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FINTECH - REGULATORY AND INNOVATION SANDBOX

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The Indian fintech industry is rapidly evolving to provide innovative technologies in the financial services sector. In a bid to further promote innovation and allow testing of new products in a relaxed regulatory framework, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) have introduced a sandbox mechanism for the fintech industry. While a 'sandbox' originally referred to a box containing sand where children play and experiment under supervision, it has since acquired a whole new meaning for innovators and regulators across the world. A sandbox mechanism is now used to refer to an enabling framework where regulators, for a limited time, relax certain regulatory requirements (which may be in the form of licensing requirements or any other compliance) or provide support in some other form to permit innovators to experiment with their ideas. The concept of a sandbox originated in the United Kingdom in 2015 and currently over 20 jurisdictions are actively implementing or exploring this concept.

The different types of sandbox mechanisms recently introduced by RBI and SEBI in India are (i) 'Draft Enabling Framework for Regulatory Sandbox' issued by RBI on 18 April 2019 (RBI Regulatory Framework); (ii) 'Framework for Innovation Sandbox' issued by SEBI on 20 May 2019 (SEBI Innovation Framework); and (iii) 'Discussion Paper on Framework for Regulatory Sandbox' issued by SEBI on 28 May 2019 (SEBI Regulatory Framework). The RBI Regulatory Framework and the SEBI Regulatory Framework provide for live testing of innovative products on limited customers with certain regulatory relaxations. On the other hand, the SEBI Innovation Framework provides for offline testing of products with the help of data provided by certain regulators which is not otherwise available to such entities.

Basic features of the RBI Regulatory Framework

The RBI Regulatory Framework provides for a regulatory sandbox where live testing of fintech innovative products and services will be allowed with limited customers and certain regulatory relaxations on a case by case basis. Selected entities will be allowed to test their innovations for a specified time period and the sandbox processes will be theme based with a focus on financial inclusion, payments and lending, digital KYC etc. For an entity to become part of any such sandbox process, it must fulfill the eligibility criteria.

The eligibility criteria prescribed by RBI, *inter alia*, states that the entity should have a minimum net worth of Rs 50 lakhs and qualify as a start-up. This means that an entity must not have been incorporated for more than seven years, its turnover must never have exceeded Rs 25 crores and its minimum net worth should be Rs 50 lakhs. RBI has also prescribed an indicative list of innovative products and services that can be included in the sandbox which range from marketplace lending, wealth management services to data analytics.

Upon selection of the entities and the products, RBI in consultation with the applicants will finalise the test design of the products and initiate the testing process. For the duration of the sandbox, RBI may consider relaxing some regulatory requirements depending on the type of products/services. However, observance of some requirements such as customer privacy, data protection, and KYC will be mandatory. Upon exiting the sandbox, the applicants must fully comply with the relevant regulatory requirements before the product or service can be permitted for wider application.

Suggested changes to the RBI Regulatory Framework

While the RBI Regulatory Framework is a step in the right direction, it is still in a draft form and RBI can consider the following modifications in the final framework:

- Entry barriers: RBI's eligibility criteria is restrictive and excludes both smaller firms and established firms which can develop equally meaningful technology. Most other jurisdictions including United Kingdom and Singapore have chosen not to prescribe such restrictive monetary requirements.

- Protection of intellectual property**:** Unlike the SEBI Innovation Framework as detailed below, the RBI Regulatory Framework does not provide safeguards for intellectual property rights. Since a sandbox is often the first live test for a new innovation, participants may have legitimate fears regarding the escape of their technologies to the public domain. RBI can also take cue from Singapore which introduced the 'Fintech Fast Track initiative' in 2018 to expedite the process for fintech patent applications to as fast as 6 months.

- Scope of liability and grievance redressal - The RBI Regulatory Framework absolves RBI of any liability arising from the sandbox process or in case of any dispute among the customers and participants. RBI may consider incorporating a grievance redressal system to cover for undue liability and require the applicants to have in place an adequate dispute resolution system as is mandated under the sandbox mechanism in Australia. In Australia, fintech companies are required to have a two-tier dispute resolution system consisting of an internal dispute resolution system, and membership of an external dispute resolution scheme approved by their regulator.

