



# Politics, Playgrounds, and Public Ledgers:

## *The Political Obstacles that Regulatory Sandboxes Face and How to Overcome Them*

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### **Introduction: Everyone Wants to Play in the Sandbox**

There's a saying around most professional sports that it's all a "copycat league." Take, for example, the NFL: in 2008, the Miami Dolphins started running trick plays out of the "wildcat formation" with Ronnie Brown and Ricky Williams, most notably using the formation in a 38-13 upset over the New England Patriots. After the Dolphins' initial

success, other teams began instituting wildcat plays into their offenses looking to gain a competitive edge over unsuspecting defenses. However, professional sports are not the only "copycat league" and, arguably, not even the best. Our 50 states are infamous for copying the laws and policies of others, looking to create jobs by remaining competitive for investment and businesses seeking to expand or relocate.

One of the newest policies catching fire across the states, especially as they seek to jump-start their economies in a post-COVID world, is to foster and recruit innovative technologies, start-ups, and entrepreneurs through a regulatory sandbox.

Regulatory sandboxes are programs to assist innovative entrepreneurs and small business owners as they test, try, and launch new technologies and products by providing temporary relief from archaic regulations that would otherwise make it difficult or impossible to get products or businesses off the ground.<sup>1</sup> Regulations often serve as a barrier to entry for new companies and technologies. According to the National Small Business Association, the average cost of regulations for a business in its first year is more than \$83,000.<sup>2</sup> Regulatory sandboxes offer a way to curtail the barriers to entry for innovative businesses and allow them to scale up and grow without the need for difficult broad regulatory reform.<sup>3</sup>

Sandboxes have a promising track record. A study of the world's first sandbox, the United Kingdom's Financial Conduct Authority (FCA) created in 2016, found that of the 700 FCA participants, 80 percent were still in business and 40 percent of them saw a reduction in time to get to market.<sup>4</sup> Another study found FCA participating companies were 50 percent more likely to obtain investment funding and would receive 15 percent more funding than nonparticipants.<sup>5</sup>

Since Arizona created the first state regulatory sandbox in 2018 focusing on financial technology companies ("fintech"), the idea has spread like wildfire, with ten states creating 17 different sandbox programs

in just a few short years.<sup>6</sup> While regulatory sandboxes started almost exclusively in the fintech space, the concept has been applied to as diverse areas as digital medical technology in Wyoming, property technology in Arizona and, most notably, Utah's first-ever universal sandbox that covers the entire regulatory scope of the state.

### **It's Hard to Play Nice: Political Obstacles**

While many states have looked to create regulatory sandbox programs, that doesn't mean sandboxes don't have their detractors. In fact, the majority of sandbox proposals have failed, with dozens of sandbox legislative proposals filed since 2018.<sup>7</sup> For example, when the Consumer Financial Protection Bureau sought to create a regulatory sandbox at the federal level, it received considerable pushback, with over 80 advocacy groups from a wide variety of backgrounds writing to oppose the idea.<sup>8</sup> Additionally, over 20 state attorneys general similarly opposed the proposal, with New York AG Letitia James asserting she rejected the notion "that innovation can only be fostered by permitting companies to evade the law."<sup>9</sup>

State proposals have likewise encountered resistance. For example, despite fintech sandboxes often focusing on encouraging innovations that bring new financial products and services to small businesses and those typically underserved, Illinois's chapter of Small Business Majority opposed the fintech sandbox proposal in Illinois in 2019.<sup>10</sup> The next year, the Illinois Department of Financial and Professional Regulation argued in a report that the state should not pursue a regulatory sandbox due to

consumer protection fears and instead advocated that the state pursue Special-Purpose Depository Charters (SPDIs) similar to Wyoming.<sup>11</sup> One writer for the *Financial Times* compared sandboxes to nothing more than a “publicity stunt.”<sup>12</sup>

Even if a governor’s administration proposes a regulatory sandbox, it’s no guarantee of success. During the 2020 legislative session in Tennessee, the Tennessee Department of Commerce and Insurance, the regulatory agency responsible for regulating the insurance industry and all commerce-related licensed professions, had the “Licensing Innovation Act” introduced as part of Gov. Bill Lee’s agenda.<sup>13</sup> However, the proposal was ultimately defeated due to push back from professional associations like the TN Society of Professional Engineers and Home Builders of Tennessee. In 2021, my organization, the Beacon Center of Tennessee, and our sister advocacy organization, Beacon Impact, worked on a revised and improved version of the 2020 legislation with the “Innovation FastTrack Act.”<sup>14</sup> The new bill faced similar opposition, this time from additional organizations like the Tennessee Funeral Directors Association, who was concerned that the sandbox could be used for “virtual funerals” or could inadvertently spread disease with dead bodies. Never mind the fact that the bill prohibited sandbox participants being exempted from regulations that would endanger public health and safety, and events like virtual weddings and memorial services had already become common because of the pandemic.

