THE BUCKEYE INSTITUTE

‘Fintech’ Regulatory Sandbox: Cutting Red Tape for Employers & Offering Innovative Tools to Ohioans

Interested Party Testimony
Ohio Senate Financial Institutions and Technology Committee
Senate Bill 249

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Chair Wilson, Vice Chair Hottinger, Ranking Member Maharath, and members of the Committee, thank you for the opportunity to testify today regarding Senate Bill 249 and Ohio's need to innovate its financial technology regulation.

My name is Logan Kolas. I am the economic policy analyst at **The Buckeye Institute**, an independent research and educational institution—a think tank—whose mission is to advance free-market public policy in the states.

Senate Bill 249 creates a consumer-centric environment in which approved financial technology—or fintech—firms may experiment and test new products and services under the watchful eye of expert regulators. By constructing a "regulatory sandbox," the bill removes outdated and complicated regulatory obstacles currently impeding fintech companies looking to innovate safely and cost-effectively.

Innovative and emerging financial technology **offers** businesses and consumers more secure transactions, remote financial access, easier **loan repayments**, **cloud-based banking**, and **financial opportunities** for the unbanked. But as they try to bring these products and services to market, fintech firms face expensive, complex regulatory hurdles. Many startup companies spend **more than $83,000** to comply with regulations in their first year alone—a hefty price for fledgling firms with **thin profit margins**. Pursuing national expansion can **cost** millions of dollars in additional regulatory fees and compliance expenses.

Regulatory sandboxes ease these burdens, **decrease risk and uncertainty**, make it easier to attain **investment capital**, and give lawmakers and regulators time to accommodate rapidly changing regulatory needs. As a financial services leader and with its network of universities and trade schools, Ohio should have been at the fore of innovative regulatory reform in the fintech sector, but unfortunately has fallen behind instead. Arizona, Utah, Nevada, Wyoming, West Virginia, North Carolina, and Florida have already **created** regulatory sandboxes for their fintech sectors. Arizona's sandbox, for example, gave financial companies the regulatory flexibility to offer **low-cost banking services** to unbanked residents. And some of these states have expanded their sandboxes to other industries, including legal services, insurance technology, and drones. Sandboxes were so successful in Utah that its legislature **unanimously** voted to extend the sandbox to all industries—a move that Ohio should eventually emulate.

Senate Bill 249 makes a laudable effort to catch-up and wisely sidesteps pitfalls suffered by other states. First, the bill avoids Nevada's mistake of **capping** the number of consumers available to sandbox participants—an error that has cost Nevada all sandbox participation. Second, as recommended in The Buckeye Institute's ***Policy Solutions for More Innovation: Build a Regulatory Sandbox for Financial Technology Innovators*** (attached to this testimony), Senate Bill 249 coordinates Ohio's regulatory sandbox with other states' sandboxes to harmonize rules, streamline compliance, reduce costs, and avoid divergent regulatory schemes that could stifle sandbox participation. Finally, Senate Bill 249 acknowledges the importance of virtual and online businesses by allowing fintech firms that maintain a physical presence in the United States or conduct virtual operations to participate in Ohio's regulatory sandbox.

These are all solid steps forward and The Buckeye Institute commends these policies to the Committee.

Thank you for the opportunity to testify on this important proposal. I would be happy to answer any questions that the Committee may have.

About The Buckeye Institute

Founded in 1989, The Buckeye Institute is an independent research and educational institution – a think tank – whose mission is to advance free-market public policy in the states.

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Buckeye Policy Brief

Policy Solutions for More Innovation

Build a Regulatory Sandbox for Financial Technology Innovators

By Logan Kolas

March 29, 2021

Introduction

Ohio Governor Mike DeWine recently proposed that the state invest $1 billion to strengthen Ohio communities still recovering from a pandemic that continues to reshape how Ohioans live and work.[1] Recognizing an increasingly online economy and the rise of telework and e-commerce options, the governor's plan wisely prioritizes improving Ohio's technology and innovation policies.[2] To assist policymakers in making those improvements, The Buckeye Institute will release a series of papers recommending policy improvements to spur innovation, attract new businesses, and make Ohio more prosperous.

