HB 1268

Testimony of Securities Commissioner Karen Tyler

Before House Industry, Business and Labor

February 8, 2021

In Opposition

Comment on Amendment

HB 1268 appears to be modeled after the Wyoming Fintech Sandbox legislation (WY HB 0057). Because of this close modeling, the Secretary of State was included in the oversight responsibilities of the sandbox structure created by this bill. A very significant difference between Wyoming and North Dakota that was not adjusted for in the bill drafting process is that, while in WY the Secretary of State is a financial regulator with oversight of the investment industry, in ND the Secretary of State is not a financial regulator. This bill as originally drafted inadvertently or unintentionally created new financial regulatory authority for the Secretary of State. Accordingly, the distinction was brought to Rep. Toman's attention and addressed.

United Kingdom Financial Conduct Authority Fintech Sandbox

The concept of a fintech regulatory sandbox was first introduced, and ultimately launched by, the United Kingdom Financial Conduct Authority in 2016, and the first cohort of company participants was approved in 2017. The Financial Conduct Authority has extensive regulatory authority in the United Kingdom. The FCA's scope of authority would be largely comparable to combining the authority of the SEC, FINRA, CFTC, CFPB, OCC, state insurance regulation, and the non-depository authority of state bank regulators.

The FCA's sandbox concept and initiative has captured the attention of lawmakers and regulators in the United States. Notably, a primary driver of the UK fintech sandbox participation and success is that it resides at the federal level, with this vast portfolio of regulatory power behind it. It is a difference or distinction that should not be overlooked when contemplating this trend of launching a sandbox environment in the United States on a state by state basis.

Limited application of state securities regulation to sandbox companies

One of the selling points of launching a sandbox has been the idea that regulations are too burdensome for start-up financial technology companies, and a sandbox allows innovators to experiment with new products and services within some guard rails, but without the heavy hand of regulation weighing them down.

Specific to the regulation of investment related fintech companies, if there is concern about the burden imposed on a start-up company, a state level sandbox may not lighten that load. I think it is important to understand that for most companies seeking to engage in a business that involves offering and selling investment securities and/or investment advice to investors – examples would be a brokerage app like Robinhood, or a robo-adviser app like Betterment - the regulatory starting point for this type of company will be at the federal level with the Securities and Exchange Commission, and a state level sandbox has no impact on that requirement.

The only area of investment industry regulation over which states have exclusive jurisdiction is the small investment advisory firm. These are advisory firms that have less than $100 million of assets under management and are exclusively advisory firms, and they do not offer brokerage services.

So as a threshold matter, the universe of securities and investment related applicants to a sandbox that a state securities regulator would have exclusive authority over, and could waive certain regulatory requirements for, is going to be quite limited.

Risk Exposure for the Investor

In a securities transaction, it is the investor who carries the risk. Whether investment advice is given or a stock trade is placed by a financial professional in a brick and mortar office, or through an algorithm based robo-adviser or an app based trading platform, and whether the record of a securities transaction is electronic or resides on a blockchain, the risk of owning that investment is carried by the investor. As such, protections afforded through securities regulation should never be marginalized regardless of how investors access investment services.

Facilitating an Uneven Playing Field

To the extent there would be applicants to the sandbox seeking to test new technologies related to investment products and services, the clients and assets the fintech start up would need to attract in order to engage in testing would likely come from fully regulated banks, broker-dealers and investment adviser firms. It seems incongruous for regulators to be involved in influencing competitive conditions and facilitating the movement of assets from a fully regulated to a less regulated environment, especially given the investor's risk exposure in a securities transaction.

In a report released in the UK last year related to their sandbox initiative, one concern raised by the fintech industry is that companies that are approved to participate in the sandbox structure may have a competitive advantage in attracting customers and capital because the sandbox approval is perceived as a badge of honor or regulators' endorsement.

Growth of Fintech Utilization – New Risks

For a variety of reasons financial technology has figured prominently in the changes we have encountered in this country throughout the last year. The number of new investors participating in our equity markets increased dramatically in 2020. One recently released study puts the number of new brokerage accounts opened in 2020 at 10 million. On the upside, innovations by fintech companies have expanded economic inclusion, and democratized access to financial services, but on the downside, fintech innovation has also created new risks.

A very visible example of the risks presented by fintech innovation has taken center stage over the last few weeks with the activity we have seen related to GameStop stock and stock trading apps like Robinhood.

While some of these issues were already being examined by regulators, and not all of these issues are unique to an online or app-based trading platform, risks related to gamified features, push notifications, payment for order flow, no limits on acct openings, trading technology system failures, behavior influencing content, capital requirement stress, inability to enforce policies on options trading – these are all issues that regulators will be examining in the wake of this market event.

Regulatory Resource Allocation – Position for Innovation and Impact

Rather than devoting resources to stand up this new regulatory structure as presented in HB 1268, a pragmatic and impactful approach to supporting innovators is to equip regulators to innovate along with the industry. Devote resources instead to the existing regulatory structure in order to attract talent and build the skills and expertise to better understand and work with new fintech innovations and business models, and help innovators operate in a compliant manner.

This is the approach that has been utilized at the federal level in the United States with the Securities and Exchange Commission launching their fintech hub (FinHub), the CFTC launching their fintech lab (LabCFTC), and FINRA establishing an innovation outreach initiative. Last session, here in North Dakota the legislature approved an additional FTE for our department to hire a fintech analyst and examiner.

Resources will be better deployed if applied to supporting and regulating innovators under our existing structure, instead of administering a new government program.

Progress and Future State

Much has changed in the last 4 years since the launch of the first fintech sandbox. Regulators have worked to address fintech industry concerns about regulatory uncertainty or confusion about what regulations apply. Both through regulatory guidance and enforcement work, much more clarity has been brought to the digital asset securities space for example.

Additionally, simply because a company is considered to be or calls itself a financial technology entity, does not mean that it is difficult to identify what regulatory structure applies to it. Here in the United States we have a system of Functional Regulation that makes this analysis largely straightforward. While there may be some outliers, the *function* of the financial product or service – e.g., insurance, banking, money transmission, investment securities, creates a clear path to the applicable regulator, regardless of how the product or service is packaged and delivered.

And finally, where regulatory gaps or uncertainties do remain, it can reasonably be expected that more action will be taken on the federal level under the current administration, actions that may render state level initiatives obsolete.