If policy advocates or organizations wish to create a regulatory sandbox in their

state, what are some ways to overcome the political hurdles sandbox proposals typically face? When looking at the lessons in other states, advocates should consider two avenues: identifying champions and building business community support.

### **King of the Hill: Identifying and Creating Champions**

One of the inherent drawbacks in advocating for a regulatory sandbox from a political standpoint is that there will rarely be a constituency who immediately benefits from the proposal. One idea in public choice theory explains how government inefficiencies develop when there are concentrated benefits and diffused costs. Regulatory sandboxes face a compounded version of this. Not only do incumbent firms and industries benefit from the current regulatory environment and therefore wish to prevent new innovative firms from entering the marketplace, the benefits of sandboxes, the new products, and services for consumers from innovative entrepreneurs often do not exist yet. So when policymakers and legislators ask who benefits from such proposals, the difficult answer is often: “We don’t know yet.” At best, one can point to how a sandbox could have helped with the dilemmas some entrepreneurs faced in the past.<sup>15</sup> Because of this paradox, it is important for sandbox advocates to identify passionate policy champions who can articulate the vision of a proposal and its future benefits.

In fact, the first ever sandbox in the United States, Arizona’s Fintech Sandbox, was the effort of a policy champion looking to spearhead the idea: the state attorney general. Arizona’s AG at the time, Mark

Brnovich, first made the case for a state regulatory sandbox in an op-ed in the *American Banker* in 2017.<sup>16</sup> Within the AG's office, the Civil Litigation Division lead Paul Watkins helped design and administer the program and would later go on to lead the Bureau of Consumer Financial Protection Bureau's Office of Innovation.<sup>17</sup> Watkins would take his experience in Arizona and go on to propose three tools the CFPB could use to facilitate innovation: renovated no-action letters, and the federal government's first two sandboxes—a product and disclosure sandbox. While these proposals would go on to receive the previously mentioned criticisms, Watkins argued how sandboxes help regulators to better understand new innovations, facilitate innovation, and increase access to all consumers, but particularly underserved communities.<sup>18</sup>

Arguably, no state has mastered the idea of using policy champions to drive change more than Wyoming, which has become a leader on innovation issues, especially related to cryptocurrencies. In the past few years, the state has passed over a dozen laws, including a fintech sandbox and a sandbox focused on digital medical technologies, to make Wyoming the epicenter for cryptocurrency and blockchain investment and development. This effort started as the brainchild between state representative Tyler Lindholm and Caitlin Long, a former executive at Morgan Stanley from Wyoming back in 2017.<sup>19</sup> Rep. Lindholm and other stakeholders urged the state legislature to create the Wyoming Blockchain Task Force, the brain trust of the state's crypto-focused legislative proposals. In 2020, after the numerous successes of the task

force, legislative leaders made the task force a permanent committee.<sup>20</sup> Despite focusing on such a new and innovative technology, Wyoming serves as an example of how one policymaker willing to champion an issue can create enough buy-in and interest in a new and difficult subject for a state usually associated with cowboys and ranchers to be a technology leader in the span of a few short years.

### **Field of Dreams: Building Business Engagement**

Another way for policymakers and advocates to overcome the political hurdles regulatory sandboxes face is to build a coalition of support from broadly focused business organizations and communities to counteract the opposition from specific industries and organizations. These types of organizations can speak to the wide economic benefits of boosting entrepreneurship and a favorable regulatory environment. For example, when Utah was considering its industry-agnostic sandbox in 2021, the measure was supported by both Silicon Slopes, a non-profit that represents Utah's growing startup and tech community, and the Salt Lake Chamber of Commerce, which testified in support of the bill. The bill was passed unanimously in part due to its strong business community support.<sup>21</sup> Earlier this year, the Missouri legislature considered a bill that would have made it only the second state to pass an industry-agnostic sandbox. Despite skepticism from environmental groups, the state's Chamber of Commerce and the Associated Industries of Missouri supported the measure.<sup>22</sup> While the bill was unable to pass both Chambers

before the legislature adjourned for the year, the measure passed the state House of Representatives with overwhelming majorities, which was no small feat.<sup>23</sup>