Building upon recent legislative successes requiring more rigorous reviews of regulatory burdens and occupational licensing,[3] Buckeye's initial suggestion call for Ohio to construct a "regulatory sandbox" for the financial technology sector—a controlled regulatory environment in which firms can temporarily experiment with new and innovative financial technology with less red tape between them and their consumers. Regulatory sandboxes offer a safe, efficient, and cost-effective way to bring new technologies to market. With the global rise in financial technology—or "fintech"—Ohio needs to act quickly to attract and keep fintech firms as both employers and service providers, and a regulatory sandbox can help. Policymakers should understand the basics, the need for, and the essential characteristics of a well-designed regulatory sandbox for innovators.

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[1] **Governor DeWine, Lt. Governor Husted Unveil Plan of More than $1 Billion Targeted to Strengthen and Grow Ohio Communities and Businesses**, Governor Mike DeWine press release, February 1, 2021.
[2] Spencer Gross, **Governor DeWine's Proposed State Operating Budget Has an Eye Toward Innovation**, OhioX.org, February 2, 2021.
[3] Greg R. Lawson, research fellow, The Buckeye Institute, Testimony before the Ohio Senate Government Oversite and Reform Committee, "**Reducing Red Tape Will Help Ohio's Economy**," February 10, 2021; and **Ohio Governor Signs The Buckeye Institute Championed Best in the Nation Occupational Licensing Reform**, The Buckeye Institute press release, January 4, 2019.

The Basics

A regulatory sandbox serves two primary purposes: it cuts regulatory red tape for select industry innovators; and it protects consumers from potentially harmful new products. To accomplish these objectives, state regulators construct a controlled regulatory and consumer-centric environment in which approved firms may experiment with new technology for a limited time under watchful regulator supervision. Before granting permission to use the sandbox, regulators may first conduct a consumer-centric safety analysis to protect consumers from harm, and then monitor the firm and the new technology until they "graduate" from the sandbox.[4] Fintech includes increasingly popular products and services with names like Venmo, GoFundMe, blockchain, Acorns, Credit Karma, and countless online banking and investing websites and applications—or "apps." As fintech innovation continues, Ohio can use a fintech-specific regulatory sandbox to make it easier and more affordable for fintech firms to test new products and services on a limited basis. Here is how a fintech sandbox could work:

1) A financial technology firm identifies laws, regulations, or licensing requirements that prohibit them from safely selling their product or service in the marketplace.
2) The firm applies to participate in the "regulatory sandbox"—citing the relevant regulatory obstacles, explaining how the firm's product or service benefits consumers, and noting what it will do to keep consumers safe.
3) State regulators—likely at the Ohio Department of Commerce—accept or reject the firm's application to participate, making clear why the application is accepted or rejected.
4) An accepted firm may then temporarily test their product or service with a limited consumer base under careful regulator supervision.
5) At the end of the sandbox trial period, regulators assess the test product's performance and safety in the market, and determine which, if any, regulatory restrictions and obligations should apply.[5]
6) Unless an extension is necessary, the participating firm "graduates" from the sandbox to the marketplace and policymakers adjust the regulations and restrictions as needed.

In just a few steps, Ohio regulators could loosen regulatory red tape that keeps innovative financial technology from reaching would-be users. Constructing a regulatory sandbox balances the need for progressive innovation and investment against commonsense consumer safety. Striking that balance will be key for Ohio to take full advantage of the burgeoning fintech sector going forward.

The Need

Fintech's innovative web of far-reaching, easy to use technology is changing how businesses and consumers interact. Even before the pandemic pushed more of the economy online, North

[4] James Czerniawski, **Utah Innovates: Regulatory Frameworks for the Future**, Libertas Institute, December 30, 2019.
[5] **All-Inclusive Regulatory Sandbox**, Libertas Institute.

America saw tens of thousands of fintech startups,[6] and the pandemic has only accelerated the financial industry's pursuit of fintech integration into consumer and business operations.[7] Only 16 percent of consumers used fintech in 2015, but that number grew exponentially to 64 percent in 2019—a trend that shows no sign of abating as the pandemic pushes Americans to adopt more online services.[8] Moreover, because fintech offers cheaper solutions, more security, and a great deal of accessibility to consumers,[9] it has the power, for example, to link unbanked and financially disadvantaged consumers to previously inaccessible financial services.[10] Roughly 7.2 percent of Ohio households are unbanked, and accessible financial technologies can help them save money and plan for their financial futures.[11]

