



# Bocconi Students Fintech Society

Regulatory Sandboxes

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# Introduction

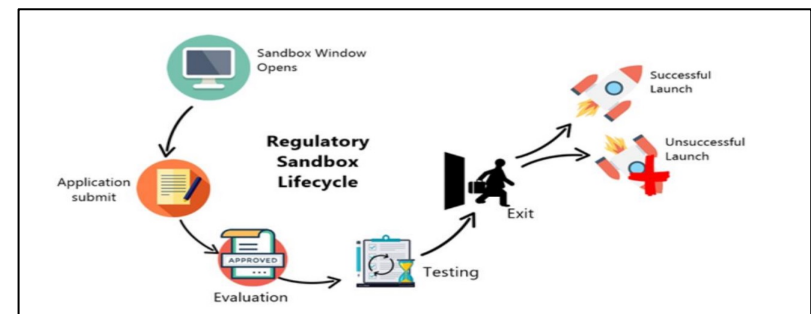
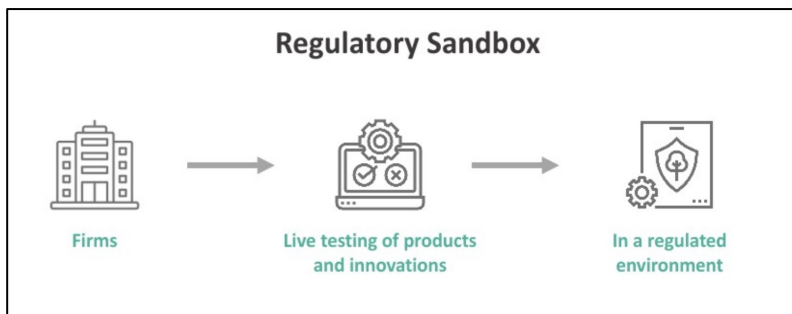


## What are Regulatory Sandboxes and How do they help?

Regulatory sandboxes are delimited spaces in which rules are applied more loosely, being the perfect places to test new technologies, approaches, or services. These technologies are not ready for the market, not being compliant in entirety with the legal or regulatory framework. Therefore, Regulatory Sandboxes are usually operated for a limited time and in a limited part of a sector or area prior to the technologies' launch.

The purpose of sandboxes is to find the risks and opportunities that a specific innovation creates in a scene alike the real world and to develop an environment that can accommodate it. Therefore, sandboxes help small businesses ensuring that they comply with complex frames of regulations and, since small firms do not have the power to legally challenge regulations, sandboxes give them a chance to level the playing field.

The idea of regulatory boxes appeared in 2014 in the United Kingdom. The Financial Conduct Authority(FCA), a regulatory body, characterizes sandboxes as “a ‘safe space’ in which 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.”



Sources: Federal Ministry for Economic Affairs and Climate Action, Wall Street Mojo, State Policy Network, Royal Monetary Authority of Bhutan

# An Analysis on the Effects of Regulatory Sandboxes



## Benefits

The main beneficiaries of sandboxes are small businesses/entrepreneurs and customers.

Entrepreneurs have a space to experiment with loose regulations.

While customers benefit from all the improvements made in the sandboxes.

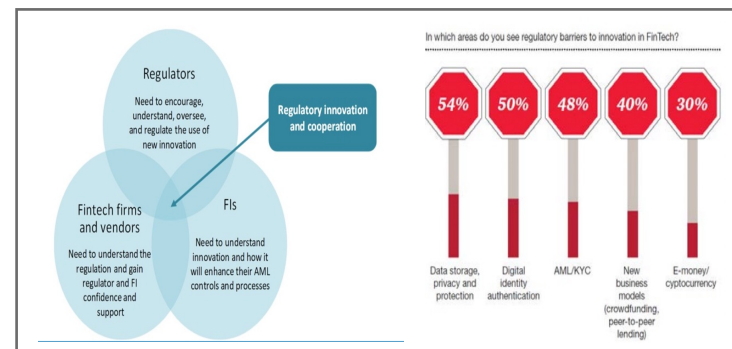
Furthermore, the economy benefits from the easier integration of new innovations in the market, by creating jobs and opportunities.

Sandboxes also make the entry barrier in some industries lower and thus increase competition.

## Risks

Although the benefits seem incredible, not everybody looks so keenly on sandboxes, for example the already established industries with high entry barriers due to potential competitors.

Moreover, some economists pointed out that the sandboxes can be misused or abused, while Hester Peirce, Commissioner of the US Securities and Exchange Commission (SEC), brought up the idea that sandboxes actually slow or even halt innovation.



