments-Consumer Groups Final*, Americans for Financial Reform Education Fund (Feb. 2019) <https://www.regulations.gov/document?D=CFPB-2018-0042-0026>.

- I. What are regulatory sandboxes and how do they work?
 - a. What is a regulatory sandbox?

The term “regulatory sandbox” is a broad concept that encapsulates a wide variety of newly emerging regulatory regimes, primarily in the financial sector. Its precise definition will vary depending on the jurisdiction using it and the regulatory regime they have created.⁹ For the purposes of this article, we define a regulatory sandbox as a legal construct that allows firms to offer products or services for a limited time to a limited number of customers in a modified regulatory environment in order to allow the firm to test out a product or service before it is broadly offered.

Regulatory sandboxes differ from general regulatory reform in that the relief provided by a sandbox only applies to specific firms on a case-by-case basis and is only in effect for a limited period. Additionally, sandboxes frequently include an expectation of increased transparency where the regulator is able to monitor or review the participating firms’ actions and progress as a way to learn, while broad rules based changes do not generally provide such an opportunity.

- b. How do regulatory sandboxes work

While the design of sandboxes varies across jurisdictions, they frequently share certain common criteria. Where there is differentiation between jurisdictions, it might be the result of differing policy preferences or differences in the authority held by the administrative bodies. The type of relief offered by a regulatory body is constrained by the type of relief they are empowered to offer. This section will discuss the common criteria and processes found in sandboxes, as well as the differences. This section will analyze a variety of different sandboxes including: the United Kingdom’s Financial Conduct Authority’s (FCA) “Project Innovate” sandbox; the Australian Securities Investments Commission’s (ASIC) Fintech Licensing Exemption; the State of Arizona’s FinTech sandbox administered by the Arizona Attorney General’s office; the State of Utah’s regulatory sandbox administered by the Utah Department of Commerce; and the CFPB’s Compliance Assistance Sandbox (CAS).

- i. Sandbox purpose

Jurisdictions create regulatory sandboxes to further specific policy objectives. While there is frequently significant similarity in purpose across jurisdictions, especially with regard to the goal of encouraging innovation, there can also be differences that arise from the mandates placed upon the various regulators overseeing the sandboxes as well as the economic and policy goals of the different jurisdictions.

⁹ United Nations Secretary-General’s Special Advocate for Inclusive Finance for Development, *Early Lessons on Regulatory Innovations to Enable Inclusive Fintech: Innovation Offices, Regulatory Sandboxes, and RegTech 26*, (2019) (Hereinafter UN Report).

1. Innovation

Unsurprisingly, encouraging innovation and entrepreneurialism is one of the most frequently cited goals for regulatory sandboxes. For example, the FCA established its sandbox in part to support “disruptive innovation” in the market for financial services by helping to reduce the regulatory uncertainty that the FCA believes inhibits the ability of innovative products to reach the market.¹⁰ Likewise, the ASIC’s Innovation Hub project, which includes their sandbox, seeks to “foster innovation that could benefit consumers by helping Australian FinTech startups navigate [Australia’s] regulatory system.”¹¹ Arizona established its sandbox to “encourage businesses to develop innovative products and services in the financial services sector.”¹² Likewise, Utah created their sandbox to attract “innovative products and services to Utah’s financial services sector.”¹³ Finally, the CFPB pursued their CAS in part in furtherance of their mission to “facilitate access and innovation” when it comes to financial services.¹⁴

2. Consumer benefit and protection

Of course, innovation is not an end in itself but is rather a means to obtaining the benefits that come along with innovation. One of those benefits is the protection of consumers. The CFPB explicitly justifies their CAS on the grounds that innovation leads to a number of benefits for consumers¹⁵ including increasing competition, lowering prices, and increasing access to more and better financial services.¹⁶ Likewise, the FCA believes that its sandbox will benefit consumers by facilitating “an increased range of products and services, reduced costs, and improved access to financial services.”¹⁷ The ASIC’s sandbox comes out of the agencies commitment to “encouraging and facilitating innovation in financial services and credit *where this is likely to produce good outcomes for investors and financial consumers.*”¹⁸ Arizona’s sandbox is intended to help foster innovation aimed at making financial products and services *more available, affordable, and safe for consumers.*¹⁹ In all of these cases, it is the explicit intention that innovation will bring about benefits and protections for consumers. For its part, Utah’s sandbox requires applicants to describe how their product will benefit consumers as a criterion for evaluation when seeking entry to the sandbox.²⁰

¹⁰ See *supra* note 1.

¹¹ *Innovation Hub*, ASIC, <https://asic.gov.au/for-business/your-business/innovation-hub/>.

¹² *Frequently Asked Questions*, Arizona Attorney General Mark Brnovich, <https://www.azag.gov/fintech/faq>

¹³ *Regulatory Sandbox*, State of Utah Department of Commerce, <https://commerce.utah.gov/sandbox.html>

¹⁴ See *supra* note 7.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ See *supra* note 1.

¹⁸ Australian Securities & Investments Commission Regulatory Guide 257, *Testing FinTech products and services without holding an AFS or credit license* 4, August 2017, <https://download.asic.gov.au/media/4420907/rg257-published-23-august-2017.pdf>

¹⁹ See *supra* note 12.

²⁰ Utah Code Annotated § 13-55-103(3)(f)(ii).

3. Regulatory access and knowledge sharing

Another goal driving the creation of sandboxes is their potential to allow regulators to get access to innovations early in their life cycle, allowing regulators to gain a better understanding of the products and services they are tasked with regulating and giving them the ability to encourage “responsible” development. This access is obtained by the communication with, and supervision of, entrepreneurs that the sandbox structure usually provides.²¹ The FCA notes that their sandbox will allow the FCA to work with firms to insure that the firms’ products and services are built with appropriate consumer protections before they are released more broadly.²² The ASIC operates its sandbox somewhat differently from most other examples.²³ The ASIC requests that firms using the sandbox submit an after-action report, in part to help the ASIC identify “key risks or issues faced by testing businesses and consumers.”²⁴

4. Industry support and economic development

Sandboxes can be established with a variety of different goals. Many of the goals of sandboxes are aimed at benefiting consumers, either directly through more and better products or indirectly through a more educated and effective regulator. Other sandboxes are explicitly aimed at supporting the development of the “FinTech” industry, specific types of firms within it, and economic development more generally.