But if advocates are unable to garner much industry and business community support, what are they to do? Build their own business community. After unsuccessfully trying to advocate for a regulatory sandbox in Tennessee in both the 2020 and 2021 legislative sessions, supporters are trying a new approach. In January of 2022, the Beacon Center created an “Entrepreneurship and Innovation Council” made up of over a dozen influential entrepreneurs and business owners from across the state. The Council’s members come from a wide variety of sectors such as finance, blockchain, healthcare, venture capital, and retail. More than a sounding board, the Council is meeting throughout 2022 to hear from national experts on different policies and to discuss the policies and reforms needed to make Tennessee a leader in entrepreneurship and innovation in the decades to come. To date, members of the Council have heard from experts from the Mercatus Center on the idea of permissionless innovation and the principles of sound public policy, from The James Madison Institute on how states can and should lead on innovation policy, and from the Tax Foundation on the intricacies of corporate tax policy and its impact on different industry sectors and how states can incentivize economic growth through

tax reform. The Entrepreneurship and Innovation Council going forward will be researching the specific policies necessary to make Tennessee a leader in:

1. **Tax and Regulatory Policy:** Despite being a no-income-tax state, what tax reforms and regulatory reforms, like a regulatory sandbox, would ensure Tennessee has the best general business environment in the country?
2. **Barriers to Entry:** How can the state and local governments make it easier for new entrepreneurs and the smallest of businesses to launch quickly and effortlessly and ensure compliance with required regulations?
3. **Healthcare:** The city of Nashville is already a leader in the healthcare services industry, with industry giants like HCA, Vanderbilt, and Healthstream located here. What policies would facilitate Tennessee being the leader in other aspects of healthcare such as telemedicine, pharmaceuticals, and research and development?
4. **Logistics:** Tennessee is already a major player in transportation and logistics, uniquely located within the heartland of the country. With Fortune 500 giant FedEx based out of Memphis, how can Tennessee become the leader in

innovations in shipping and logistics technology like autonomous vehicles, drones, and smart highways?

5. **Blockchain:** While states like Wyoming and cities like Miami have sought to create hubs focused on cryptocurrencies like Bitcoin, with one of the fastest-growing tech workforces in the country, how can Tennessee, and specifically Nashville, become the hub for the development of new applications of blockchain technology in other sectors?

At the end of the year, the Council will present its recommendations to legislative leadership and the governor's administration in time for the start of the 2023 legislative session. Having these policy recommendations coming from a group of entrepreneurs without any previous policy or political experience will accomplish two goals. First, sandboxes and other innovation policies are sometimes viewed as too far-fetched or theoretical, the brainchildren of think-tanks in ivory towers. But by having real Tennessee business owners researching, coming up with, and proposing these solutions, it will add legitimacy to how these policies truly empower entrepreneurs and innovators because the solutions are coming from people who have built successful businesses and who know what it takes. Second, we will have created a cohort of business leaders invested in

educating state lawmakers and policymakers about these proposals and the benefits to Tennessee. Ideally, the business leaders on the Council will also share these ideas and proposals with other business leaders throughout their community, expanding the network of individual business owners advocating for these policies and innovations even if more traditional business advocacy groups decide not to engage.

### **Conclusion: Playing Chess Instead of Checkers**

Regulatory sandboxes are arguably one of the most exciting public policy innovations in recent memory. Sandboxes provide a mechanism for regulatory flexibility in the environment of an ever-growing government and administrative state, helping to ensure innovative products and services are not stomped out before ever launching. While they help innovators and regulators work together, they can also provide data to lawmakers about laws and regulations in need of reform or repeal. Despite this, regulatory sandboxes in many jurisdictions have faced opposition from concerns about consumer protection and environmental damage or merely due to the anti-competitive nature of legacy industries and businesses.

When designing a regulatory sandbox program, there are best practices for advocates to consider from a policy perspective. For example, advocates should consider how to reduce legitimate consumer protection

fears and ensure the sandbox is as accessible as possible to prevent governments providing one firm with an unfair government granted advantage. However, due to the public choice imbalances sandboxes face, first, and perhaps more importantly, is for innovation advocates to consider the political questions and obstacles they are likely to face. Successful proposals in other states show a history of either policy champions who were more than just open to the idea

but worked to drive change within their communities, or engagement and support from business advocacy groups and organizations. And if no other supporters or champions exist, advocates can always build their own.

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