Sources: AITE, European Parliament, State Policy Network

# Case Study: The DLT Pilot Regime Sandbox



## Structure and Exemptions Provided by the Sandbox

The European Blockchain Sandbox, initiated by the European Commission, aims to facilitate regulatory dialogue and address legal obstacles for innovative Distributed Ledger Technology (DLT) solutions like **blockchain**. The project provides a confidential environment for regulators and innovators to exchange insights, enhance regulatory knowledge, and contribute to best practices across industry sectors and regions.

While traditional regulations allow only institutional investors to enter the **DLT MTF**, the regulations allows also **neutral and legal persons as members or participants**, provided that: they possess a reputable standing, demonstrate sufficient trading proficiency, refrain from acting as market makers, avoid employing high-frequency algorithmic trading, abstain from providing direct electronic access to the **DLT MTF**, avoid executing client orders for their own account, and provide informed consent while being apprised of potential risks when engaging in trading DLT financial instruments on the **DLT MTF**.

## Requirements for Entry

Annually supporting **20** projects from 2023, the sandbox is open to **blockchain** use cases based on any infrastructure, prioritizing maturity, legal relevance, and alignment with EU policy priorities. Participants, including companies and public entities, with validated proof of concepts, can apply through the website.

The DLT Pilot Regime Regulation applies exclusively to **crypto-assets** meeting the criteria of financial instruments, namely:

- Shares of a value inferior to **€500 million**
- Bonds and money market instruments of value inferior to **€1 billion**
- Units in collective investment undertakings subject to the UCITS Directive whose market value is less than **€500 million**
- Aggregate value of financial instruments traded on the market structure which needs to be below **€9 billion**

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Sources: : European Commission; Lexia

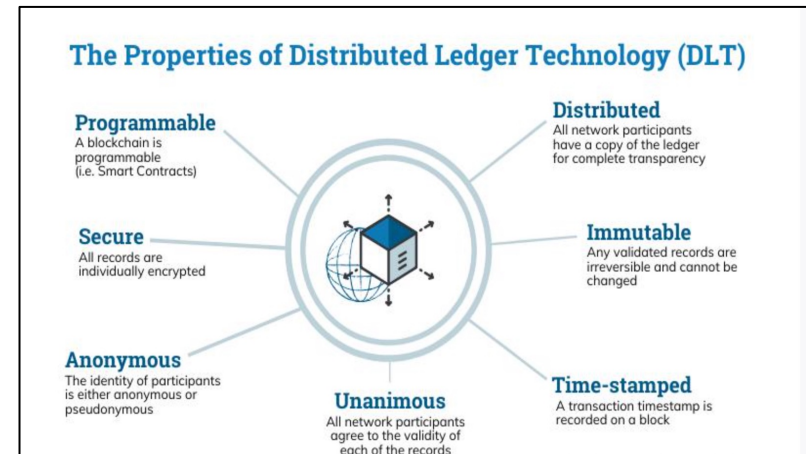
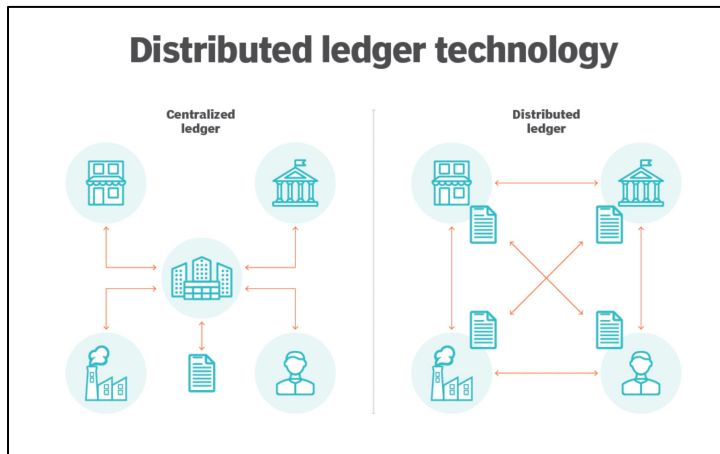
# An Elaboration on DLTs



## What are DLT's?

Distributed Ledger Technologies (DLT) are innovative systems that use **decentralized networks** to maintain **secure** and **tamper-resistant ledgers**, allowing transparent and **immutable recording of transactions** through **consensus** mechanisms. The financial sector is leveraging technology, with a focus on decentralized technologies like DLTs, for digitalization. DLT offers advanced and mature characteristics, ensuring **operational reliability**, **resilience to cyber-attacks**, and **robust governance**. This enables benefits such as **efficiency** improvements, **extended operating hours**, **cost reduction**, and **faster transactions**, while DLT's sandboxes allow operators to manage **crypto-assets** exempt from major sector regulations.