Supporting innovative firms directly by helping them speed up their path to market and attract investors more easily, serves as an explicit justification for a sandbox in some jurisdictions. For example, the FCA’s sandbox is justified in part by the FCA’s desire to help provide innovative firms with a way to reach the market at a lower cost and receive improved access to investment.²⁵ On the last point, the FCA notes that regulatory uncertainty can serve as a barrier to firms obtaining investment, and can lead to lower valuations, because investors have to consider regulatory risk that is difficult for them to assess.²⁶ When a sandbox is able to reduce that regulatory risk for a specific firm, it increases the potential value of the firm for a potential investor, as they no longer have to bear the compliance costs associated with that risk. The ASIC also views improving innovative firms speed to market and access to capital as goals of their sandbox.²⁷ The ASIC believes that a lack of access to capital can become a consumer protection issue to the extent a lack of funds forces firms to race to market without taking the steps

²¹ Dirk A Zetsche, Ross P. Buckley, Janos N. Barberis, and Douglas W. Arner, *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation*, 23 FORDHAM J. CORP. & FIN. L. 31, 78 (2017); UN Report p. 27; Hilary J. Allen, *Regulatory Sandboxes* 87 GEO. WASH. L. REV. 579, 614-16 (2019).

²² See *supra* note 1.

²³ See section I(b)(ii)(4)

²⁴ See *supra* note 18, at 31.

²⁵ See *supra* note 1.

²⁶ *Id.*

²⁷ See *supra* note 18, at 7.

necessary to confirm they are actually ready to operate their business in a safe and appropriate manner or hire people with appropriate experience and competence.²⁸

Regulators also use sandboxes to make their jurisdiction more attractive to potential firms, with the expectation that it will result in more jobs and tax revenue within their jurisdiction. The FCA views its sandbox as a tool to “ensure that we [The United Kingdom] continue to be an attractive market [for innovative financial firms] with an appropriate regulatory framework.”²⁹ Arizona established its sandbox in part to “encourage businesses to develop innovative products and services in the financial services sector [In Arizona]” and “sent a strong message that Arizona is leading the way in fostering innovation aimed at making financial products and services more available, affordable, and safe for consumers.”³⁰ Likewise, Utah cites a desire to attract “innovative products and services to Utah’s financial services sector.”³¹

This support for industry has borne fruit in some cases. For example, the FCA has reported that “At least 40% of firms which completed testing in the first cohort received investment during or following their sandbox tests.”³² However, participation in a sandbox is not a guarantee of success as evidenced by the fact that a nontrivial number of firms using sandboxes end up failing or becoming insolvent.³³

ii. Entry criteria and process

Sandboxes are limited regulatory environments that only apply in certain circumstances in order to further the sandboxes’ stated purposes. As such, entry is usually predicated on some sort of criteria a firm needs to meet in order to qualify. Unsurprisingly, this criteria is generally tied to the underlying purpose of the sandbox, but it can also reflect other concerns, such as the need to preserve scarce regulatory resources. Entry criteria present an important inflection point for the risk that the sandbox will become a source for undue regulatory advantage because an excessively exclusory set of criteria will make it more likely that the sandbox underserves the relevant market and extends its benefits too narrowly.

1. Firm characteristics

Different jurisdictions place different requirements on firms which seek to enter the sandbox. The FCA sandbox for example is open exclusively to FCA regulated firms, firms normally regulated by the FCA but lacking a license, and service providers of FCA regulated firms.³⁴ Utah

²⁸ *Id.*

²⁹ *See supra* note 1.

³⁰ *See supra* note 12.

³¹ *See supra* note 13.

³² *Regulatory Sandbox Lessons Learned Report*, Financial Conduct Authority, Oct. 2017, <https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf>.

³³ Ross P. Buckley, Douglas Arner, Robin Veidt, and Dirk Zetsche, *Building Fintech Ecosystems: Regulatory Sandboxes, Innovation Hubs and Beyond*, University of New South Wales Law Research Series Paper 72 (2019) p.4, n. 5.

³⁴ *Applying to the Regulatory Sandbox*, Financial Conduct Authority, Jun. 16, 2017, <https://www.fca.org.uk/firms/regulatory-sandbox/prepare-application>.

opens its sandbox to firms that are subject to Utah’s jurisdiction, have a physical office within Utah where testing will be conducted and will serve as a repository for books and records, and meets certain requirements with regard to its management team and ability to adequately conduct its test.³⁵ Arizona likewise requires that the firm be subject to the Arizona Attorney General’s jurisdiction and have a “physical or virtual” location accessible to the Attorney General’s office where testing will be conducted and records will be maintained.³⁶ The CFPB does not impose specific requirements on the types of firms that can apply for its sandbox, though they must presumably be subject to the CFPB’s jurisdiction or intend to work with firms who are.³⁷

2. Product characteristics

Much like the requirements placed on firms, most jurisdictions establish requirements where products must meet certain characteristics before they can be tested in a regulatory sandbox. Limiting the type of products that can be tested can be a result of limits in the regulator’s jurisdiction, specific policy objectives (e.g. a desire to attract certain type of businesses or concerns about consumer protection), and efforts to conserve scarce regulatory resources.

Many of the requirements are uncontroversial. For example, the FCA requires that a product seeking to enter the sandbox be “in scope”, which means that it is the type of product an FCA regulated company would offer or purchase.³⁸ Likewise, the CFPB’s sandbox is broad as to what types of products can be tested.³⁹ Conversely, Arizona limits its sandbox to “money transmission, consumer lending, and investment advice.”⁴⁰ The FCA also requires that the product be in a position to be tested.⁴¹

All of this makes sense, accepting a product outside of the regulator’s jurisdiction would be a waste of the regulator’s resources as well as the firm’s time, since the regulator is not in a position to grant meaningful relief or gain useful knowledge from the experiment.

