

Framework for Regulatory Sandbox*

PROLOGUE

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.

Participants in the capital market in India have been early adopters of technology. According to SEBI, encouraging adoption and usage of financial technology ('FinTech') would have a profound impact on the development of securities market. FinTech can act as an instrument to further develop and maintain an efficient, fair and transparent securities market ecosystem.

With a view to facilitate the development and adoption of innovative FinTech solutions, SEBI vide circular SEBI/HO/MRD/2019/P/64 dated May 20, 2019, stipulated a framework for an industry-wide Innovation Sandbox. Under this framework, FinTech start-ups and entities not regulated by SEBI may use the Innovation Sandbox for offline testing of their proposed solution, subject to fulfilment of the eligibility criteria.

Moving a step ahead in the same direction, SEBI introduced a framework, called as 'Regulatory Sandbox'. ***Under this sandbox framework, financial institutions regulated by SEBI shall be granted certain facilities and flexibilities to experiment with FinTech solutions in a live environment and on real customers. These features will be fortified with necessary safeguards for investor protection and risk mitigation.***

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Views expressed in the Article are the sole expression of the Author and may not express the views of the Institute.

THE SANDBOX FRAMEWORK- A SNAPSHOT

The term “Regulatory Sandbox” shall be defined as a live, testing environment where new products, processes, services and business models can be deployed on a limited set of eligible customers for a specified period of time with certain relaxations in the extant SEBI regulations and guidelines.

Innovation through investor-centric experimentation has the potential to create better financial products, lower the costs of transaction for investors and promote financial inclusion especially for Indian investors with limited means. However, there have been instances when innovation without proper regulatory oversight has caused damage to investors and economies. Therefore, it is imperative that new technology intensive business models and innovations are deployed with proper regulatory oversight and risk mitigation safeguards.

Purpose and Scope of the Regulatory Sandbox

- The purpose of the sandbox environment is to start an early dialogue with companies experimenting with innovative technologies, so that more innovation and technologically intensive products may be brought under the purview of SEBI/ regulatory ambit at an early stage and potential adverse events, if any, can be identified and avoided.
- The sandbox is intended to serve as a testing ground for new business models and technologies that benefit the investors, Indian markets and the Indian economy at large.
- Regulatory Sandbox as a platform would facilitate seamless information sharing between innovative firms and SEBI.
- By participating in the sandbox, while the companies would get an opportunity to test their solutions on real customers/ investors, on the other hand, it may help SEBI to frame policies that may reduce the time and cost of deploying new investor-centric solutions in the capital market.

Benefits of the Regulatory Sandbox

The sandbox framework provides many benefits through greater FinTech experimentation in the Regulatory Sandbox. Commendable aspects of the Regulatory Sandbox Framework are highlighted in the infographic below.

- Greater participation of investors as well as people who are raising capital or providing services. Increased financial inclusion and penetration of financial products, especially in Tier II/III towns and cities and rural areas.
- Ease of accessibility for retail investors (especially those with limited means), resulting in greater convenience, reduced operational costs, lower fees and transaction charges, while at the same time increasing the efficiency and transparency.
- Lower risk and more effective supervision.

LEGAL FORM AND MANDATE OF AN REGULATORY SANDBOX

The Sandbox Framework provides that all market participants registered with SEBI under section 12 of the SEBI Act 1992, shall be eligible for testing within the Regulatory sandbox. A market participant can come on its own or use the services of a fintech firm. The registered market participant shall be treated as the principle applicant, even if it uses the services of a fintech firm, and shall be solely responsible for testing of the solution in the sandbox.