DLTs operate through a decentralized **network of nodes** that collectively maintain a secure and tamper-resistant ledger. Each transaction, represented as a **block**, is added to the **chain** in a chronological order through **consensus mechanisms**, ensuring transparency and immutability, while acceptance of new information requires **validation by majority** of the network participants, **preventing unauthorized alterations** to the ledger.



Sources: Deloitte, TechTarget,

# Predicted Impact on the Market



## Impact on Market Regulators

National regulators and supervising authorities will be able to discuss regulatory issues that have arisen on a national level in a **cross-border setting** with other EU and national regulators making use of the **Pan-European** sandbox framework that is established for this project.

Regulators have the chance to **support applications** of use-cases for the sandbox that they find particularly relevant for a regulatory dialogue.

Participating regulators and supervising authorities will have an opportunity to contribute to the **development of best practices** and **lessons learned** which can be shared between them. Moreover, regulators will be able to **cooperate and exchange experiences** and insights with other national and EU regulators participating in the sandbox for a specific use case.

The best practices reports will identify regulatory and legal issues and solutions with a focus on **fostering mutual learning** across sectors. These will be prominently published, highlighting the contributions of the participating regulators and supervisors.

## Impact on Market Participants

### Positives

- High **investor protection, transparency, market integrity** and **stability**
- Firms operating with the licenses compete against central security depositories, but central security depositories may now be able to offer **trading facilities** through becoming a **DLT TSS**
- The regime allows for **more efficiency** and **disintermediation** in trading and settlement

### Negatives

- New entry barriers (licenses) will mean **non-incumbent** firms may **move outside the EU**
- It does **not** provide for third country regimes applying to platforms **outside EU**
- Due to the temporary nature of the project, firms **might not invest significantly** upfront

Sources: Lexia, Linklaters, Freshfields Bruckhaus Deringer

# Regulatory Sandboxes Vs. Traditional Regulation



## Traditional Regulation

Regulation can be defined broadly as those measures in which the government supervises market activity, protects consumers, maintains financial stability, and upholds the public interest. Therefore, in many cases, they are quite strict and the increasing use of technology in finance ('FinTech') in recent years has added complexities and posed challenges for regulators across the globe.

Traditional Regulation within the realms of fintech aims to ensure the proper functioning of financial institutions. It refers to the established legal and regulatory frameworks designed to monitor financial services, which include a set of rules and laws enforced by regulatory authorities. The framework contains aspects such as licensing requirements or consumer protections norms and these constitute criteria that must be met by fintech companies.

### Characteristics :

Compliance-based: one of the main characteristics of Traditional Regulation is its strong insisting on compliance. The frameworks require fintech companies to comply with the criteria, aiming for the functioning of these firms

Specific Nature: Involves specific rules and standards such as defined operational guidelines and exact capital requirements. Additionally, entities must obtain specific licenses which ensures only qualified institutions within the market.

Stable and Rigid structure: Both Traditional frameworks are involved in fixed legal frameworks and apply uniform standards to entities as a whole rather than assigning to individual entities. These stable standards imply a predictable environment which alongside the strong requirement of compliance, reduces the place for risk.

### Benefits:

Financial Stability: Traditional regulation is crucial in maintaining an overall stable market. By enforcing strict compliance rules, this reduces the risk of market instabilities due to failure of financial entities. Thus, the rigid and strict nature of traditional regulation alongside the continuous monitoring ensure that the institutions operate in a way that decreases the risk of market disruptions

Consumer protection: Regulations aim to protect consumers and build trust in fintech services. The regulation frameworks establish consumer protections standards and regulatory authorities enforce the compliance with these standards, for fintech companies to practice methods that protect consumers from fraud and financial crimes. One example in the USA is the **Truth in Lending Act** which ensures that individuals are fully informed about the different costs of credits, enhancing transparency and fair decision making in lending processes.

Sources: UNSGSA, European Parliament, Organization for Economic co-operation and Development

# Regulatory Sandboxes Vs. Traditional Regulation



## Similarities:

Communication and collaboration: Both regulatory sandboxes and traditional regulatory frameworks recognize the importance of essential communication between regulators and market participants to inform regulatory actions that strike the correct balance between promoting innovation and mitigating (new) risks. A shared goal is ensuring the safety and well-being of consumers.

Overnight Law Compliance: Both are involved in regulatory oversight. Regulatory authorities are responsible for monitoring activities, whether in a controlled sandbox environment or under traditional regulation. They require businesses to comply with the applicable laws and regulations. While the level of flexibility can vary, compliance with legal requirements is fundamental in both regulatory sandboxes and traditional regulatory frameworks.