Other criteria can be more controversial and potentially problematic. For example, the FCA, Arizona, Australia, and Utah all require that a product be “innovative” to qualify for admission.⁴² The definition of “innovative” varies by jurisdiction. The FCA favors products that are new or significantly different from those that are currently offered and disfavors products that have numerous comparable competitors.⁴³ Arizona and Utah also look to see if there are other comparable products widely available within the state. In addition, they both require the innovation to have a new technology or new use of an existing technology.⁴⁴ The ASIC expects firms to be new and innovative and excludes firms whose products are considered insufficiently

³⁵ Utah Code Annotated § 13-55-103(3)(a-e) (2018).

³⁶ A.R.S. § 41-5603(C)(2).

³⁷ See generally *supra* note 7.

³⁸ See *supra* note 34.

³⁹ See *supra* note 7.

⁴⁰ Buckley, *supra* note 33, at 10-11.

⁴¹ See *supra* note 34.

⁴² *Id.*; A.R.S. § 41-5601; Utah Code Annotated § 13-55-104(2); *supra* note 18, at 17.

⁴³ See *supra* note 34.

⁴⁴ A.R.S. § 41-5601; Utah Code Annotated § 13-55-102(7)

innovative or fail to use technology adequately.⁴⁵ Depending on how strictly the technology and uniqueness requirements are interpreted, there is a risk that innovative but non-first mover firms might be blocked from entry. Further, this requirement empowers regulators to determine just what counts as “innovative,” a decision they are likely ill equipped to evaluate.⁴⁶

In contrast, the CFPB’s sandbox does not contain a technological component when considering whether a product is eligible,⁴⁷ nor does it appear to require that the product be unique.⁴⁸ In fact, the CFPB’s sandbox makes provision for substantially similar products to apply based on the publically available information of an existing sandbox product.⁴⁹ Utah makes a similar provision where a competitor participating in the sandbox is to be considered as a factor in favor of admitting a firm.⁵⁰

Many sandboxes also impose some limit as to the number of customers that can access the product. For example, the FCA will negotiate limits with the firm at the time of application⁵¹ and Arizona limits the number of customers, size of individual transaction, and size of aggregate transactions per customer that the firm may perform while within the sandbox.⁵² Utah grants its regulator the discretion to set limits on the number of customers allowed to experiment with a specific sandboxed product and dollar limits the firm must adhere to.⁵³

3. Entry process

The FCA, Arizona, Utah, and the CFPB all require firms to apply to access their respective sandboxes.⁵⁴ As part of the application process, the firm will generally be required to provide: details about the firm; the product or service they seek to test; what sort of question or regulatory uncertainty they seek to address through the use of the sandbox; how the product can benefit consumers; what form of regulatory relief or clarity the firm is seeking; and how the firm plans to protect consumers.⁵⁵

Once the application is submitted, the regulator evaluates the application. Regulators in Arizona, Utah, and at the CFPB must review and decide on application within a limited timeframe (90 days for Arizona and Utah with the possibility of a mutually agreed upon extension,⁵⁶ 60 days for the CFPB with the understanding that extenuating circumstances may increase the time required.⁵⁷). Regulators generally have broad discretion as to whether to grant an application or

⁴⁵ See *supra* note 18, at 17.

⁴⁶ Buckley, *supra* note 33, at 9.

⁴⁷ See *supra* note 7.

⁴⁸ *Id.* (Listing evaluation criteria for application, which do not include a uniqueness component.)

⁴⁹ *Id.*

⁵⁰ Utah Code Annotated § 13-55-103(10)

⁵¹ See *supra* note 1, at 11.

⁵² A.R.S. § 41-5605(B)(3); A.R.S. § 41-5605(B)(4); A.R.S. § 41-5605(C)(1-2).

⁵³ Utah Code Annotated § 13-55-104(2)(b-d).

⁵⁴ See *supra* note 34; A.R.S. § 41-5603; Utah Code Ann. § 13-55-103; 84 FR 48246(VIII)(B).

⁵⁵ See *supra* note 34.; A.R.S. § 41-5603(F); Utah Code Ann. § 13-55-103(3); 84 FR 48246(VIII)(B).

⁵⁶ A.R.S. § 41-5603(I); Utah Code Annotated 13-55-103(7-8).

⁵⁷ See *supra* note 7.

not,⁵⁸ though Utah at least requires the regulator to provide a written description of the reasons for the rejection.⁵⁹

4. Australia as exception

The ASIC sandbox differs considerably from the FCA, Arizona, Utah, or CFPB sandboxes, in that it does not require the regulator to approve the firm before the firm can take advantage of the sandbox. As Zetzsche, Buckley, Barberis, and Arner argue, the ASIC “sandbox” may serve, at least in part, as more of a “class waiver” for a broad swath of FinTech firms who meet certain criteria rather than a traditional sandbox.⁶⁰ In addition to programs that provide firm-specific relief the ASIC’s “Fintech Licensing Exemption” allows qualifying firms to test certain products in the market for a limited period of time without obtaining a license that would otherwise be required.⁶¹

While the ASIC Fintech Licensing Exemption lacks a front-loaded application process, the firm is still required to notify the ASIC that it intends to take advantage of the exemption as well as provide the ASIC with information to show that the firm meets the necessary qualifications. This requirement includes information on the firm’s business model, the firm’s management, and the firm’s insurance coverage and membership in a dispute resolution regime.⁶² While the ASIC Fintech Licensing Exemption lacks the firm-by-firm discretion of other sandboxes it has more proscriptive requirements that firms must satisfy, including limiting the number of customers and amount of value transacted as well as requiring that the firm have adequate resources to compensate customers in the event of mishap and making certain disclosures to customers.⁶³

iii. Relief offered

The type of relief a sandbox will offer will depend on the policy goals that led to its establishment as well as the powers held by the administering regulator. For example, the FCA operates with broad authority as both a licensing and conduct regulator with a competition mandate. Therefore the FCA can offer multiple forms of relief ranging from restricted authorization (a sort of learner’s permit), to no action letters, rule waivers and modifications, and individual guidance.⁶⁴ Conversely, both Utah and Arizona explicitly state they will not provide firms with legal advice.⁶⁵ Rather, relevant regulators in Arizona and Utah provide firms with a limited license to test their product or service.⁶⁶ The ASIC Fintech Licensing Exemption serves to remove the need, at least temporarily, for a license to allow firms to test their products and

⁵⁸ See *supra* note 7; Utah Code Annotated § 13-55-103(12)(a); A.R.S. § 41-5603(J);

⁵⁹ Utah Code Annotated § 13-55-103(12)(b)

⁶⁰ Buckley, *supra* note 33, at 82-83.