Basic features of the SEBI Regulatory Framework

Along the lines of RBI's Regulatory Framework, the SEBI Regulatory Framework grants flexibilities to financial institutions to experiment with fintech solutions on real customers in a live environment with regulatory relaxations on a case by case basis (such as relaxations from registration fee, track record etc). The SEBI Regulatory Framework is substantially the same as that of the RBI Regulatory Framework with a few procedural changes along with variations in the eligibility criteria. In the initial phases, only entities regulated by SEBI will be eligible for testing within the sandbox (without any monetary entry barrier). However, SEBI may subsequently consider permitting other entities (including start-ups) to participate depending on the responses received. Additionally, the SEBI Regulatory Framework also requires the participants to have a clearly defined grievance redressal mechanism for consumers.

Suggested changes to the SEBI Regulatory Framework

SEBI has invited comments on the SEBI Regulatory Framework by 18 June 2019. While SEBI has already addressed concerns regarding entry barriers and grievance redressal for consumers, it can consider making the following modifications in the final framework:

- Protection of intellectual property: Like the RBI Regulatory Framework, SEBI may consider incorporating safeguards for intellectual property rights in the SEBI Regulatory Framework.

- Scope of liability: While the SEBI Regulatory Framework does not explicitly absolve SEBI of any liability arising from the sandbox process, it does not provide for any grievance redressal system provided by SEBI for addressing grievances of the participants.

- Co-ordination between SEBI and RBI: Since, fintech innovations can be governed by both SEBI and RBI, there is a need for co-ordination between the two regulators to avoid any overlap of participation in the RBI Regulatory Framework and the SEBI Regulatory Framework.

Basic features of the SEBI Innovation Framework

The SEBI Innovation Framework proposes an innovation sandbox, which is an offline testing of innovative technologies in the securities market by fintech entities which are not regulated by SEBI. Unlike the regulatory sandbox, testing in SEBI's innovation sandbox takes place in isolation from the live market, without any participation from real customers. The testing is facilitated by providing a virtual environment where applicants can test their innovations by using market related data provided by stock exchanges, depositories and qualified registrar and share transfer agents, which data is not otherwise available to such entities. In this mechanism, the support provided by the regulator is in the form of providing data and infrastructure and not providing any regulatory relaxations as such.

SEBI has prescribed a subjective eligibility criterion for selecting an entity which includes all the fintech players intending to test innovative products in the securities market and having necessary resources to support the testing. For the purpose of testing, historical anonymized datasets will be made available to participants such as KYC data, transactions data, and mutual fund transactions data. The database will be provided through an application program interface and will be governed by a confidentiality agreement. Virtual machines may also be made available with configurations similar to the live environment.

In an improvement from the RBI Regulatory Framework, the innovation sandbox proposes to formulate rules to ensure that all applicants can perform tests while protecting their intellectual property rights. It also provides for a grievance redressal mechanism to deal with any grievances of applicants in the innovation sandbox.

Suggested Changes to the SEBI Innovation Framework

While the SEBI Innovation Framework is not in a draft form, relevant rules and guidelines under the framework are yet to be formulated. SEBI may consider the following issues while framing the rules to ensure successful implementation of the sandbox:

- Data accuracy**:** Since the success of the test depends upon the quality of the data provided to the applicants, SEBI must ensure that the data is accurate and representative of the market.

- Rules of participation: The rules of participation in the innovation sandbox which will provide operating guidelines, reporting requirements etc. should not be restrictive or cumbersome otherwise the framework would be counterproductive.

Sandbox – A win-win for all stakeholders

The regulatory and innovation sandboxes are expected to benefit all stakeholders involved in the process:

- Regulators**:** Regulators can develop an innovation-enabling framework after reviewing the empirical data generated from the sandbox testing.

- Fintech companies: Fintech companies can test the viability of an innovation without an expensive roll out, both in terms of customer satisfaction and regulatory amenability.

- Consumers: Consumers can get access to a wider range of products and services at reduced cost.

The role of regulators across the world is rapidly changing from being 'restrictors' to 'enablers' of technology. The Regulatory Frameworks by RBI and SEBI and the Innovation Framework by SEBI are enabling measures and if implemented well, are expected to provide a boost to fintech innovations and financial inclusion.

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