

UK 'regulatory sandbox' to foster FinTech innovation

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The UK's Financial Conduct Authority ("FCA") will launch a 'regulatory sandbox' on 9 May 2016 to foster innovation in the UK financial services market. Unauthorised firms that successfully apply to the FCA will be able to obtain restricted authorisation to test innovative products or services in a live environment. Authorised firms that want to test innovative products or services and clarify applicable rules before testing can seek assistance from the FCA by obtaining individual guidance, waivers or modifications to the FCA rules, or no enforcement action letters.

Background

The regulatory sandbox is part of the FCA's 'Project Innovate'. This project is aimed at encouraging innovation in the UK financial services market from both market entrants and incumbent financial institutions and at promoting competition through disruptive innovation. The sandbox aims to provide a safe space for testing innovative products and services without triggering the otherwise applicable full set of regulatory consequences. The goal is to foster innovation by lowering administrative barriers and costs for testing innovative products and services, while ensuring that risks from testing do not transfer to consumers.

Key elements of the regulatory sandbox

Target group

Both unauthorised and authorised firms that want to test innovative products or services in a live environment, without immediately incurring all the normal regulatory consequences of engaging in the activity in question, can participate in the sandbox programme.

Unauthorised firms that successfully apply to the FCA will be able to obtain restricted authorisation to test innovative products or services without having to obtain full authorisation. Any later regulated activity outside the sandbox will still require full authorisation, but the FCA expects that full authorisation for a product or service that has previously been tested in the 'sandbox' can be obtained quicker and more easily.

Authorised firms that want to test an innovative product or service that may not easily fit into the existing regulatory framework may wish to obtain more clarity about applicable rules before testing. For these firms, the FCA envisages providing assistance in the following ways:

- The issuance of **individual guidance** on the interpretation of certain rules in the context of the testing. Compliance by a sandbox firm with the guidance would then be seen by the FCA as compliance with the rules to which the guidance relates.

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- The granting of **waivers or modifications** to FCA rules that would otherwise be breached by the test. The FCA can only waive or modify its rules if these are unduly burdensome or not achieving their intended purpose. EU law or primary legislation cannot be waived.
 - The issuance of **no enforcement action letters**. The FCA will consider using this instrument very carefully and only for cases where it is not able to issue individual guidance or grant waivers, and where it sees such a letter as justified in light of the particular circumstances and characteristics of the relevant test. As long as the recipient of the letter closely collaborates with the FCA, keeps to the agreed testing parameters and treats its customers fairly, it will not face disciplinary action from the FCA even if something unexpectedly goes wrong during testing. However, the letter would only apply for the duration of the relevant sandbox test and only to the FCA's disciplinary action – it cannot limit any liabilities to consumers.

Eligibility criteria

Applications for testing in the sandbox will be reviewed against the following FCA [eligibility criteria](#):

- **The firm must be in scope:** The firm's intended activity must be regulated by the FCA or intended for firms regulated by the FCA. The goal of this criterion is that the intended activity will benefit the UK financial services market.
- **The product or service must be a genuine innovation:** The product or service must be ground-breaking or be significantly different from existing offerings in the marketplace. If there are similar offerings in the market already, or if the FCA deems any differentiation from existing offerings to be artificial, a product or service is unlikely to fulfil this criterion.
- **There must be a consumer benefit:** The product or service must offer a good prospect of identifiable benefit to consumers, such as higher quality services or lower price. A firm will be more likely to meet this standard if it identifies any possible consumer risks and proposes mitigation.
- **There must be a need for a sandbox:** The firm must have a genuine need to test its product or service on real customers and in the FCA sandbox. Potential reasons include where the firm has no alternative means of engaging with the FCA or of achieving the testing objective, or where the full authorisation process would be too costly or burdensome for a short viability test.
- **The firm must be ready for testing:** The product or service to be tested must be ready for testing in a live environment. The FCA will look at whether the firm has conducted any previous testing and whether the testing plan and the testing objectives are adequately developed.

Testing parameters

The exact parameters for each test will be agreed with the relevant firm on a case-by-case basis. However, the FCA has developed and published [default standards](#) for such parameters. These provide some guidance on what the FCA will be expecting as part of an agreement on testing parameters. These default standards cover the following areas:

- **Duration:** Sandbox testing is intended for a limited duration. It appears that the FCA generally considers three to six months to be an appropriate duration.
- **Number of customers:** The size of the test and the number of participating customers will be strictly limited. However, the FCA recognises that the number of customers should be big enough to obtain statistically relevant data.
- **Customer selection:** The firm must find the customers for testing. The type of customers must be appropriate for the product or service to be tested, the intended market and the risk involved.
- **Customer safeguards:** The firms must have appropriate customer safeguards in place. These will be agreed with the FCA on a case-by-case basis.
- **Disclosure:** Firms should disclose information about the test and the available compensation (including in the event of firm failure) to customers who are engaging in the sandbox under informed consent.

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- **Data:** The FCA states that it is not responsible for the provision of data to firms testing in the sandbox.
 - **Testing plans:** Testing plans should clearly set out the timeline, key milestones, measures for success, testing parameters, customer safeguards, a risk assessment and an exit strategy for customers that participate in the test to avoid negative consequences for these customers.

Collaboration and reporting requirements

The FCA expects firms in the sandbox to cooperate closely with the FCA. In particular, firms will have to report to the FCA in accordance with requirements to be agreed on a case-by-case basis with the FCA. Generally, the FCA expects reporting every week on milestones, key findings and risk management. After completion of the testing, firms will have to produce and submit to the FCA a final written report. Firms considering participation in the sandbox should be aware that the FCA aims to publish findings from sandbox testing to educate the industry, even though the FCA recognises that it will have to review what it can publish on a case-by-case basis to ensure that any commercially sensitive information is protected.

Applications

Initially, the FCA has planned that two cohorts of firms a year will be accepted onto the programme.

The application form for the first cohort will be published on 9 May 2016. Applications can be submitted from 9 May 2016 to 8 July 2016. From 9 July 2016, the FCA will assess all applications. Applicants will be informed by mid-August whether their application has been successful. For the second cohort, the deadline will be in mid-January 2017.

Evaluating the applications, agreeing on testing parameters, and accompanying the sandbox firms through their testing activities will require a high degree of 'bespoke' effort from the FCA. The FCA will therefore only be able to admit a small number of firms into the sandbox at a time. This introduces a competitive element into the sandbox programme. The FCA has revealed that its 'final decision criterion' will be the 'readiness for testing' eligibility criterion. Firms that get their ducks in a row quickly will have a higher chance of being admitted into the first cohort.

Concluding thoughts

When introducing the regulatory sandbox at the Innovate Finance Global Summit 2016 in London on 11 April 2016, Christopher Woolard, the FCA's Director of Strategy and Competition, claimed that the FCA was the first regulator in the world to run a sandbox programme of this nature. He recognised that it is "*a bold and complex project for any regulator to undertake*". Just as FinTech firms and innovative incumbent financial institutions will be testing new waters, the FCA will face new challenges and gain valuable learning opportunities through its sandbox programme. Implementing a regulatory sandbox despite these challenges and the required efforts underscores the FCA's ambition to ensure that the UK financial services market remains at the forefront of innovation while protecting consumer interests.

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