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BOSTON HEADQUARTERS
7 Winthrop Square, Boston, MA 02110-1245
Phone: 617-542-8010 • Fax: 617-542-8028

WASHINGTON OFFICE
1001 Connecticut Avenue NW, Suite 510, Washington, DC 20036
Phone: 202-452-6252 • Fax: 202-296-4062

www.nclc.org

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Kelly Griffith
Executive Director
Center for Economic Integrity
509 E. Radburn Street
Tucson, Arizona 85704

Re: HB 2434 (Weninger), Regulatory Sandbox Program

Dear Kelly:

You have asked me to analyze HB 2434, sponsored by Arizona Attorney General Mark Brnovich and introduced by Representative Jeff Weninger, to establish a regulatory "sandbox" in Arizona. The proposal would exempt a broad and vaguely defined category of "innovative" services offered by lenders, money transmitters, insurers and other financial providers from the obligation to obtain an otherwise-required license in Arizona for up to three years.

In my opinion, the license exemption could relieve companies of the obligation to comply with a host of consumer protection measures, and prevent oversight from the Arizona Department of Financial Institutions, with little to nothing to compensate for the substantial risks posed to consumers by untested and unsupervised products and services.

Overview

The premise of the sandbox program is to allow truly innovative and beneficial start-ups or products a space to test their products. But the vague definition of "innovative" could apply to almost any new or slightly revised product or service.

Companies would not have to fulfill licensing requirements that are designed to protect the public, not even the barest minimum safety and soundness requirements or other conditions relevant to their product or service. For example, a company that employed new technology, such as virtual currencies, in a money transmission product would not have to post a bond or to demonstrate sufficient capital to protect consumers if the funds disappear or are not transmitted as promised.

The proposal appears to relieve companies of regular supervision by the Arizona Department of Financial Institutions, which has the expertise to oversee products and services that require an Arizona license. Instead, the Arizona Attorney General's office, which has experience in enforcing the law but not in overseeing financial products, would be in charge of the exemption application process. The AG could request records if desired but companies would have no ongoing reporting requirements. The bill fails to require tests or reports that generate actionable information and provides no mechanism to ensure that consumer concerns voiced are addressed. The proposal contains only vaguely-worded consumer protection assurances.

Ironically, oversight would be relaxed for precisely the untested companies and business models that could most benefit from it. The proposal differs markedly from efforts by other regulators to encourage innovation while maintaining consumer protections. In brief, the proposal would weaken the protections for Arizona consumers and would constrain the ability of the State of Arizona to prevent or detect problems with new products or services.

Analysis

A vague and broad class of "innovative financial product or services" could escape licensing requirements and oversight.

The proposal allows for testing of any "innovative financial product or service" that would come under the purview of the Arizona Department of Financial Institutions so long as the product or service "includes an innovation." The bill defines innovation broadly:

> *"Innovation" means the use or incorporation of new or emerging technology or the reimagination of uses for existing technology to address a problem, provide a benefit or otherwise offer a product, service, business model or delivery mechanism that is not known by the attorney general to have a comparable widespread offering in this state.*

Financial products and services are constantly improving. The use of new or reimagined technology is the rule rather than the exception. As long as the product is novel – or claims to be – then the product could escape regulatory oversight. Indeed, the use of technology need not even be that new or untested; it could have been offered for a considerable period of time outside of Arizona or could have been tested in Arizona and now is being offered on a widespread basis.

The use of technology is deemed innovative if its use "is not known by the attorney general." Yet the AG is not a financial services regulator and does not have a staff with experience in examining or regulating financial services providers, or even in monitoring this market. The AG simply is not equipped to monitor every product, service or technology used in the state and to know what is new and what is not.

The innovation need only address a "problem" or provide an undefined "benefit." Yet any use of technology can be said to address a problem or provide a benefit. There are no standards to distinguish minor or routine iterations or upgrades from truly revolutionary or unusual innovations.

One can imagine a situation where a technology is "reimagined" with only the slightest change in order for the provider to evade licensure. For example, should a money transmitter that allows consumers to fill out the paperwork on their own mobile device before handing off the funds be exempt from licensure because it has reimagined the forms? This may sound like a far-fetched example, but since the proposal allows anyone to apply, including already regulated entities, it seems entirely possible.

Innovations are also not always positive for the public. Pick-a-payment, negative amortization and exploding interest rate mortgages were also touted at the time as innovations. Innovations that are not subject to oversight are more likely to harm consumers.

The bill exempts companies from licensing requirements that create basic safeguards for consumers.