⁶¹ See *supra* note 18, at 15.

⁶² *Id.* at 29-30.

⁶³ *Id.* at 22-26.

⁶⁴ *Sandbox Tools*, Financial Conduct Authority, Dec. 15, 2017, <https://www.fca.org.uk/firms/regulatory-sandbox/sandbox-tools>.

⁶⁵ See *supra* note 13; See *supra* note 12.

⁶⁶ Utah Code Annotated § 13-55-103(2)(b); A.R.S. § 41-5602

services.⁶⁷ In addition, the ASIC offers other forms of relief including a waiver of certain rules and regulations.⁶⁸

While the FCA, Arizona, Utah, and the ASIC are all licensing bodies, and can therefore offer limited access licenses or temporarily waive the licensing requirement, the CFPB does not license. As such, it cannot provide a limited purpose license. Instead, the CFPB provides firms with a Compliance Assistance Statement of Terms (CAST) that will provide firms with CFPB approval for a particular offering provided it meets the requirements stipulated in the CAST.⁶⁹ Approval means that the CFPB believes that the product or service is in compliance with the law and that the firm will have a safe-harbor from liability so long as it remains in compliance with the requirements set forth in the CAST.⁷⁰

An additional limitation to the scope of relief that can be offered exists if there are regulators with overlapping jurisdictions. For example, a firm obtaining relief from the Arizona or Utah sandbox will still need to worry about federal regulators, including the CFPB, since Arizona and Utah cannot bind the federal government. While the CFPB has a process for entering into agreements with other jurisdictions⁷¹ and says that it plans to coordinate with other regulatory bodies for the purposes of its Compliance Assistance Sandbox, it is not guaranteed that it will do so.

c. Potential costs of a regulatory sandbox

While regulatory sandboxes have been adopted to obtain certain potential gains there are also concerns about risks and costs posed by sandboxes. While some cost is inevitable, since a sandbox will require scarce regulatory resources to administer, other potential risks, such as risks to consumer protection, are more speculative or susceptible to mitigation. This section will briefly discuss some of the potential costs of a regulatory sandbox.

i. Taxing scarce regulatory resources

Regulatory sandboxes are generally “high touch” affairs where the regulator and the participating firms engage in significant interaction. This interaction requires adequate staffing and resources to achieve, with sandboxes typically taking six months and significant staff time to develop.⁷² Sandbox staff can also become overwhelmed by applications and requests if there is strong demand from the market.⁷³ Concerns have been raised that regulatory sandboxes will be

⁶⁷ *Fintech Regulatory Sandbox*, ASIC, <https://asic.gov.au/for-business/innovation-hub/fintech-regulatory-sandbox/>.

⁶⁸ *Id.*

⁶⁹ *See supra* note 7.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² UN Report at 30.

⁷³ *Id.*

inordinately resource intensive relative to their value, and that they may cause regulators to divert resources that could be better deployed elsewhere, such as more general innovation hubs.⁷⁴

ii. Consumer protection

Concerns have been raised that regulatory sandboxes will become “consumer protection desert[s]”⁷⁵ where consumers will lose the protection of regulation and be left vulnerable.⁷⁶ Regulators may also misjudge the success of an experiment and allow an unduly risky product onto the market. Further, there is concern that sandboxes could lead to a “race to the bottom” where, in an effort to become more attractive to innovative firms, jurisdictions progressively expand the scope of the sandbox and reduce the amount of regulations that apply to firms.⁷⁷ How much of a risk this actually is has yet to be determined. Many sandbox regimes, including those discussed above, explicitly include consumer protection concerns in their requirements for entry. For example, Australia requires firms carry adequate insurance to compensate consumers who are harmed⁷⁸ and Utah and Arizona require firms to detail how they will protect consumers in the event of a failure.⁷⁹ How effective these requirements will prove to be will depend on the quality of execution on the part of regulators.

II. The risk of economic privilege in regulatory sandboxes

As described above, the leading regulatory sandboxes seek to make it easier for firms to test new products and services, with the goal of encouraging competition, innovation, and access within the financial sector.⁸⁰ Regulatory sandboxes work towards this goal by granting specific firms authorization to test new products and services without having to go through the traditional licensing process and by waiving certain legal and regulatory requirements or limiting a firm’s potential legal liability.⁸¹ While trying to promote entrepreneurialism and innovation in a sector

⁷⁴ *Id.* at 30-31

⁷⁵ Lauren Saunders, *Are Fintech Sandboxes A Consumer Protection Desert?*, Nov. 29, 2018, <https://thehill.com/blogs/congress-blog/economy-budget/418770-Are-fintech-sandboxes-a-consumer-protection-desert%3F>

⁷⁶ *See supra* note 8; *See also* comment from 22 State Attorneys General, [file:///C:/Users/tmitchell/Downloads/CFPB NAL and sandbox comment \(FINAL\).pdf](file:///C:/Users/tmitchell/Downloads/CFPB%20NAL%20and%20sandbox%20comment%20(FINAL).pdf) (“The Proposed Policies do not reflect [a cautious and deliberative regulatory] approach. Instead, they would permit the CFPB to exempt – in some cases indefinitely – companies and even entire industries from certain consumer protection laws and regulations through a process designed to value speed over careful decision-making.”)

⁷⁷ Jemima Kelly, *A “fintech sandbox” might sound like a harmless idea. It’s Not.*, FINANCIAL TIMES ALPHAVILLE, December 5, 2018, <https://ftalphaville.ft.com/2018/12/05/1543986004000/A-fintech-sandbox-might-sound-like-a-harmless-idea-It-s-not/> (“Worryingly, there now appears to be a kind of race to the bottom among global regulators to set up the most “light-touch” possible regimes so as to attract start-ups to their jurisdictions — whether or not they are offering consumers and investors anything useful. Sandboxes are a part of that.”).

⁷⁸ *See supra* note 18.

⁷⁹ Utah Code Annotated § 13-55-103(3)(f)(VIII); A.R.S. § 41-5603(F)(3)(g).

⁸⁰ *See* section I.

⁸¹ *Id.*

burdened by heavily restrictive regulatory requirements is a noble goal, it also presents a potential problem. What happens to the firms that are not admitted into the sandbox?

