REDUCING REGULATORY UNCERTAINTY:

SANDBOXES AND LETTERS OF INTERPRETATION

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Table of Contents

Introduction 3
Reducing Regulatory Uncertainty. 4
Regulatory Sandboxes (With Oversight) 5
Letters of Interpretation with Presumptive Authorization (No Oversight). 6
Existing Sandbox Laws and Models. 6
Arizona 7
Utah 7
West Virginia 7
American Legislative Exchange Council Model . . . 7
National Council of Insurance Legislators Model Sandbox Legislation 8
Issues with Existing Sandboxes 8
Recommendations 8
Proposals for the State of Texas 9
Conclusion 9
References. 11

Reducing Regulatory Uncertainty: Sandboxes and Letters of Interpretation

Rod Bordelon

Introduction

Every day in America, individuals and businesses choose whether to save and invest their money and capital to earn a return. Business capital may derive from operating profits or from debt or equity financing. These choices carry risks of losing capital and the opportunity costs of not using that capital for other profitable endeavors. In addition to market and financial risks, these businesses must also consider regulatory risks. Unfortunately, these regulatory risks are not always clear.

Regulations often constrain economic growth and prevent the realization of new ideas and initiatives. The cost and burden of research, applications, reporting, compliance, fees, and possible administrative and civil penalties for violations can overwhelm all but the most strident and fully capitalized innovators. And in many instances of new and innovative products or services, it is not clear what regulations may apply or if there are alternatives to compliance.

The state of Texas has the fifth highest number of regulations in the country, with approximately 263,000 regulatory restrictions in its Texas Administrative Code (Broughel et al, 2020). Regulations imposed by the federal government added another nearly 1.08 million regulatory restrictions as of June 2020.

These regulatory restrictions have an adverse effect on the economy and on the ability of businesses to operate and compete. A 2018 study by the Mercatus Center at George Mason University estimates that the accumulation of regulations since 1980 had the effect of slowing economic growth in the U.S. by an estimated $4 trillion in 2012 GDP (McLaughlin, 2018). Not surprisingly, individuals and smaller firms have even more difficulty complying with regulations than larger firms, and this has led to greater inequality. In fact, the Mercatus study found that larger and more established businesses actually benefitted from increased regulation as new and smaller businesses were deterred from entering the market, a phenomenon referred to as "regulatory capture" in economics.

This deterrence can and should be addressed. If certain regulations are determined to be overly restrictive with little to no benefit to consumer protection, the best solution is to eliminate them. But even if the regulations are determined to be necessary in some instances, they may not be necessary in others. Additionally, questions may exist about the applicability of existing regulations to newer, innovative business operations that were not contemplated when the regulations were originally adopted.

Key Points

- Regulations often adversely affect economic growth, particularly with innovation and new initiatives.
- Individuals and businesses may feel reluctant to commit capital and effort to new initiatives without some assurance from government to do so without incurring regulatory penalties or closure.
- Where the applicability of regulations to innovative businesses is uncertain, state regulators should be directed to issue letters of interpretation to provide clarity and protection. If the interpretation is that regulations do not apply in whole or in part, the letter should so specify and provide a presumption of authorization to protect businesses engaged in these innovative operations from enforcement of such regulations.
- Where regulations are determined to apply, a regulatory sandbox program with modifications should be established to provide a trial period to foster innovation and test the further applicability or need for amendment or repeal of regulations.

These innovative businesses need greater certainty regarding what regulations may prohibit or restrict their business and how to proceed with operations without penalty.

Fortunately, there are such solutions: regulatory sandboxes and letters of interpretation with presumption of authorization. In either instance, an application would be submitted to a government agency by a business proposing an innovation and seeking clarity regarding the applicability of certain regulations. The government agency would then be directed to respond by issuing a letter of interpretation of applicable regulations and how such regulations apply to the innovative business. If the interpretation determines the regulations do not apply, or there is some question as to their applicability, the letter would further provide a presumption of authorization to proceed without fear of regulatory enforcement. If the regulations do apply, the business may still be offered an opportunity to participate in a regulatory sandbox—a trial period of operations where the business would be allowed to proceed for a limited amount of time without fear of regulatory enforcement in order to determine whether the business model is successful and whether regulations should be amended or repealed. In either case, the government agency should be directed to recommend whether to amend or repeal the regulations to ensure that all similar businesses are subject to the same rules.