The applicant must demonstrate eligibility criteria to the satisfaction of SEBI by showing clear evidence as listed below: -

a) Genuineness of innovation

The solution should be innovative enough to add significant value existing offering in the Indian securities market.

b) To test genuine need

The entity should have a genuine need for live testing the solution on real customers. Further, the applicant should demonstrate that the solution cannot be developed without relaxing certain regulations, if any, being sought.

c) Limited prior testing

Before applying for testing in sandbox, limited offline testing of the solution should have been carried out by the applicant.

d) Direct benefits to users

The solution should offer identifiable benefits (direct or indirect) to the investors or entities or to the capital market at large.

e) No risks to the financial system

The solution should have proper risk management strategy to incorporate appropriate safeguards to mitigate and control potential risks to any market participants/users that may arise from the testing of the solution and shall propose appropriate safeguards to manage the risks and contain the consequences of failure.

f) Testing readiness of the solution

The applicant should have the necessary resources to support testing in the sandbox and must demonstrate well developed testing plans with clear objectives, parameters and success criteria.

g) Deployment post-testing

The applicant should demonstrate the intention and ability to deploy the solution on a broader scale. To this effect the applicant should share a proposed sandbox exit and transition strategy.

APPLICATION AND APPROVAL PROCESS

Monitoring and administering a Regulatory Sandbox is a resource intensive activity on part of the SEBI. A Rolling approach will be followed wherein the applicant can apply anytime for participation in the regulatory sandbox. The applicant should ensure that the eligibility criteria are satisfied before submitting the application to SEBI. SEBI will communicate with the applicant/ sandbox participant in the course of evaluating the sandbox application, and continue to do so during the testing phase. If the applicant is a suitable participant for the sandbox and the project meets the eligibility criteria, it can proceed to submit the sandbox application form signed by the Chief Executive Officer (CEO) of the applicant or officer duly authorized by the CEO or compliance officer, to SEBI.

At the “Application Stage”, SEBI shall review the application and inform of its potential suitability for sandbox within 30 working days from the submission of the complete application. SEBI may issue guidance to the applicant according to the specific characteristics and risks associated with the proposed solution. SEBI may also consult its Committee on Financial and Regulatory Technologies (CFRT), if necessary, to evaluate the application.

At the “Evaluation Stage”, SEBI will work with the applicant to determine the specific regulatory requirements and conditions (including test parameters and control boundaries) to be applied to the proposed solution in question. The applicant will then assess if it is able to meet these requirements. If the applicant is able and willing to meet the proposed regulatory requirements and conditions, the applicant will be granted permission to develop and test the proposed FinTech innovation(s) in the sandbox.

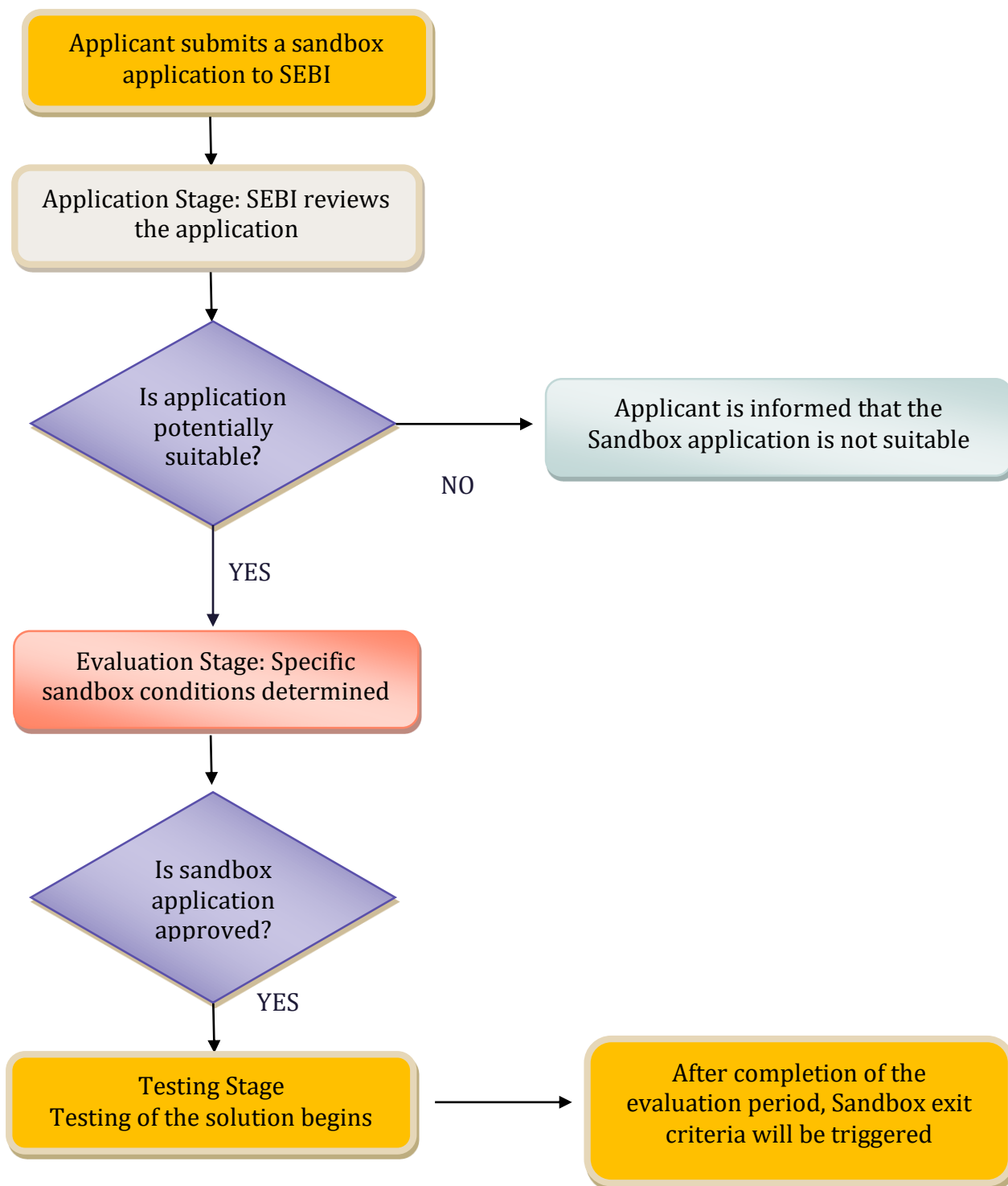
Upon approval, the application proceeds towards the “Testing Stage”. The participant shall disclose to its users that the solution shall operate in a sandbox and disclose the potential key risks associated with the solution. The applicant is also required to obtain the user’s acknowledgement that they have read and understood the risks.

