

LUCY FREW'S FINTECH COLUMN: DECEMBER 2015

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Lucy Frew is a Partner in Kemp Little LLP's Financial Regulatory practice. Lucy shares her views on topical FinTech issues with our subscribers.

In her first FinTech column, Lucy considers recent developments relating to the FCA's plans for a regulatory sandbox, and its calls for input on its role in supporting the development of RegTech, and the use of Big Data in the retail general insurance sector.

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FCA'S LAUNCH OF REGULATORY SANDBOX

The FCA has set out its plans (in a [November 2015 report](#)) to introduce a so-called "regulatory sandbox" to provide a safe space where businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory consequences of engaging in the activity in question. This is aimed at innovator firms (both authorised firms and new entrants), accelerators, software firms, and technology companies, who will be subject to criteria similar to those for requesting support from the FCA's Innovation Hub. The aims of the regulatory sandbox are undoubtedly excellent. However, while on first glance the regulatory sandbox looks very positive, on closer reading it isn't clear how workable certain aspects will be in practice.

The FCA believes that potential benefits of a regulatory sandbox could include reduced time-to-market at potentially lower cost, better access to finance and more innovative products reaching the market. It rightly identifies regulatory uncertainty as the key obstacle to these benefits. However, in doing so it relies on data from the pharmaceutical industry to argue that a regulatory sandbox will reduce regulatory uncertainty and, as discussed below, it is not clear that this will work in the FCA context. Also, it is the FCA's firm authorisation process, not testing, which creates the greatest regulatory uncertainty and barrier for firms. The FCA will not grant authorisation until a firm has mobilised capital, hired staff and put IT and other infrastructure in place. Start-ups find it difficult to attract investment without authorisation, yet cannot afford to mobilise for authorisation without investment. Testing in a regulatory sandbox doesn't solve this problem. Further it would be unfortunate if the regulatory sandbox initiative distracts attention from the need to re-think the authorisation process.

The FCA clearly identifies in its report many of the challenges associated with the establishment of a

regulatory sandbox and, although it isn't clear how workable various aspects of the regulatory sandbox will be in practice, it contains valuable aims and ideas. Some of the pros and cons of the options identified by the FCA for introducing a regulatory sandbox are outlined below:

- **Legislative change.** Options that require legislative change are limited by EU legislation. The FCA cannot exempt those firms that must be authorised or registered under EU law from authorisation. This includes credit institutions, some insurance and reinsurance companies, insurance and reinsurance intermediaries, firms who provide "investment services or activities" under MIFID, some payment institutions and e-money institutions, UCITS and their management companies, Alternative Investment Fund Managers, and (from 21 March 2016) mortgage lenders, administrators and brokers, and creditors: in other words, most firms.
- **Restricted authorisation.** The FCA will be able to authorise sandbox firms with restrictions, allowing them to test their ideas, but no more. However, before being able to test, firms still will need to become authorised, which requires time and resources. Within the limits of applicable EU legislation, authorisation requirements would be calibrated to an individual firm's restrictions, so that these are less difficult for innovators to meet. However, as stated above, as EU legislation imposes onerous authorisation requirements for most types of firm, the FCA's flexibility is severely limited.

More helpful would be to enable firms (innovative and otherwise) to obtain "authorisation in principle", albeit based on detailed and solid business plans, before they mobilise capital, personnel, IT and other infrastructure. Although unable to obtain final authorisation to operate until they have mobilised, it would be considerably easier for firms to get financial

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backers if they were authorised in principle. Without this change, many innovative firms are trapped in a vicious circle of being unable to get financial backing without being authorised, yet unable to become authorised without financial backing.

- **Virtual sandbox.** This would be an environment to enable firms to test their solutions virtually without entering the real market. The FCA does not propose to set up the virtual sandbox itself. Rather, it believes that the industry, acting collectively, is well placed to do this. It is not entirely clear whether the virtual sandbox route would allow testing on consumers. It would at least, however, facilitate collaboration between businesses, academia and other interested parties when developing innovative products or services.
- **Sandbox umbrella.** This would be a not-for-profit company set up by industry, acting collectively, as a sandbox umbrella that allows unauthorised innovators to offer their services under its shelter as appointed representatives. The umbrella company would need to be authorised with appropriate permissions and then supervised by the FCA in the same way as other authorised firms, and would be responsible for monitoring its appointed representatives. This is essentially a variation on the FCA's existing appointed representative regime, whereby a firm can carry on regulated activity if it becomes the appointed representative of another authorised firm (its principal). This is a very useful and already commonly used route for firms that cannot or do not wish to become authorised. However, it is not yet clear whether industry will rush to act collectively to encourage disruptive competition. It is also worth noting that the appointed representative regime is only available for a limited range of regulated activities, so not all innovative businesses would be able to use the sandbox umbrella.