Despite these advantages, emergent fintech firms can face significant and expensive regulatory hurdles trying to bring their products and services to consumers who need them. State approval to operate in a single state can cost a firm thousands of dollars[12] and, as the North Carolina Banking Institute has noted, fintech firms "can expect millions in expenses and years of frustration in the pursuit of national expansion."[13] Such costs hurt businesses, diminish their resources to expand and hire workers, and increase prices and fees inevitably passed on to consumers.[14] And because antiquated regulatory rules and rule-making cannot possibly keep pace with startup technology developments, the costs associated with regulatory schemes make it even harder for startup technology firms to raise investment capital when they need it most. Consequently, fledgling firms lay-off employees or close their doors before ever having a chance to market their products.[15]

A fintech regulatory sandbox can reverse this trend, ease access to investment capital, and make ambiguous, expensive regulatory compliance more transparent.[16] Unclear regulatory landscapes make investors hesitant to invest in startup firms,[17] so by creating a clear regulatory structure for accepted firms, regulatory sandboxes minimize uncertainty, increase investment, and reduce risk.

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[6] **Number of Fintech Startups Worldwide from 2018 to 2021, by Region**, Statista Research Department, February 15, 2021.

[7] ***Pulse of Fintech H1'20***, KPMG, September 2020; Libby-Jane Charleston, **Why Fintech is the Most Important Industry Right Now,** HuffPost.com, January 10, 2015.

[8] **Global FinTech Adoption Index 2019**, Ernst & Young, September 9, 2019.

[9] **6+ Reasons Why Fintech is Important**, Axios Holding, September 23, 2019.

[10] Swati Bucha, **The Importance of Fintech In The Post-COVID World**, Skeps.com, June 2, 2020.

[11] Laura McMullen, **States and Metro Areas With the Most Unbanked Households**, Nerd Wallet, September 28, 2016.

[12] Luke G. Thomas, ***The Case for a Regulatory Sandbox for Fintech Companies***, North Carolina Banking Institute, March 1, 2018.

[13] *Ibid.*

[14] James Czerniawski, **How Utah Can Welcome Better Innovation**, *Deseret News*, December 20, 2019.

[15] Liya Palagashvili and Paola Suarez, ***Technology Startups and Industry-Specific Regulations***, Fraser Institute, July 30, 2020.

[16] Giulio Cornelli, Sebastian Doerr, Leonardo Gambacorta, and Ouarda Merrouche, **Inside the Regulatory Sandbox: Effects on Fintech Funding**, Bank for International Settlements Working Papers No. 901, November 3, 2020; and Jayoung James Goo and Joo-Yeun Heo, **The Impact of the Regulatory Sandbox on the Fintech Industry, with a Discussion on the Relation between Regulatory Sandboxes and Open Innovation**, *Journal of Open Innovation: Technology, Market, and Complexity*, June 19, 2020.

[17] *Ibid.*

Regulatory sandboxes have already caught on in some states, with Utah, Florida, West Virginia, Arizona, Nevada, and Wyoming all passing legislation to create fintech sandboxes.[18] In fact, Utah recently enacted legislation to create a sandbox for all industries.[19] With a clearer regulatory landscape conducive to testing new fintech products, Ohio can join the growing list of states looking to attract new fintech firms. And Ohio is already well-positioned for the task as one of the national leaders in the financial services sector and home to exemplary universities and trade schools already cultivating technological talent across the state.[20]

The Essentials

Regulatory sandboxes offer states, firms, and consumers significant advantages, but they must be designed and implemented carefully. There are right ways and wrong ways for policymakers to build a fintech regulatory sandbox. And a solid sandbox should have essential characteristics. It should be voluntary, instructive, transparent, impartial, and—when possible—coordinated with other states.

Voluntary. All regulatory sandboxes should be voluntary, with firms applying to participate in the program and not compelled either by state mandate or coercion.[21] A well-designed sandbox will disentangle some regulatory red tape, but it should not penalize firms that choose to operate harmlessly under the full regulatory construct.[22]

Instructive. State regulators lack the perfect information necessary to perfectly tailor regulations to fit every company. Regulatory sandboxes provide valuable information to help regulators learn which rules are necessary, and which may be redundant, ambiguous, or overly burdensome. Sandboxes should be instructive and tell policymakers how to make rules more effective and efficient. Sandbox regulators should provide the General Assembly with an annual report on the lessons learned and which regulations should be amended or rescinded.