The duration of the sandbox testing stage will be a maximum of twelve months and extendable upon request of the applicant.

During the testing stage, if the applicant intends to make material changes to the solution, the applicant should apply to SEBI and provide details of the proposed changes with reasons. SEBI’s approval will be required before the proposed changes can be implemented.

In case an application is rejected at any stage, the applicant will be informed accordingly along with the reasons for rejection which includes failure to meet the objective of the sandbox or any of the eligibility criteria. The applicant may re-apply for the sandbox when it is ready to meet the objective and eligibility criteria of the sandbox, subject to an appropriate cooling off period as decided by the SEBI.

The flowchart for the application and approval process is depicted as under:



EVALUATION CRITERIA

The applicant may be evaluated using a scoring process by the concerned department, inter alia, based on the parameters given below:

S.No.	Evaluation Criteria	Weightage (%)	Evaluated by	
			Department	Committee
1	Profile of the applicant	10		
2	Usage of innovative solution including technology and/or processes	10		
3	Identified benefits to the investors and/or the securities/commodities markets	10		
4	Compilation of meaningful test scenarios and expected/desired outcomes	10		
5	Risk measured/graded testing conditions and parameters so as to ensure safety and protection of the markets/investors	10		
6	Risk mitigation for high risk testing conditions and parameters	10		
7	Appropriate disclosure requirements and protection to their users	10		
8	Clearly defined grievance redressal mechanism and user rights	10		
9	Adequate disclosure of the potential risks to participating users	10		
10	Prior confirmation from users that they fully understand and accept the attendant risks	10		
11	Intent and feasibility to deploy the proposed FinTech solution post testing	10		

12	The deployment and monitoring strategy post testing (in the event the tests are deemed successful) or the exit strategy (in the event the tests are not successful)	10		
13	Any other factors considered relevant by SEBI	10		

The applicant has to score minimum marks in each parameter and achieve a minimum overall score to qualify for testing in the sandbox. Since these are the early stages of implementation of the regulatory sandbox and the learning curve, SEBI will reserve the right to modify the parameters, weightages and cut-offs as and when necessary. Further, SEBI will reserve the right to reject the project based on its evaluation and judgment.

