
Arizona Jumps Ahead of Other States In Financial Innovation

By Joann Needleman, Thomas A. Brooks / Apr 06, 2018

The dual banking system in the United States has been criticized because it is cumbersome and often results in more than one financial regulator having oversight over a bank or thrift. The virtue of the dual banking system, however, is that it has fostered a healthy competition between federal and state regulators that has resulted in innovation in products and services to the benefit of businesses and consumers. While the Comptroller of the Currency is developing its special purpose national bank charter and several states have agreed to a common application for approval for a money services business, Arizona is the first state that has created a statutory framework to develop a Regulatory Sandbox Program (“Sandbox” or “Program”) to temporarily test innovative financial products or services on a limited basis without otherwise being licensed or authorized to act under its existing laws.

In recent years, states have been the innovators in approving new products and services for financial institutions. Paying interest on checking accounts was the result of the development of NOW accounts in New Hampshire. Making funds more readily available to consumers was the result of innovations approved for New York chartered banks. Regional compacts in the Northeast and Southeast predated interstate banking. Disclosure of credit card interest rates, annual fees, holding periods, and transaction charges all started in the states, and were later adopted by Congress at the federal level.

Advances in technology and the widespread use of the internet and mobile communication devices have helped fuel the rise of financial services provided by nonfinancial firms, including large and small technology firms. Often referred to as fintech, these firms are offering payment services, loans to consumers and businesses, advice on investments or other financial activities, and other services.

A recent study by the GAO determined that the U.S. regulatory structure poses challenges to fintech firms. With numerous regulators, fintech firms noted that identifying the applicable laws and how their activities will be regulated can be difficult. Although regulators have issued some guidance, fintech payment and lending firms say complying with fragmented state requirements is costly and time-consuming.

Because fintech companies have to comply with different states’ laws and regulations, development of new products and services can be prohibitively expensive. To help resolve this problem, seven states have agreed to simplify the way financial technology companies can apply for licenses. The states of Georgia, Illinois, Kansas, Massachusetts, Tennessee, Texas and Washington, will recognize each other’s findings when assessing the suitability of companies applying for money service business licenses. While the goal is to have all 50 states participate in this process by 2020, at the moment it is limited to fintech entities engaged in money services businesses.

Arizona has taken a more progressive approach to encourage fintech entities to develop innovative products and services. On March 22, 2018, Governor Ducey signed into law the Regulatory Sandbox Program. The purpose of the Program is “to enable a person to obtain limited access to the market in this state to test innovative financial products or services without obtaining a license or other authorization that otherwise might be required.”

The experiment is limited in duration and size. The Program will end in 2028, but participants will have two years (some extensions are possible) after the date its application is approved to test the innovative financial product or service described in the Sandbox participants application. Generally, each product or service will be limited to the participation of not more than 10,000 consumers, but this can be increased if a participant demonstrates adequate capital, a risk management process and management oversight that is acceptable to the Attorney General, who will manage the Program. A significant benefit to a participant is that it will not have to undergo state licensing requirements for the service or product to be offered.

The Sandbox legislation allows it to be broad and flexible in the types of products or services that can be offered. An “innovative product or service” means a financial product that includes “the use or incorporation of new or emerging technology or 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” Arizona.

Due to the emergence of new products and services making innovative use of technology, other countries are experimenting with how to encourage innovation while at the same time offering protection to consumers in a controlled environment. While other states and the federal regulators are making efforts to facilitate the use of technology by bank and non-bank financial entities, no state has taken the bold step that Arizona has in encouraging the development of new and innovative products and services to benefit businesses and consumers.

As with all legislation, the details of how the Arizona Sandbox will be implemented remain to be seen. Will an emphasis be placed on the financial strength of the applicant and its business plan? Will the type of product or service—whether it is lending, payment processing or some other activity—govern how an application will be treated? What kind of emphasis will be given to consumer protections in the Program’s implementation? These are questions that will be answered as the details of the law’s implementation evolve.

If you would like additional information as to how you might take advantage of the opportunity that is presented by the Arizona Sandbox, please contact Tommy Brooks at tbrooks@clarkhill.com, 202 552 2356, or Joann Needleman at jneedleman@clarkhill.com, 215 640 8536.

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