In a competitive market, a benefit granted to one firm can be a blow to that firm's competitors. This is because firms are usually competing with each other for market power and so a benefit given to one firm that makes it easier or cheaper for them to obtain a larger share of the market is ultimately a detriment to all of their competitors. Therefore, anytime a regulator helps a specific firm it potentially harms all of the other firms within the industry that did not receive the same benefit.

This is not just a problem for the admitted firm's competitors; it also harms overall market competition, which in turn can reduce the benefits gained by consumers. In addition, when the government allows only one firm to experiment with a particular product or service it gives that firm, at least for a limited period of time, monopolistic control over that product or service, which can lead to worse outcomes for consumers.⁸² Herein lies the paradox – to make applying for and entering a regulatory sandbox worthwhile, it must provide some benefit to the firms operating inside it. However, those benefits may then harm overall market competition by disadvantaging firms outside of the sandbox, which can be detrimental for both the other competing firms within the sector and ultimately consumers.

The exact nature of the potential advantage will depend on the structure of the sandbox and the advantages it offers. For example, making it easier for firm A to obtain a limited use license for testing a new product or service can harm incumbent firm B who was not able to obtain the limited use license. Firm B is now compelled to spend the time, money, and effort necessary to obtain a full license. All the while, firm A is already establishing a customer base and gaining, what is commonly referred to as, the "first mover advantage."⁸³ This redirects investment resources that could have been spent on research and development or marketing. While at a fixed point in time firm B may seem to be advantaged as an incumbent, over the life of the firms, A's smoother entry point may lead to a long-term advantage.

To the extent that entry into the sandbox is limited on the basis of a product or service's innovative nature or novelty, as for example in the regulatory sandboxes established by Australia and Arizona, a new firm that competes in a space but offers a more traditional product may not be able to get a testing license. This would serve as a marked advantage for firms seeking to offer new and innovative products over firms offering products and services that are more traditional.

Making admittance into the sandbox contingent on a products novel or innovative nature may be justified on the grounds that more traditional firms lack the regulatory uncertainty that is associated with innovative new products or services. It may also make sense because the stated

⁸² Matthew D. Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism*, MERCATUS CENTER (2012) ("When a government grants one firm a monopoly, however, there is no discipline. The firm will possess pricing power that a competitive firm lacks. It need not accept the price that would emerge in a competitive market and is instead said to be a "price maker." If the firm is interested in maximizing its profit, it will set a higher price than that which would prevail in a competitive industry.").

⁸³ See generally Roger A. Kerin, P. Rajan Varadarajan & Robert A. Peterson, *First-Mover Advantage: A Synthesis, Conceptual Framework, and Research Propositions*, 56 J. of Marketing 33 (1992).

purpose of many of these sandboxes is to encourage entrepreneurialism and innovation. However, there are countervailing concerns that may outweigh these justifications. First, there may be sources of regulatory uncertainty that do not arise from developments in technology or the novel nature of a product or service. In those cases, a firm might very well benefit from a trial period but still not meet the entry criteria necessary to gain admittance into a specific sandbox.

Additionally, because a firm admitted into a sandbox can bring their product to market more quickly than their non-admitted rivals, it can give admitted firms a head start over their more traditional competitors. Admitted firms can start working on brand creation and begin to develop customer loyalty by serving customers successfully during the trial, while their non-admitted counterparts are still navigating the standard regulatory process.

In a similar vein, the exposure gained by firms within the sandbox may make it easier for them to find and obtain investment compared to non-sandbox rivals. As Jemima Kelly points out in the Financial Times Alphaville, there is a risk that participation in the sandbox becomes a form of government provided public relations for those firms lucky enough to gain admittance.⁸⁴ If investors see that a firm has participated in a sandbox, it can signal a number of things. First, it can signal that the firm is engaging in innovative and entrepreneurial activities to stay ahead of the competition. This is especially true if regulators restrict sandbox entry to novel products and services. Second, it can signal that regulators have reviewed a firm and have found that firm to be stable and capable of expansion. In a similar vein, it can signal that regulators view a firm favorably, which can affect an investor's view regarding that firm's regulatory liability.

Likewise, there is a risk that the regulators behind the sandbox become government provided legal or consulting advisors for the accepted firms. "Informal steers" and other non-public guidance could allow firms in the sandbox to obtain a great benefit from the regulator while a non-sandbox firm would need to hire a law firm, and even then the non-sandbox firm would lack the certainty provided by getting the answer straight from the regulator's mouth. This is not to say that it is bad for regulators to provide guidance and clarity, in fact this is generally a good thing, but if the benefit falls unequally on some participants, it can advantage those firms at the expense of others.

There are also risks of unequal treatment with regard to enforcement to the extent that the sandbox limits regulatory exposure. For example, the CFPB's sandbox provides mechanisms for firms to eliminate risk of liability for certain activities if the CFPB grants approval relief.⁸⁵ While this is not necessarily objectionable *per se* if the firm's conduct is consistent with the law and should not be subject to liability, the risk is that because firms must obtain the relief from the CFPB directly and at the CFPB's discretion, firms may face different liability risks for comparable behavior depending on whether they went through the sandbox process. This can be a significant advantage as litigation is a costly and time-consuming endeavor that can hinder a firm's ability to compete effectively.

⁸⁴ Jemima Kelly, *A "fintech sandbox" might sound like a harmless idea. It's Not*, FINANCIAL TIMES ALPHAVILLE, December 5, 2018, <https://ftalphaville.ft.com/2018/12/05/1543986004000/A-fintech-sandbox-might-sound-like-a-harmless-idea-It-s-not/>.

⁸⁵ See *supra* note 7.

None of this is to say that regulatory sandboxes are inherently bad or undesirable. To the extent they facilitate better understanding of regulation, more entry, more competition, and more innovation they can benefit consumers, and that is valuable. However, there are also potential risks that can have a detrimental effect on competitors and the market as a whole.