Transparent. Access to a regulatory sandbox can help startup fintech firms reduce investment costs and bring their products to market faster and more efficiently. They should have every incentive to participate in the sandbox program. Given the incentives to participate, rejected sandbox applicants should be given clear reasons for being rejected and guidance for how to improve their chances.[23] As with all regulatory programs, transparency is a key to success.

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[18] **More States Establishing Regulatory Sandboxes for Fintech**, Native American Financial Services Association, September 4, 2020.

[19] Ben Winslow, **Weirdest. Session. Ever. Here's What the 2021 Utah Legislature Did to Your Life**, Fox 13 Salt Lake City, March 5, 2021; and **Gov. Cox and Lt. Gov Henderson Sign 56 Bills at the Governor's Rural Office**, Governor Spencer J. Cox press release, March 22, 2021.

[20] Terry Gore, **Banking on Ohio as a Fintech Leader**, CIOReview.

[21] Brian Knight, **How to Build a Good Regulatory Sandbox**, Mercatus Center at George Mason University, April 17, 2019.

[22] Brian Knight and Trace Mitchell, **The Sandbox Paradox: Balancing the Need to Facilitate Innovation with the Risk of Regulatory Privilege**, Mercatus Working Paper, Mercatus Center at George Mason University, March 26, 2020.

[23] Nicolas Elliot, **Where Fin-Tech is Struggling with Regulation**, *The Wall Street Journal*, November 24, 2015.

Impartial. Regulators accepting or rejective applicants to the sandbox must remain impartial as to the perceived likelihood of a product's success or utility in the market. The market, not regulators, should decide which firms and products will succeed. Sandbox regulators should ask firms how the product will benefit consumers, how firms will protect consumers against potential harms, and then carefully supervise firms so that no harm is done. Similarly, there is no reason to limit access to Ohio's regulatory sandbox to firms with a physical presence in the state. Like Arizona, Ohio's sandbox should admit firms that can establish either a physical or virtual presence here so long as it is accessible to regulators.[24] Nor should fintech firms already doing business in Ohio be denied access to the sandbox. Firms and regulators can benefit and learn from participating in the sandbox, and such benefits should not be limited to startups.

Coordinated. Ohio should coordinate its regulatory sandbox with the other states that have already built a fintech sandbox.[25] Regulatory continuity across various states helps fintech firms streamline compliance, reduce costs, and make their products more efficient. The more divergent regulatory schemes become, the more expensive they are to satisfy.[26] Coordinating Ohio's regulatory sandbox with those in other states could help Ohio compete more effectively with more regulated states, and help Ohio firms compete against foreign firms that comply with more homogenous restrictions.[27]

Conclusion

The financial technology sector offers an ideal platform for building Ohio's first regulatory sandbox. The high-growth, fast-paced sector presents significant challenges for traditional regulatory rulemaking, and those challenges often mean that fintech firms fall between the regulatory cracks or never muster the momentum to overcome regulatory obstacles. Consumers ultimately pay the price as useful products prove more expensive than necessary or never make it to market at all. But Ohio can join several other states in leading by example and making the regulatory process less daunting, less expensive, and more transparent for fintech firms looking to expand. A regulatory sandbox offers an efficient way to balance the concerns of public safety and product development. And once Ohio has constructed a fintech sandbox, policymakers should capitalize on that effort and build more sandboxes across various industries, including insurance, legal services, and even unmanned vehicles or "drone" technology.[28] A fintech regulatory sandbox built with the right essentials could be the beginning, not the end, of innovative regulatory reform in Ohio.

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[24] **Ariz. Rev. Stat. § 41-5063(C)(2)**, 2019

[25] **More States Establishing Regulatory Sandboxes for Fintech**, Native American Financial Services Association, September 4, 2020.

[26] Luke G. Thomas, ***The Case for a Regulatory Sandbox for Fintech Companies***, North Carolina Banking Institute, March 1, 2018.

[27] *Ibid.*

[28] Utah **House Bill 402**, Regulatory Waiver Process; **Utah Supreme Court Adopts Groundbreaking Changes to the Legal Services Regulation**, Utah Courts Recent Press Notifications, August 29, 2019; and Miriam McNabb, **Utah Opens Drone Corridor to Encourage Industry Innovation**, Dronelife, November 5, 2018.

About the Author

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