These solutions exist in many forms in other states, such as Utah, Arizona, and West Virginia, but with limited success. In most cases, sandboxes exist for a temporary period and only benefit the applicant business. The business is still left with uncertainty about future regulatory applicability and the regulations identified as restricting innovation are left in place for other businesses in the market. This leads to competitive disadvantages and continued regulatory uncertainty. Texas can improve on these solutions by providing greater clarity of regulatory applicability upfront through letters of interpretation and by creating a mechanism to repeal or amend problematic regulations to improve business development overall.

Reducing Regulatory Uncertainty

Texas law requires that regulations must be clear and unambiguous so those subject to them have full and adequate notice of what compliance requires. This is why the process of setting regulations must conform to strict rules of public notice, requiring opportunities for public input to ensure they adhere to statutory authority and the public interest. Even after regulations are adopted, their enforcement must continue to conform to notice and hearing requirements to ensure due process for anyone accused of a violation of these regulations. Nonetheless, despite these protections, questions still arise about the applicability of regulations and compliance.

Large enterprises that operate within a clearly regulated industry with little or no variation are generally better equipped to understand and comply with these requirements. These businesses are usually already familiar with applicable regulations and have budgeted for the expected costs associated with compliance. But businesses seeking to offer new, innovative products or services that may not perfectly match existing regulations often do not have such resources, which can create an added cost of uncertainty.

This uncertainty results in regulatory compliance risk: either being found in violation of existing regulations and being forced to defend those allegations or attempting to comply and still potentially paying enforcement penalties. Regulatory compliance risk also involves the risk that a change in laws and regulations will materially affect the business. A change in laws or regulations by the legislature can cause business closure or substantial losses.

There are three basic scenarios when analyzing regulatory risk:

1. The business, product, or service is clearly prohibited or restricted by existing statutes or by statutory interpretation in court rulings;

2. The business, product, or service is clearly not prohibited or restricted by existing statutes or by statutory interpretation in court rulings; or

3. The business, product, or service does not clearly fit within existing statutes, or there is a question as to the applicability or extent of existing or contemplated statutes.

The first two scenarios are clear, and the affected businesses would generally need no additional clarification or certainty about the applicability of regulations. Any problems or concerns with applicable regulations can and should be handled by petitioning the agency or the legislature to repeal or amend the affecting regulations to allow the intended operations. This greater risk is with the third scenario, where innovations do not clearly fit in the regulatory framework or there is a question about their applicability.

In that case, some clarity and certainty are needed to allow the business to proceed with its operations without the risk of regulatory oversight and enforcement.

Regulatory Sandboxes (With Oversight)

A regulatory sandbox is a controlled environment where startups and other innovative businesses can test products or services under regulatory supervision while being temporarily exempt from specific regulations that would otherwise restrict or prohibit operations. The term was first used by the Financial Conduct Authority (FCA) in the United Kingdom, which created the first sandbox in 2014 for their financial sector (SPN, 2021). They referred to a sandbox 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" (FCA, 2015, p. 1).

Ultimately, they are a "legal" classification that creates a space where participating businesses will not be subject to onerous regulations—usually for a limited amount of time. "The point is to allow these businesses to 'play' in the sandbox without regulations to see if innovative ideas and products can get traction and enter the market" (SPN, 2021, para. 3).

The ultimate purpose of a regulatory sandbox is to foster innovation by removing or temporarily waiving restrictive regulations. "The process allows for private companies to develop or introduce an innovative product or service into a market space where current industry standards do not apply or are still being created" (Czerniawski, n.d., p. 4). These sandboxes typically provide such waivers during a trial period to determine whether the waived regulations are necessary, and if so, whether the regulations should be amended to better fit the product or service being offered. The business submits an application to the designated government agency outlining its proposed product, service, or business model and lists the specific regulations it wishes to have waived. The application may be approved in whole or in part, and if approved, the business is granted initial clearance to begin operations and is not subject to enforcement penalties for violations of the applicable regulations.