III. The cost of economic privilege

As discussed above, regulatory sandboxes have the potential to create a form of governmentally granted economic privilege that is not enjoyed by firms outside of the sandbox. This is an issue for several reasons. For one thing, it can be considered unjust for the government to empower certain firms at the expense of other firms. When the government engages in the business of picking winners and losers it goes against the notions of the rule of law, equal rights, and the generality principle.⁸⁶

In addition, firm specific economic privileges also distort the market and undermine its function as a knowledge process. When the government decides that one firm, or even one industry, should get some form of advantage over another, it gives that firm or industry market power they would not naturally have. This can make comparatively efficient firms do more poorly in the market than they would have, while comparatively inefficient firms do better. This means that firms can succeed or fail even if pure consumer preference would have led to the opposite outcome. Because individuals rely on these types of market signals to make decisions, governmentally granted economic privilege can lead to the misallocation of resources as well as forgone opportunities for firms and individuals to profit.

Finally, allowing the government to grant privileges to some firms at the expense of other firms opens up the door for cronyism and favoritism in the regulatory process. As the political satirist P.J. O'Rourke once quipped, "When buying and selling are controlled by legislation, the first things to be bought and sold are legislators."⁸⁷ Again, all this is not to say that the costs associated with economic privilege outweigh the benefits that come from increased entrepreneurialism and innovation as a result of regulatory sandboxes. However, these costs do exist, and we should acknowledge them and take them into account when analyzing regulatory sandboxes, and we should work to find methods and best practices to mitigate them when feasible.

⁸⁶ The generality principle was best articulated by the economist James M. Buchanan as "that which modern politics is not. What we observe is 'politics by interest,' whether in the form of explicitly discriminatory treatment (rewarding or punishing) of particular groupings of citizens or of some elitist-dirigiste classification of citizens into the deserving or non-deserving on the basis of a presumed superior wisdom about what is really 'good' for us all. The proper principle for politics is that of generalization of generality." James M. Buchanan & Roger D. Congleton, *Politics by Principle, Not Interest: Toward Nondiscriminatory Democracy* (2003).

⁸⁷ P.J. O'Rourke, *Parliament of Whores-Open Mark*, Vintage Books USA (1992).

a. Governmentally granted economic privilege is unjust.

One of the main issues with governmentally granted economic privilege is that it goes against basic notions of fairness and justice. Why should a bureaucrat be in charge of deciding which firms or individuals do and do not succeed within the market? The concept of equality before the law has long been a core component of the western legal tradition. It is the main principle underlying the Equal Protection clause of the Fourteenth Amendment.⁸⁸ While this principle of legal equality is not often applied to the distributional effects of political decisions, it is not clear exactly why. As the economist James M. Buchanan once asked, “Why should the politics of democracy, either in idealized form or in practice, be different from the law, again as idealized or in substance? Why is discrimination in political action constitutionally permissible whereas discrimination in law is out of bounds?”⁸⁹ Because of a regulator’s decision, a firm that might otherwise be more successful than their competitors could very well do worse. This could lead to some firms succeeding who would have otherwise failed and some firms failing or would have otherwise succeeded. When regulators have broad discretion over whether or not to grant a particular advantage to a firm, this undermines the principles underlying the notion of the rule of law and the generality principle.

In order to make sure that resources are being allocated efficiently, we want individuals and firms to have as much certainty as possible when making decisions based on how they think they will be regulated. Because of the basic notion of fairness, we also hope that similarly situated firms or individuals will not be regulated in highly disparate ways that heavily favor some firms over others. When regulators are given more discretion, people’s certainty surrounding how they think they will be regulated decreases drastically and market participants are often left to the will of a bureaucrat. In this situation, similarly situated firms can face remarkably different regulatory requirements and legal liability. For most people, this disparate treatment feels intuitively unfair.

Defenders of certain forms of governmentally granted economic privilege will argue that there are good reasons for regulators to support or hinder certain firms from time to time. There could be other issues at play that the government is working to address. Other goals it is working to achieve. Giving certain firms advantages over other firms could simply be the inevitable result of an otherwise completely justifiable government policy. For example, after the 2008 financial crises certain banking firms received substantial bailouts while others did not. However, this was justified as a way to stabilize the American economy. As Tim Geithner, former United States Secretary of the Treasury, said, “It wasn't fair. But it was necessary.”⁹⁰ While this may be true, and while there might be justifiable reasons to allow the government to grant specific firms privilege over their competitors in certain situations, it does not change the fact that it is unjust. It may be a necessary evil, but it is still an evil we should work to avoid.

b. Governmentally granted economic privilege distorts the market

⁸⁸ U.S. Const. amend. XIV § 1.

⁸⁹ James M. Buchanan, *Three Amendments: Responsibility, Generality, and Natural Liberty*, Cato Unbound (Dec. 2005).

⁹⁰ Tim Geithner, *Secretary of Treasury Tim Geithner Remarks at Office of Financial Stability Town Hall*, Sep. 2010, <https://www.treasury.gov/press-center/press-releases/Pages/tg866.aspx>.

Another cost associated with governmentally granted economic privilege is that it distorts the market's function as a knowledge process. When consumers decide whether or not to purchase a particular good or service, they are signaling to other market participants that they have a demand for this good or service. This provides information to other market participants on how likely it is that this good or service is of high quality, or at the very least how popular this good or service is amongst other consumers. In an undistorted market, firms can only succeed if they are able to establish consumer demand for their product which brings in enough revenue to outweigh their cost of doing business. When the government begins granting economic privileges, it muddies this signaling function and it becomes difficult for a consumer or an investor to determine whether a firm's success has been earned in the market or granted by a governmental body.

A firm could be doing relatively well, or at least could be perceived as doing relatively well, despite the fact that they would be doing far worse if it were not for their governmentally granted advantages over their rivals. This could allow the firm to bring in more consumers than they would naturally have because of the reputational boost that comes from their unearned market advantage. The result could be that this firm drives higher quality, lower cost, or more innovative competitors out of the market that would have created more benefits for consumers, and the market in general, than their governmentally empowered counterparts. In addition, this advantage could allow a firm to attract new investors that would not have otherwise invested in their firm. Investors could see the short-term economic gain enjoyed by the firm as a result of their unearned economic privilege and choose to invest in them over a competitor who will do better in the long-run. Investors could also view this governmentally granted privilege as the government endorsing certain firms and not others. Government endorsement is valuable because it signals that a regulatory body has likely reviewed this firm to some extent. It could also signal that this firm might have access to some of the government's resources and powers that their competitors do not. This would provide its own type of signaling function that could also lead investors to allocate their resources inefficiently.