## Why regulatory sandboxes are better:

Traditional regulations are more inflexible which for new entrants presents a difficulty. To help them, the innovative sandbox regulations enable access to dedicated supervisory resources with specialist expertise. Accordingly, they develop a much better understanding of supervisory expectations.

Innovation facilitators have the potential to "shorten the time-to-market cycle" for new products. Additionally, it has been reported that sandbox admission can enhance financing prospects for start-up businesses. In some cases, the facilitator schemes allow the companies "*some time before* they have to fully meet the requirements of the prudential framework", ensuring the firm adapts to its elements at a much more convenient pace.

In the field of financial innovation, fostering dialogue and the exchange of experiences between innovation champions can help regulators gain valuable insights and understand emerging risks associated with FinTech. Regulatory sandboxes and their controlled environments allow regulators to closely monitor the development and implementation of new financial products, services, or business models. The acquired knowledge supports timely updates of regulatory policies and removes practical barriers to innovation. Additionally, they also increase the visibility of technology-related developments across regulatory frameworks, allowing regulators to assess the need for coordination.

The regulatory sandboxes foster competition, encourage financial inclusion and expand consumer choice by reducing regulatory barriers and uncertainties for newcomers and established institutions.

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Sources: European Parliament, Organization for Economic co-operation and Development



# Regulatory Sandboxes Vs. Traditional Regulation



## How regulatory sandboxes can prove to be different to traditional regulation in terms of international collaboration

### Purpose and flexibility :

**Traditional Regulation** is more **rigid**: it contrasts with more **flexible** and **innovative** regulatory approaches like the ones of regulatory sandboxes (experimentation Traditional regulation often results in a **delay** in technological developments

**Sandboxes** are used in **evolving sectors** like finance and tech, meanwhile, traditional regulation is more static (it responds to evolution)

### Adapting to Global trends:

**Sandboxes**: designed to be flexible and adapt to different situations.

- facilitates the process of incorporating new global fintech innovations, products or services. Serves as an advantage in today's globalized world particularly in terms of the technological aspect of the world from which new technologies or business emerge internationally.

**Traditional Regulation**: more rigid framework which is a challenge, implies a slower time process to adapt to global trends.

- delay between emerging technologies and regulatory responses. They are engaged in sets of complex legal frameworks that require legislative action to modify. (slow and lengthy process ) The pace of legislative change rarely keeps up with the speed of technological advancements, especially in sectors like fintech.

### Attraction on a global scale:

**Sandboxes**: a supportive environment for global trends

- seek to test new services which can attract international companies.
- wider recognition of the services and investment
- improves the global realm of the sandboxes

**Traditional Regulation**: rigid and slow adaptation to change of trends, may be viewed as a barrier by international companies due to its complexity and the slower pace The lack of capacity to rapidly adapt to newly evolving technology can demotivate companies on an international scale to rely on traditional regulation as they depend on newer existing technology or services. Often have rules that vary from one country to another which is a form of complexity, a burden for **international companies**.

**Example** : European union law that is applied to all companies. Lays down rules for the protection of personal data meanwhile the United states does not have a unified federal law governing privacy protection

Sources: UNSGSA, European Parliament, Organization for Economic co-operation and Development

# Regulatory Sandboxes: Summary



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## A Helpful Tool for both Fintech Firms, Financial Institutions and Regulators

Regulatory Sandboxes work as laboratories where firms testing out new technologies can experiment on market responses as well as realize compliance requirements without facing heavy consequences before launching these technologies.

As a collectively designed environment, a regulatory sandbox can facilitate fintech firms to also comprehend appropriate financing practices like capital structuring, cash management etc. The sandboxes also provide financial institutions to identify and fund well-performing companies in addition to realizing the regulatory requirements entailed in the particular investment process.

A notable case study that can be observed to evaluate the effects of a regulatory sandbox is the European DLT Pilot Regime Sandbox. The European DLT Pilot Regime Sandbox represents a significant step forward in fostering innovation within the financial technology sector. This regulatory sandbox initiative allows companies to test and deploy their distributed ledger technology (DLT) solutions in a controlled environment, enabling them to experiment with new ideas without the burden of full-scale regulatory compliance. The sandbox framework not only facilitates a more agile and collaborative approach between regulators and industry players but also helps identify potential risks and challenges associated with emerging technologies.

In comparison to traditional regulation systems, a regulatory sandbox provides a more flexible and collaborative environment. In traditional regulatory frameworks, compliance requirements are established and enforced before financial products or services are launched, often leading to a lengthy and complex approval process.



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