An issue with existing sandboxes is that while the regulations are temporarily waived, the government regulators are still able to demand reporting and review and oversee the operations to determine whether the innovation meets the criteria established in the approval of the application. Essentially, the business is still regulated, albeit to a lesser extent, and its relief is temporary with uncertainty as to its authority to proceed with operations after the trial period.

This uncertainty has led some to question the effectiveness of sandboxes. For instance, in a 2018 speech, SEC Commissioner Hester M. Peirce, an appointee of President Trump, noted her concerns about sandboxes:

> My fear that regulators will grab hold of the shovels and buckets is why I am often wary of so-called regulatory sandboxes. I am entirely in favor of finding ways to make appropriate regulatory allowances that clear the way for innovation to flourish. What troubles me about sandboxes, however, is that the regulator is typically sitting right there next to the entrepreneurs. (Peirce, 2018, para. 29)

This opportunity for hands-on involvement by regulators may allow too much ambiguity and subjective determination to be helpful for all businesses. For instance, the application may be denied if the regulator determines it fails to meet the eligibility criteria, or the regulator determines the sandbox test fails to adequately show why regulations should not apply. Without clear objective criteria established in statute, this subjectivity can result in competitive disadvantages for some businesses. This creates an unlevel playing field in the market, where some businesses in the marketplace are subject to regulation and others not.

What is needed is a modified program that provides greater certainty, broad application to the marketplace, and clear, objective, and limited criteria for decision making.

Improvements should include:

- Ensuring the enabling statute clearly identifies the criteria to approve or deny an application as well as how to determine its success;
- Ensuring broad-based application to allow greater participation in multiple industries;
- Limiting regulatory restrictions and review during the sandbox trial;
- Requiring the regulator's review and decision making be overseen and approved by a centralized government office such as the governor's office;

The first sandboxes in the United States were created in 2018 in Arizona. Since then, other states like Utah, West Virginia, Hawaii, and South Dakota, among others, have instituted sandboxes.

- Requiring that all approvals be made public and available to other applicants for use in their applications;
- Directing the regulatory agency and the governor's office to recommend, at the conclusion of the sandbox trial, whether to modify or repeal the applicable regulations; and
- Creating a program to statutorily authorize the issuance of letters of interpretation with presumption of authorization, where a sandbox is not necessary.

Letters of Interpretation with Presumptive Authorization (No Oversight)

An improvement to traditional sandboxes would be to provide an option for a letter interpreting the regulation in question from the appropriate regulatory or other governmental body if a trial period is not necessary. Similar to traditional sandboxes, an innovative business would submit an application seeking an interpretation of law—specifically whether or not certain regulations apply to the innovation. The governmental agency would issue a letter of interpretation stating whether and to what extent the innovation is prohibited or otherwise subject to regulations, and if so, cite the regulations.

If the letter determines that the regulations in question do not apply, this should be clearly stated and further provide that, unless the regulation is later determined to explicitly prohibit or restrict the activity, the business is presumed to have authorization to conduct the activity with no ongoing regulatory scrutiny and that government regulators will not take enforcement action for violations of regulations identified in the letter. This is often referred to as a "no-action statement," meaning the state agrees to not take any enforcement action against the businesses if it operates in good faith according to the application and letter of interpretation.

This letter of interpretation with presumptive authorization would provide greater certainty and relief to the applicant business and others with similar operations. Unlike a temporary waiver as with traditional sandboxes, the letter would be an official interpretation of statutory and regulatory law issued by the government, with protection from penalties for good faith violations and no required ongoing regulatory review.

If the interpretation is that the regulations in question do apply and restrict or prohibit the innovation in question, the business may still apply for a sandbox as noted above.

The enabling statute for letters of interpretation should provide specific direction and authority to issue such letters and the process for filing and review of applications. For instance, the law could direct such authority be provided to existing regulatory agencies with oversight by, or directly to, a central processing office, such as within the governor's office. An example would be the existing Division of Regulatory Compliance. Without specific statutory direction, government agencies are often reluctant to provide such interpretation and certainty, because the requests are hypothetical in whole or in part and may be affected by later determinations (such as in a court of law) that the operations are, in fact, subject to regulation by the clear language of the statute or rule in question. In addition, the enabling statutory authority must specifically provide the legal presumption of authorization for the business activity and a no-action clause to protect all parties in the event of a subsequent determination that statutory provisions prohibit the business activity listed in the application.