Most existing umbrella firms operate on a commercial basis, typically taking on a number of appointed representatives to which they charge many tens of thousands of pounds per annum. In return, however, they bear significant regulatory risk and may provide valuable compliance assistance. Different regulatory regimes exist for different business models, so commercially it is more efficient and less risky to specialise. Umbrella firms tend to mitigate risk by only taking on appointed representatives with a particular business model. A sandbox umbrella, on the other hand, would presumably take on start-ups across a wide range of different and innovative business models. It would therefore need significant expertise across a number of different regulatory regimes. This would be a costly enterprise, so "not-for-profit" would not necessarily mean fee-free for innovator appointed representatives.

The extent to which firms will be allowed to test their products and services on the general public in the sandbox is unclear. The FCA has identified a number of approaches that it can take to protect customers that participate in sandbox testing. One would allow sandbox firms to

test their new solutions only on customers who have consented to be included in testing. Another would require businesses undertaking sandbox trials to compensate customers for any investment losses and to demonstrate that they have the capital resources to do so. However, this could make the sandbox an unaffordable option for firms. Both approaches appear likely to distort testing outcomes. In the absence of any clear solution, the FCA's preferred approach is to agree on a case-by-case basis the disclosure, protection and compensation appropriate to the testing activity. It is not clear how long determining a bespoke agreement would take in each firm's case.

The FCA intends to open the sandbox unit for testing proposals in spring 2016. Over the course of the next few months it will engage with interested parties to finalise the design of how the unit will operate. It will also start engaging with stakeholders regarding establishing a virtual sandbox and a sandbox umbrella.

It is to be hoped that the FCA's report will stimulate dialogue that will result in a genuine reduction in regulatory barriers to innovation. Watch this space!

FCA'S ROLE IN SUPPORTING THE DEVELOPMENT AND ADOPTION OF REGTECH

"RegTech" is shorthand for new technologies that facilitate the delivery of regulatory requirements and reduce compliance costs. The FCA is seeking input (in a [November 2015 Call for Input](#)) on how it can support the development and adoption of RegTech, having identified a number of areas where it believes this can be achieved.

In its Call for Input, the FCA notes that, "it is the Government's hope that the UK can capitalise on the development and commercialisation of new financial business models and disruptive innovation (known collectively as 'FinTech') and become the world's leading FinTech hub". It is, therefore, well worth bearing in mind which FinTech and RegTech areas the FCA has earmarked as being of interest and, which (for example, blockchain technology) are omitted. It should be noted though that the FCA has clearly acknowledged developments in distributed ledgers and virtual currencies elsewhere (for example, in its [June 2015 Call for Input](#) on regulatory barriers to innovation in digital and mobile solutions).

The FCA's commitment to support the adoption of RegTech could be an incredibly valuable initiative for innovative firms in particular. The FCA has rightly identified providing regulatory expertise as one of the areas where it can support RegTech and there is enormous scope to facilitate the determination of perimeter issues (in other words, whether a firm actually needs to be authorised and, if so, what specific permissions should it apply for) and capital resources requirements (in other words, how much risk capital will a particular firm need to have in place in order to become authorised and maintain on an ongoing basis).

The FCA's development of Project Innovate to provide this type of guidance to innovative firms is entirely admirable but, with the best will in the world, it is not scaleable. In

its first year Project Innovate has helped five businesses to become authorised. Lawyers find themselves required to advise on these same issues over and over again, resulting in a duplication of work and fees, which could be vastly reduced if the FCA could provide this expertise on a freely available centralised basis. RegTech could also vastly improve and speed up the application process, with benefits and efficiencies not only for firms, but also for the FCA itself.

The FCA has not specified a closing date for this Call for Input, but if firms wish to inform the initial workshops planned for Q1 2016 they will need to provide input soon.

BIG DATA IN THE RETAIL GENERAL INSURANCE SECTOR

The position taken by the FCA in its *November 2015 Call for Inputs* on the use of Big Data in the retail general insurance sector is likely to have wider ramifications for financial services and anyone interested in FinTech should take good note of the FCA's developing thoughts in this area.

The FCA acknowledges that new technologies are needed to generate, collect and store the new forms of Big Data that are emerging (such as, data from social media, or the use of advanced data processing technologies). It rightly recognises that Big Data is having an ever-growing social and commercial impact and has the potential to transform practices and products across financial services. The FCA is starting its work on Big Data by seeking to better understand how insurance firms are using data, and how this may evolve in the future. This will help the FCA to understand Big Data's impact on firms' decisions and in turn the effects that this is having on consumer outcomes (including pricing structures and consumer behaviours).

In particular, the FCA is eager to understand how its regulatory framework currently constrains, or can further foster innovation in, Big Data in the interests of consumers. It recognises that there are important statutory protections for consumer data that are outside its regulatory remit, but considers that they may materially impact on how Big Data is being used and is interested in understanding these effects.

The FCA is to be applauded for proactively seeking early engagement with stakeholders. The Call for Inputs will close to responses on 8 January 2016 and we will find out the FCA's next steps when it publishes a Feedback Statement in mid-2016. In the meantime, the FCA's Call for Inputs is likely to stimulate dialogue in an area which gives rise to some challenging questions in the FinTech space.