REGULATORY EXEMPTIONS

To encourage innovation with minimal regulatory burden, SEBI will consider exemptions/relaxations, if any, which could in the form of comprehensive exemption from certain regulatory requirements or selective exemptions on a case-by-case basis, depending on the FinTech solution to be tested.

REQUIREMENTS WHICH WILL NOT BE RELAXED AND WHICH MAY MERIT RELAXATION

a. Requirements for which relaxation will not be considered

- i. Confidentiality of customer information
- ii. Fit and proper criteria particularly on honesty and integrity
- iii. Handling of customer's moneys and assets by intermediaries
- iv. Prevention of money laundering and countering the financing of terrorism
- v. Risk checks (like price check, order value check, etc.)
- vi. Principles of KYC

b. Requirements that may merit relaxation

- i. Net worth
- ii. Track record
- iii. Registration fees
- iv. SEBI Guidelines, such as technology risk management guidelines and outsourcing guidelines
- v. Financial soundness

(The above-mentioned list is for illustrative purpose only and not exhaustive)

Entities desirous of participating in sandbox will make an application, including exemption/relaxation being sought from relevant provisions of the applicable regulatory framework. The registration granted by SEBI to all entities registered with SEBI under Section 12 of the SEBI Act, 1992 is activity based. An entity which is registered with SEBI for a particular activity is authorized to carry out activity in that domain. In order to enable the cross domain testing of FinTech solutions, an existing registered entity would be required to first obtain a limited certificate of registration for the category of intermediary for which it seeks to test the FinTech solution(s).

“This concept of limited registration will facilitate the entities registered with SEBI to operate in a Regulatory Sandbox without being subjected to the entire set of regulatory requirements to carry out that activity”

Accordingly, regulatory relaxations from various SEBI regulations may be provided after analysing specific sandbox testing applications. SEBI has further notified SEBI Regulatory Sandbox (Amendment) Regulations, 2020 so as to enable the respective regulation to grant relaxation(s)/exemption(s), as may be deemed fit, while granting such limited certificate of registration.

SUBMISSION OF TEST RELATED INFORMATION AND REPORTS

During the testing period in the sandbox, SEBI may require the participant to submit information relating to the test.

The participant must ensure proper maintenance of records during the testing period to support reviews of the test by SEBI. Further, the participant shall also maintain such records for a period of five 5 years from completion of testing/ exit from the sandbox.

Interim Reports

During the testing period, SEBI may require the participant to submit information/ interim reports including:

- i) Key performance indicators, milestones and statistical information
- ii) Key issues arising as observed from fraud or operational incident reports
- iii) Actions or steps taken to address the key issues identified above

Final Reports

The Sandbox Participants must submit a final report containing the following information to SEBI within 30 calendar days from the expiry of the testing period:

- i. Key outcomes, key performance indicators against agreed measures for success or failure of the test and findings of the test
- ii. A full account of all incident reports and resolution of user complaints, if any
- iii. Key learnings from the test

Confirmation of Report

The interim and final reports must be confirmed by the Chief Executive Officer (CEO) of the applicant or officer duly authorized by the CEO or the compliance officer.

Obligations of the Applicant towards the User

The applicant will ensure that before signing up, the user has read the full documentation provided by the applicant and confirm that he/she is aware of the risks of using the solution. The applicant shall ensure that users participating in the sandbox have the same protection rights as the ones participating in the live market.

EXTENDING OR EXITING THE SANDBOX

At the end of the testing period, the permission granted to the applicant as well as the legal and regulatory requirements relaxed by SEBI, will expire.

Upon completion of testing,

- i) SEBI will decide whether to permit the FinTech innovation to be introduced in the market on a wider scale. Where allowed, participants intending to carry out regulated businesses shall be assessed based on applicable licensing, approval and registration criteria under various SEBI regulations, as the case may be.

OR

- ii) The applicant may employ an exit strategy.

OR

- iii) The applicant may request for an extension period to continue testing.

The applicant may exit the sandbox on its own by giving a prior notice to SEBI, in writing, of its intention to exit the sandbox. The applicant will ensure that any existing obligation to the users of the FinTech innovation(s) in the sandbox are completely fulfilled or addressed before exiting the sandbox or before discontinuing the sandbox testing.