As with sandboxes, the letter of interpretation should be made available to the public and should be allowed to be used in an application by any similarly operated business, including those currently subject to regulatory oversight.

To provide greater clarity and consistency, the enabling statute should also require a recommendation from the governor's office and the regulatory agency on whether to repeal or amend the identified regulations.

Existing Sandbox Laws and Models

The first regulatory sandboxes were created in the United Kingdom in 2014 (Dobrinski, 2022, p. 4). Since then, over

700 participants have joined the program, and almost 80% are still in existence. The first sandboxes in the United States were created in 2018 in Arizona. Since then, other states like Utah and West Virginia, among others, have instituted sandboxes. Model laws have also been adopted by organizations like the National Council of Insurance Legislators (NCOIL) and the American Legislative Exchange Council (ALEC).

Arizona

Arizona was the first U.S. state to create a regulatory sandbox. The Arizona Financial Technology Sandbox began on August 3, 2018 and is limited to financial technology (fintech) innovations (Peterson, 2022, p. 16). Operated by the Office of the Attorney General, the sandbox authorizes accepted financial technology companies to test their products without obtaining licenses or authorizations otherwise required by law (Arizona Attorney General, n.d.-a). This sandbox does not require participating businesses to identify and explain what regulations they seek to have waived but rather allows the attorney general to determine which regulations are appropriate and which should be waived in each case. While the sandbox claims 10 alumni (primarily small consumer-lending and loan-repayment programs) that have successfully entered and exited the program, only three companies exist in the sandbox as of the publication date of this report indicating only limited interest (Arizona Attorney General, n.d.-b).

Utah

Utah has the most expansive sandbox system in the country, originally covering financial technology (2019), insurance and legal services (2020), and universal applications (2021). All but the legal services sandboxes have since been merged into the universal sandbox (Utah Commerce, n.d.). Originally, these were administered by separate agencies within the state government but are now administered by the Governor's Office of Economic Opportunity, Office of Regulatory Relief. It was created in 2021 and has had two accepted participants thus far (Utah Office of Regulatory Relief, n.d.). This universal sandbox allows applicants to apply to a centralized office for waivers of all applicable regulations without identifying specific regulations or regulatory agencies.

Unique to Utah, the legal services sandbox was created in August 2020 by the Utah Supreme Court. The sandbox is administered by the Office of Legal Services Innovation, within the Supreme Court, to waive certain regulations in order to offer "new and innovative legal models and services." Applications for this sandbox are specifically limited to legal services subject to regulations such as prohibiting non-lawyer ownership and participation in legal firms. Other innovative solutions may be added as recommended by the Supreme Court (Utah Supreme Court, n.d-a). While the sandbox is relatively limited in scope, it has 33 current participants (Utah Supreme Court, n.d-b).

West Virginia

The West Virginia Legislature created a regulatory sandbox for financial technology in 2020. The sandbox is administered by the state's Division of Financial Institutions, which adopted emergency rules in June 2020 to implement the program. It allows businesses to apply and, if accepted, operate within the plan for a period of two years without the need to seek traditional licensure or regulatory approval. However, as with most sandboxes, the accepted businesses are still subject to regulatory oversight and some costs associated with the application process. For instance, the division sets an application fee of $1,200, requires a surety bond be provided, and establishes various reporting requirements. It also establishes a "Consumer Protection Board," which may require additional consumer protection bonds as deemed necessary (West Virginia Emergency Rule, 2020).

West Virginia also created a sandbox for insurance services in July 2021, administered by the Offices of the Insurance Commissioner. As for other sandboxes, the intent is to foster innovations in the insurance industry and allow those innovations an opportunity to be tested in the marketplace without being subject to existing regulatory restrictions (West Virginia Announcement, 2021). As outlined in Article 60, West Virginia Code, applicants must submit a description of the innovative services and the value to consumers, and must meet certain financial and consumer protection standards. The commissioner has 60 days to accept or reject the proposal. If accepted, the business is allowed to operate as a "beta test," with a safe harbor from regulatory restrictions but with regulatory oversight for up to a maximum of three years . This allows the Legislature and the regulators to determine how best to modify the regulations. If no modifications are made, the business presumably must comply.