The bill allows a licensing exemption for up to two years, with an option for another year extension, and exposure of up to 10,000 consumers to the exempt products or services.

The dollars that consumers could lose are considerable:

- Loans can go up to $15,000 per transaction, and up to $50,000 per consumer;
- For money transmissions, individual transactions may be up to $2,500 and up to $25,000 in aggregate per consumer;
- For insurance and investment management products, there are no limits.

Despite the substantial exposure that consumers could face, the exemption would remove the protection of Arizona's licensing regimes, which reflect substantive consumer protection concerns.

It is worth noting that many fintech products are aimed at vulnerable consumers. For example, check cashing, small dollar credit, and money transmission for the unbanked are often targets for so-called disruptors.[1] It is difficult to imagine a financially fragile household that could absorb the shock of losing $1,000, much less $50,000. Consumers would be guinea pigs in tests with few protections or oversight.

The Arizona lending license statutes ensure that licensees demonstrate "the financial responsibility, experience, character and general fitness to command the confidence of the public and to warrant the belief that the business will be operated lawfully, honestly, fairly and efficiently."[2] The statutes also ensure compliance with loan-term and disclosure regulations by requiring compliance examinations and investigations by state regulators as well as recordkeeping and annual reports.[3] These state licensing statutes reflect the strong public policy interest in ensuring that entities seeking to engage in the consumer-lending business are vetted and supervised by regulators for compliance with consumer protections and other laws.

Arizona's money transmitter licensing regime protects consumers who turn over funds for transmission domestically or internationally.[4] License applications, which must be made under oath, require companies to, *inter alia*, identify themselves, their principals and their aliases; disclose any criminal convictions; and provide a properly audited financial statement. License applications must be accompanied by a bond of $25,000 to $500,000, depending on the size of the company, and licensees must have sufficient net worth and assets held in permissible investments to protect consumers if things

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[1] *See, e.g.,* Larry D. Wall, Center for Financial Innovation and Stability, Atlanta Federal Reserve Board, "Fintech and Financial Inclusion: Notes from the Vault" (August 2017), https://www.frbatlanta.org/cenfis/publications/notesfromthevault/08-fintech-and-financial-inclusion-2017-08-30.
[2] Ariz. Rev. Stat. § 6-603(F)(2).
[3] Ariz. Rev. Stat. §§ 6-607, 6-608(A), 6-609(A)-(D).
[4] Ariz. Rev. Stat § 1201 et seq.

go wrong. Companies must file with the Superintendent of Financial Institutions a consolidated financial statement at the end of each fiscal quarter.

Yet, under the bill, any company that claims to use new technology could be exempt for up to three years from safety and soundness requirements that licensed Arizona money transmitters must meet. If the “innovative” firms fail, consumers could be out any funds entrusted to them without recourse.

Similarly, the bill appears to exempt “innovative” insurance products from the requirements for an insurance license. Those requirements are designed to ensure that people who pay considerable sums for insurance get what they pay for and, when something goes wrong, the insurance company is willing and able to pay out claims.

Insurance is an especially inappropriate product for the broad regulatory exemptions proposed by HB 2434. Arizona (and every other state) has an insurance commissioner and department staffed with insurance experts because, within the world of financial services, insurance products are unique in their level of complexity. The state owes consumers of insurance products a high level of oversight both because of this complexity and the fact that the purchase of auto insurance is mandated by the state for all drivers and home insurance is a prerequisite for a mortgage. Insofar as companies believe they can improve the insurance products offered in Arizona or any other state, they should work with the insurance department, and in accordance with state protections against unfair discrimination, excessive rates, and other standards that ensure consumers can comply with insurance mandates.

The few nominal consumer protections in the bill are meaningless.

For all of the products and services covered by the bill, the risk that a firm could fail or that a product or service could harm consumers is especially high with new, untested products – the very type that the sandbox is aimed at. Indeed, the legislation even includes several references to what happens when a product fails, anticipating that this will happen for some products. But the few consumer protections that bill does provide are so minimal as to be virtually useless.

The legislation requires that applications contain a “plan to test, monitor and assess the innovation while ensuring consumers are protected from a test's failure.” Yet that vague requirement has no specifics or standards and nothing to back it up. If an innovation fails before the end of the testing period, the sandbox participant “must notify the attorney general and report on actions taken to ensure consumers have not been harmed as a result of the innovation's failure.” But beyond this notice requirement, there is nothing to protect consumers who are indeed harmed.

Notably, the application process is overseen not by the Department of Financial Institutions, which has experience reviewing license applications and supervising financial companies, but by the Attorney General, who does not. Moreover, the AG must act on an application in 90 days, giving little time to determine whether a company poses risks to consumers.