All of this has a compounding affect where each benefit gained by a firm as a result of governmentally granted economic privilege gives the firm more resources or market power which then allows the firm to use those resources to obtain more benefits in the future. It becomes a mutually reinforcing cycle. In addition, as firms gain more resources, market power, and political influence through governmentally granted economic privilege, they are often able to obtain even more unearned economic privilege through the political process.

c. Governmentally granted economic privilege could lead to regulatory capture

Allowing regulators to grant certain firms economic privilege without extending that privilege to other firms creates a supply of, and demand for, the economic privilege. This supply of, and demand for, governmentally granted economic privilege could easily lead to rent-seeking behavior. As we have stated above, if a firm is able to obtain governmentally granted economic privilege, this gives them an advantage over the firms that were not able to obtain this privilege. Because it has the potential to give admitted competitors more market power than they would naturally have, this privilege becomes more valuable when it is granted to fewer firms. A firm who has obtained the privilege will want the number of other firms who are granted this privilege to be as small as possible. If they are able to obtain the necessary political power, there is good

reason to believe that they will attempt to limit regulatory sandbox entry to themselves and, potentially, the few firms that they do business with and benefit from.

In 1982, George Stigler won the Nobel Prize in economic science for his work on how regulation is often “captured” by interest groups, industries, or powerful firms and individuals.⁹¹ He argued that the standard “protection of the public” theory of regulation did not sufficiently explain how the regulatory process actually functioned.⁹² Instead, he posited that “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.”⁹³ He went on to say that “every industry or occupation that has enough political power to utilize the state will seek to control entry.”⁹⁴ Further, this theory asserts that even if an industry is not able to obtain regulation that fully prohibits new entry into the industry, “the regulatory policy will often be so fashioned as to retard the rate of growth of new firm.”⁹⁵ This is because restricting competition and erecting barriers to entry within an industry helps incumbent firms gain a larger share of market and more market power than they would naturally have. Competing with three other firms is much easier than competing with hundreds. If firms are able to restrict entry, it will be in their interest to do so.

This idea was further developed by William A. Jordan in his “producer-protection” theory of regulation. He argued that, regardless of whether it is or is not the motivating factor, “the actual effect of regulation is to increase or sustain the economic power of an industry.”⁹⁶ Much like Stigler, Jordan contrasted this with, what he called the “consumer-protection” theory of regulation.⁹⁷ In Jordan’s view, if the “producer-protection” theory is correct, it is likely that regulation will do “such things as increasing prices, promoting price discrimination, reducing or preventing the entry of rival firms, and increasing industry profits.”⁹⁸ Other scholars have also built upon this work and supported similar, less romantic theories that integrate the industry benefiting justifications and effects of regulation.⁹⁹

As we have established above, regulatory sandboxes have the potential to create governmentally granted economic privilege. If regulators are given broad discretion when it comes to choosing which firms are and are not allowed to participate in the sandbox, they will be able to limit entry as they see fit. Firms that are already admitted to participate in the sandbox will have a strong desire to see regulators restrict entry into the sandbox to the greatest extent possible. Because

⁹¹ *The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 1982*, The Nobel Prize (2019) <https://www.nobelprize.org/prizes/economic-sciences/1982/summary/>.

⁹² George Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. Manag. Sci. 3 (1971).

⁹³ *Id.*

⁹⁴ *Id.* at 5.

⁹⁵ *Id.*

⁹⁶ William A. Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J.L. & ECON. 151, 153 (1972).

⁹⁷ *Id.* at 152-53.

⁹⁸ *Id.*

⁹⁹ See generally Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Quarterly J. Econ. 371 (1983); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J. L. & Econ. 221 (1976); see also Richard A. Posner, *Taxation by Regulation*, 2 Bell J. Econ. Manag. Sci. 22 (1971) (“The “capture” of regulation by the regulatees is, of course, an old theme in the literature of regulation. Professor Stigler’s theory allows for capture by effective political groups other than the regulated firms themselves, and there is accordingly no necessary inconsistency between it and the analysis in this paper.”).

there is a potential supply of regulation – regulators discretion on whether or not to admit a firm into the sandbox – and there is a demand for the regulation – firms who would benefit if entry into the sandbox were more heavily restricted – the is the potential for regulatory capture. If firms are able to use their political power to have regulators restrict entry into the sandbox, they have a strong incentive to do so. This is not to say that firms will necessarily work towards this end, or that regulators will be susceptible to it if they do, but only that this potential exist and should be taken into account when designing the procedures underlying a regulatory sandbox.

IV. How to mitigate the risk of sandbox privilege

Acknowledging that there is a risk that regulatory sandboxes may create certain types of harm does not mean that sandboxes should be abandoned. Instead, when creating sandboxes, policy makers should design them in a way to minimize the risk of harm while balancing the benefits to innovation and entry. And to be clear, the existing sandbox regimes are not blind to these concerns or tradeoffs. This section will look at existing regimes proposals, to identify ways to mitigate risk while allowing sandboxes to function. Generally these solutions seek to address a few core potential sources of trouble: lack of access and differential treatment for similar conduct.

a. Lack of access

In a world of limited regulatory resources there is a risk that access to the sandbox will be limited. This risk is more acute the more “high touch” the sandbox experience is because the more resources a regulator needs to spend on any given firm, the fewer firms the regulator can service. The resulting lack of access for some firms may place them at an unfair disadvantage, but there are ways to mitigate these risks to at least some degree.

First, and most obvious, is simply to grant access liberally by lowering or eliminating substantive and procedural restrictions. For example, sandboxes like Arizona that use novelty as a criteria¹⁰⁰ risk excluding the marginal firm that is new enough to have regulatory certainty questions with regard to their specific business model while not being new or unique enough to qualify as “innovative” in the eye of the regulator. Adopting an intentionally wide definition of “innovation” could help move more firms into eligibility. Another option is to explicitly consider whether comparable firms have received entry into the sandbox previously as a factor weighing in favor of entry to help avoid arbitrary exclusion.¹⁰¹

A third option, seen in the ASIC’s FinTech regulatory exemption, is to have a set of objective criteria related to consumer protection and allow any firm that meets those criteria to take advantage of the exemption without the exercise of discretion by the regulator. This option is not without its own risk that the criteria will be set unnecessarily high or idiosyncratically, unduly

¹⁰⁰A.R.S. § 41-5601.