American Legislative Exchange Council Model

On August 25, 2021, ALEC adopted model acts for both universal and targeted application regulatory sandboxes. The Universal Regulatory Sandbox Act would establish a framework for government to authorize a business to launch innovative products, services, or models for a trial period under the observation of regulators while

The goal of sandboxes is to provide innovative businesses with an opportunity to test their operations during a trial period of relaxed if not total waiver of regulations.

temporarily bypassing laws or regulations that may conflict with the technology. As drafted, this model could apply to any regulation deemed appropriate by the designated agency and would create a new Regulatory Relief Office, director, and advisory committee within the government to oversee and implement the sandbox (ALEC, 2021a).

The more narrow or limited scope model is entitled Targeted Regulatory Sandbox Act and would apply to specific statutory provisions related to regulations by specifically named regulatory agencies. Similar to the universal sandbox, it would allow businesses with innovative products to proceed for a trial period under the observation of specific applicable regulators, while temporarily bypassing otherwise applicable regulations. For instance, an insurance sandbox would be administered by the insurance department. This model is obviously more limited in scope and would rely more directly on the regulatory agencies to administer the program and approve applications. It would not create a central agency such as the Regulatory Relief Office as in the universal model (ALEC, 2021b).

National Council of Insurance Legislators Model Sandbox Legislation

The Financial Services & Multi-Lines Issues Committee within NCOIL recently voted to develop a proposed Insurance Regulatory Sandbox Model Act for adoption at future meetings. The move was sponsored by Rep. Bart Rowland (KY), Rep. Wendi Thomas (PA), and Rep. Tom Oliverson, M.D. (TX) – NCOIL Treasurer (NCOIL, 2022). Limited to insurance services, it would allow businesses with innovative products to proceed for a trial period under the observation of insurance regulators, while temporarily bypassing otherwise applicable regulations. This model would rely more directly on the insurance departments or other applicable insurance regulatory agencies to administer the program and approve applications (NCOIL Draft Model Act, 2021).

Issues with Existing Sandboxes

Sandboxes may not meet the needs of all innovative businesses or government regulators. As noted previously, submitting an application and being accepted into the sandbox may waive certain restrictive regulations temporarily, but the business is far from unregulated. The application and approval process may still impose costs and reporting requirements on the business, such as the submission of financial statements, application fees, and surety bonds. Most importantly, the business may still be subject to unpredictable regulatory oversight during the temporary period of operations within the sandbox.

Even after a successful sandbox review period, the business may still be subject to the regulations and oversight it was seeking exemption from. The regulator may request the state legislature to amend the statutory regulations, but if it fails to do so, the full regulations would apply. Additionally, sandboxes may create competitive advantages for those businesses approved and corresponding disadvantages to those still subject to full regulation. This is particularly true with broad discretion provided to regulators in administering the sandbox.

Nonetheless, the goal of sandboxes is to provide innovative businesses with an opportunity to test their operations during a trial period of relaxed, if not total waiver of, regulations. For once an innovative business operating under the sandbox framework achieves success, the pertinent regulatory agency and the even legislature would, ideally, consider repealing or amending existing regulations to allow all similar businesses to operate under the same standard.

These issues can and should be addressed to provide a more effective sandbox program with greater opportunity for success.

Recommendations

We recommend implementing a regulatory sandbox program with modifications to include and begin with letters of interpretation with presumptions of authorization. As noted previously, these letters provide the applicant business with the certainty of an official statutory interpretation with protection from regulatory enforcement action being taken for good faith violations of the regulations. Additionally, the letters should be made public and apply

to all similarly situated businesses to prevent competitive advantages.