The disclosure requirements mandate that providers must tell consumers that the product is a test and the provider is unlicensed. But consumers will not appreciate the significance of the lack of a license, and those disclosures are likely to be fine print that consumers do not even notice.

Consumers may complain to the Attorney General, but there is nothing in the bill that says the department must investigate or otherwise act on consumer concerns. The bill incorporates the AG's general powers under the Consumer Fraud Act but does not ensure that the AG will be actively overseeing companies operating without a license.

The bill shields consumer complaints and other information from public record laws and public scrutiny.

There are no mechanisms to monitor the program.

The bill also fails to require anyone to gather information to make an assessment of the efficacy of the sandbox. While the AG may seek information from companies that obtain exemptions, that is no substitute for regular submissions and supervision required under the licensing laws. There are no provisions in the bill for close tracking or ongoing supervision of sandbox participants.

The bill has no reference to any powers of the Department of Financial Institutions.

Efforts to Encourage Innovation Need Not Leave Consumers Unprotected

Other financial services regulators have embarked on efforts to encourage innovation. These efforts may recognize the uncertainty present when new products or services are launched. However, regulators have been careful not to give carte blanche to new products in the name of "innovation" or to broadly exempt new products from oversight. Rather, other programs have significant safeguards built in and rigorous vetting programs for participants.

The Office of the Comptroller of the Currency (OCC), the regulator of national banks, has also launched an effort to foster financial innovation. The OCC has established an Office of Innovation, which serves as a central contact and clearinghouse for requests and information to support innovation in the federal banking system. The office, among other things, promotes a continuing dialogue with fintech companies, provides technical assistance, creates a process for pilot projects, and fosters OCC staff awareness of responsible innovation and emerging trends.[5]

The OCC innovation efforts do not exempt financial institutions from the requirement to hold bank charters to engage in banking activities or FDIC insurance where otherwise required.

Former OCC Comptroller Thomas Curry, who established the Office of Innovation, specifically rejected the concept of a "sandbox." "Sandboxes" have been pitched as "a 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms in a live environment without immediately incurring all the normal regulatory consequences."[6] In other words, a sandbox is a place to "play," but in the real world, without complying with "real world" rules. Curry explained why this was a dangerous idea:

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[5] OCC, "Office of Innovation: A General Guide," https://www.occ.treas.gov/topics/responsible-innovation/occ-innovation-general-brochure.PDF.

[6] Remarks by Thomas J. Curry, Comptroller of the Currency, Before Chatham House 'City Series' Conference, "The Banking Revolution: Innovation, Regulation & Consumer Choice" at 5 (Nov. 3, 2016) ("Curry Speech"), https://www.occ.gov/news-issuances/speeches/2016/pub-speech-2016-142.pdf.

> I do not support this approach. Waiving compliance with consumer protection or safety and soundness never makes sense, nor does our agency have the authority to waive compliance requirements. It is the company's responsibility to ensure products and processes are safe before rolling them out. But, companies can conduct carefully designed pilots responsibly and limit their liability by controlling scope and duration and ensuring their tests are closely monitored throughout.[7]

The OCC has also explored allowing banks "to test or pilot new products and services on a small scale before committing significant bank resources to a full rollout. Such a program could entail board approval and appropriate limitations that would protect consumers and would not involve giving banks a safe harbor from consumer laws and regulations during the testing phase of a new product."[8]

In the United Kingdom, the Financial Conduct Authority established a regulatory sandbox in 2016.[9] The test periods are six months long. Each sandbox participant has a dedicated case officer, who assists the participant in design and implementation of the product test.[10] The case officer facilitates engagement with subject matter experts from the UK regulator and works to ensure that appropriate safeguards are built in during and after testing. Safeguards have included extra capital requirements, systems penetration testing, and secondary review. Participants must submit a final report summarizing the outcomes of the test.

In contrast to these carefully limited and monitored programs, the Arizona proposal exempts companies broadly from licensing requirements with no specific additional requirements and little oversight.

Conclusion

The bill's premise of encouraging innovation is laudable. However, exempting broadly and vaguely defined "innovative financial product or services" from substantive licensing requirements and oversight with little to nothing in their place could pose substantial risks to consumers.

Please let me know if you have any questions.

Yours very truly,

Lauren Saunders
Associate Director

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[7] Curry Speech at 5.
[8] OCC, "Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective" at 6 (March 2016), http://consumerbankers.com/sites/default/files/OCC%20whitepaper%20fin%20inno%282%29.pdf.
[9] See https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf
[10] See https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf at 4.