The applicant is required to maintain records of acknowledgement of all its users stating that all the obligations towards the users have been met. These records shall be maintained by the applicant for a period of five years from the date of exit from the sandbox.

REVOCAION OF THE APPROVAL

SEBI may revoke an approval, to participate in the sandbox, at any time before the end of the testing period, if the applicant:

- i) Fails to carry out risk mitigants.
- ii) Submits false, misleading or inaccurate information, or has concealed or failed to disclose material facts in the application
- iii) Contravenes any applicable law administered by SEBI or any applicable law in India or abroad
- iv) Suffers a loss of reputation
- v) Undergoes or has gone into liquidation
- vi) Compromises the digital security and integrity of the service or product or elevates the risk of a cyber-security attack
- vii) Carries on business in a manner detrimental to users or the public at large
- viii) Fails to effectively address any technical defects, flaws or vulnerabilities in the product, service or solution which gives rise to recurring service disruptions or fraudulent activities
- ix) Fails to implement any directions given by SEBI

In addition to revocation of approval for participating in the sandbox, appropriate actions under relevant regulatory framework may be initiated against the applicant in case Fintech solution facilitates the following:

- i) Undermining of Know Your Customer (KYC) principles
- ii) Violation of user's/investor's privacy
- iii) Promotion of sale of fraudulent/illegal products or services
- iv) Promotion of mis-selling of products or services
- v) Violation of Anti-Money Laundering (AML) norms
- vi) Creation of risk to financial stability
- vii) Theft of intellectual property

Before revoking the approval to participate in the sandbox, SEBI will:

- i. Immediately suspend trials on new users i.e. no new users shall be permitted to sign up for using/testing the solution
- ii. Give the applicant a prior notice of its intention to revoke the approval; and
- iii. Provide an opportunity to applicant to respond to SEBI on the grounds for revocation

Where SEBI is satisfied that in the interest of the applicant, its users, the financial system or the public in general, it may revoke the approval immediately without prior notice and provide the opportunity to the participant to respond after the effective date of revocation. If the response is satisfactory, SEBI may reinstate the approval to participate in the sandbox.

Upon revocation of an approval, the participant must:

- i) Immediately implement its exit plan to cease the provision of the product, process, service or solution to new and existing users.
- ii) Notify its users about the cessation and their rights to grievance redressal, as applicable.
- iii) Comply with obligations imposed by SEBI to dispose of all confidential information including user's personal information collected over the duration of the testing.
- iv) Compensate any users who had suffered financial losses arising from the test in accordance with the safeguards submitted by the participant.
- v) Submit a report to SEBI on the actions taken, within 30 days from the revocation.
- vi) Comply with any other directions given by SEBI.

LIMITATIONS**The solutions/products will not be permitted to be tested in the Regulatory Sandbox under the following circumstances:**

- a) The proposed FinTech solution is similar to those that are already being offered in the markets, unless the applicant can demonstrate that either an innovative (efficient alternative) technology is being used; or the same technology is used more efficiently (process efficiency).
- b) The applicant has not carried out its due diligence, including testing the proposed FinTech solution in an offline test environment.
- c) The applicant has no intention of deploying the FinTech solution in India on a broader scale after exiting from the Sandbox.

POTENTIAL RISK MITIGATES

- The applicant must identify the potential risks to any market participants that may arise from the testing of the solution in the sandbox and propose appropriate safeguards to manage the risks and contain the consequences of failure.
- The applicant will follow appropriate disclosure, protection and compensation requirements related to their users agreed upon, on a case-by-case basis.
- The applicant is required to have a clearly defined grievance redressal mechanism and user rights.
- The applicant must provide adequate disclosure of the potential risks to users participating in the sandbox and seek prior confirmation from such users that they fully understand and accept the attendant risks.

- Market participants participating in the sandbox shall have the same protection rights as the ones participating in the live market.

CONCLUSION

The regulatory and innovation sandboxes are expected to benefit all stakeholders involved in the process viz. Regulators, Fintech Companies, and consumers. 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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