When letters of interpretation determine regulations prohibit or restrict an innovative business, regulatory sandboxes should be made available. These sandboxes would provide a trial period for businesses and regulators to begin operations free of regulatory restriction and to determine the future applicability or necessity of existing regulations. To ensure a level playing field, clear standards should be created for approvals, and regulatory oversight should be limited during the sandbox period. To ensure the same standards apply to all similarly situated businesses, all application approvals should be made public and new applicants should be allowed to utilize a previously approved application. To encourage future market participation, regulators and the governor's office should be directed to recommend whether applicable regulations should be repealed or amended.

We further recommend that the program be administered and overseen by a centralized government agency, such as the governor's office, in consultation with the appropriate regulator. The governor's office or other designated agency could ensure a consistent process across all regulatory agencies and be in a better position to submit recommendations to the legislature to amend or repeal statutory provisions to authorize similar products or services by all businesses, not just those within the sandbox. Additionally, the centralized government agency would receive and approve the applications and provide as much assistance as possible to encourage applications. Finally, applicable regulatory agencies should be directed to provide advice and recommendations regarding the applications and the regulatory provisions to be waived and should likewise be directed to include information on their website about the sandbox application process.

Proposals for the State of Texas

- Create statutory authority for the issuance of letters of interpretation with presumptions of authorization.
- Create statutory authority for a regulatory sandbox for a trial period for innovative businesses to test their innovation and determine whether regulations should be modified or repealed.
- Statutorily create clear standards and provide presumption in favor of approval of sandbox applications.
- Require the application approval to specify the extent and limits of the regulatory agency oversight during the sandbox review period.
- Utilize a centralized office, such as the Governor's Division of Regulatory Compliance, to receive, review, and approve applications after consultation with the applicable regulatory agencies.
- Require approved and rejected applications to be made available to the public.
- Authorize new applications to be based on previous approvals.
- Create information on the governor's website to assist applicants and interested persons.
- Direct regulatory agencies to provide sandbox information on their website, including a link to the central application office, and assist where applicable.
- Direct regulatory agencies and the Governor's Office to submit recommendations to the legislature on whether to repeal or amend statutes to conform to letters of interpretations and successful sandboxes.

Conclusion

Regulations often constrain economic growth and prevent the realization of new ideas and initiatives. The cost and burden of research, applications, reporting, compliance, fees, and possible administrative and civil penalties for violations can overwhelm all but the most established and fully capitalized innovators.

Regulatory requirements, by nature, restrict economic innovation but even more so for businesses seeking to offer innovative products or services that do not clearly fit within existing regulations or for which regulations were never contemplated as necessary. In those cases, a framework is needed to provide more certainty to these innovative companies and to government regulators to allow these operations to proceed without restriction or burdensome regulatory oversight, at least during a trial period.

Letters of interpretation with presumptions of authorization provide benefits to all parties where questions exist about the applicability of regulations to the intended business operations. The letters could provide an official interpretation that the regulations do not apply, and the applicant business has presumptive authorization to proceed

with operations without fear of regulatory enforcement. If the interpretation is that regulations do apply and restrict or prohibit the intended operations, regulatory sandboxes should be offered to allow innovative businesses a trial period to test their operations and to give the government time to determine future regulatory applicability and whether and to what extent the existing regulations should be modified or repealed. Consumers would also benefit by having earlier access to more competitive products and services. If it is later determined by a court of law that statutory or regulatory provisions apply in whole or in part, the business would be provided notice and an opportunity to comply or would be legally compelled to cease operations, albeit without penalty.

In all cases, the governor's office and the applicable regulatory agency should be directed to recommend whether to amend or repeal applicable regulations that are determined to be unnecessary. Of course, at any time and on their own legal determinations, the regulatory agencies may revise or repeal regulations, or the legislature may repeal or revise the statutory restrictions.

Properly created, regulatory sandboxes and letters of interpretation with presumptions of authorization can be valuable tools to reduce regulatory burdens and foster innovation. Already in place in many states, these tools should be modified and expanded to provide even greater certainty and to apply broadly across all spectrums of regulations and industries. Ultimately, with fewer regulations and greater certainty for those regulations that do exist, innovators can flourish, and consumers thrive.

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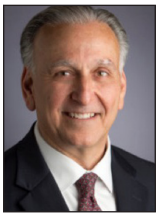

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