¹⁰¹ Brian Knight, *Comment Regarding The Consumer Financial Protection Bureau’s Proposed No-Action Letter and Product Sandbox Policies*, Mercatus Center 6-7, Jan. 28, 2019, https://www.mercatus.org/system/files/knight_-_pic_-_policy_on_no-action_letters_and_the_bcfp_product_sandbox_-_v1.pdf.

benefitting some firms over others, but it does lower the risk of arbitrary decision making by the regulator at the admission stage.

A new approach seen in the CFPB sandbox is allowing industry groups and other third parties to help facilitate sandbox entry on behalf of their members.¹⁰² This innovation may help expand access and mitigate competitive risk by allowing many market participants to benefit from the sandbox at the same time. However, there are also risks. First, industry groups rarely cover the entire competitive landscape, so while allowing them to apply will help limit the risk of unfair competitive advantage it may not eliminate it and instead just shift the advantage to the industry group level instead of the firm specific level. Second, as the CFPB notes, decisions on whether to grant relief are facts and circumstances specific,¹⁰³ so it is possible that industry groups may not be able to provide sufficient specificity to lead to meaningful relief.

Utah and the CFPB also help firms obtain access to the sandbox if they have competitors who have used the sandbox previously.¹⁰⁴ While not a guarantee of admission these provisions should help mitigate against the risk that access to the sandbox becomes a unique advantage for only one market participant.

In addition to expanding access to participation, regulators should seek to expand access to the learnings that occur in the sandbox so that, to the extent regulators find themselves acting as *de facto* consultants or legal counsel, they do so for the public and market and not just for the specific firm. While some regulatory questions will be tightly wrapped up in the details of a particular business practice, such that it is only valuable to that specific firm, there are likely to be many others where the factors, analysis, and determinations created by regulators will be valuable more broadly. To the greatest extent possible regulators should report those findings promptly to the general public, without revealing trade secrets or proprietary information.

While some sandboxes do include periodic reports, such as the FCA's lessons learned report,¹⁰⁵ so far these reports do not seem to contain detailed analysis of the law and regulation. A better analogy may be no-action letters from agencies like the SEC¹⁰⁶ that frequently contain legal and factual analysis, and while these no action letters technically only apply to the firm who received them, they are frequently used to inform other firm's expectations.

b. Differential treatment

Another risk is that comparable behavior will be treated differently depending on whether the firm is (or was) in the sandbox or not. This risks turning sandbox participation from being voluntary to being *de facto* mandatory. This would be highly undesirable since it would in effect grant regulators a veto over who can participate in a market. It would also impose new regulatory burdens, and given the potential resource limitations discussed above risk constricting the entry of new firms unfairly.

¹⁰² See *supra* note 7.

¹⁰³ *Id.*

¹⁰⁴ See section I(b)(ii)(2).

¹⁰⁵ See *supra* note 32.

¹⁰⁶ *No Action Letters*, SEC, <https://www.sec.gov/fast-answers/answersnoactionhtm.html>.

While participation in a sandbox may well be evidence of good faith and a pure heart on the part of a participating firm, not participating is not *per se* evidence of malevolence. Some sandboxes, like the FCA, explicitly contemplate relaxing certain legal and regulatory requirements.¹⁰⁷ In the FCA's case this is consistent with the relevant authorities the FCA enjoys, so it can't be considered outside or inconsistent with the law, and the firms that obtain the exemptions or approvals will be entitled to them. However, because firms are required to apply for and receive an exemption or approval from the FCA, rather than just being able to conform to an existing safe harbor, there is a risk that two firms engaged in the same behavior will face different liability. While this can be arguably justified as compensation for cooperating with the regulator and providing them information, this justification is not entirely satisfying.

Punishment can be justified as being morally just, creating deterrence, or providing compensation to a harmed party.¹⁰⁸ In the case of a firm operating in good faith in a sandbox neither punitive nor deterrence justifications apply because the firm is not seeking to violate the law and we do not want to discourage firms from pursuing innovation in a transparent way with the regulator. However, a firm that is operating in good faith outside of the sandbox does not seem to deserve punishment either, since it is operating in good faith like the sandbox firm. Nor is it clear that we should deter firms from not seeking to operate in the sandbox because sandboxes should be voluntary. This leaves us with limited justification for lower regulatory barriers and most especially lighter punishment for sandbox firms.

In addition to the risk of *de jure* disparate treatment between sandbox and non-sandbox firms there is also the risk of a *de facto* enforcement culture developing at an agency that views sandbox firms as "good" and non-sandbox firms as "bad". Firms that go through the extra steps to ingratiate themselves to the regulator and, to be fair, demonstrate tangible good faith may develop a relationship with the regulator that non-sandbox firms do not enjoy, which might lead to implicit bias when it comes time for enforcement.

To address these concerns, the first step is for the regulator to acknowledge this risk and create both formal guidance and informal norms for enforcement staff that, while participation in a sandbox can be taken as evidence of good faith, a lack of participation is not necessarily evidence of bad faith. It should also clearly understand what justifies a level of punishment and allow non-sandbox firms who are comparably acting in good faith and stand willing to make harmed customers whole to be treated similarly to sandbox firms.

V. Conclusion

Regulatory sandboxes are exciting developments in the field of regulation. Driven by a need to keep up with quickly changing technology and a desire to facilitate innovation and competition they have been adopted by several leading jurisdictions, with others on the way. However, by their very nature they pose a risk to market competition by advantaging some firms over others. The literature on this risk has been largely underdeveloped. While the potential for economic privilege may not outweigh the benefits created by regulatory sandboxes, it should be examined

¹⁰⁷ See *supra* note 64.

¹⁰⁸ See generally Richard S. Frase, *Punishment Justification and Goals*, <http://www.oxfordbibliographies.com/view/document/obo-9780195396607/obo-9780195396607-0116.xml>.

when analyzing the design or implementation of new or existing regulatory sandboxes. Economic privilege is an inherent risk associated with regulatory sandboxes and regulators should seek to mitigate this risk to the greatest extent possible.