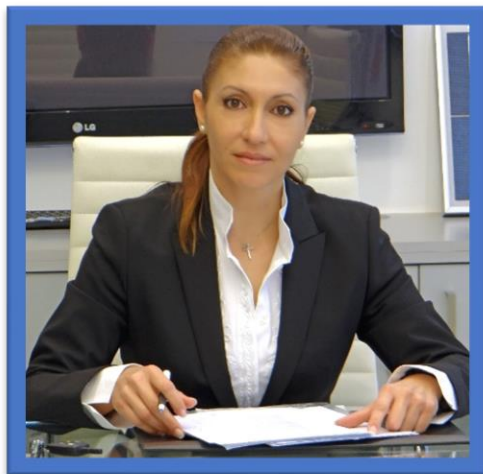


# CySEC's Upcoming Regulatory Sandbox – Prospects and Opportunities



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The Cyprus Securities and Exchange Commission ("CySEC") has launched a Call for Views on Establishing a Regulatory Sandbox. The increasing use of financial technology ("fintech") and regulatory technology ("regtech"), the growth of innovation, and the Covid-19 have decidedly informed the need for regulatory development. CySEC invited regulated entities, fintech and regtech entities, professional associations, and other interested stakeholders to exchange their views with CySEC on the potential setup of a Regulatory Sandbox.

Interested parties were able to submit their participation interest until the **28th of March 2022**. We are now expecting the next steps with the Call.

In this note, we provide an overview of the current regulatory situation in Cyprus and describe the potential regulatory developments and progress by operating a Regulatory Sandbox on the island. We wish to highlight the significant prospects and opportunities expecting innovative entities, startups, entrepreneurs, as well as incumbent regulated entities seeking to turn to innovation and fintech by establishing a Regulatory Sandbox.

## ***Current Situation***

CySEC has actively encouraged fintech and innovation but with caution over market integrity and investor protection. CySEC has supported the orderly development of fintech and innovation in financial services by drawing attention to the need to examine emerging business models and services against the existing (and potentially upcoming) legal and regulatory framework. The Innovation Hub, launched in July 2018, embodied this approach of fintech and innovation in financial services developing in a way that does not compromise investor protection and market integrity.

The Innovation Hub, short of a full-fledged regulatory sandbox, was a platform where entities (both regulated and non-regulated, domestic and international) operating in fintech, and regulatory technology (“regtech”) exchanged views with the regulator. The Hub gave these entities access to industry and regulatory expertise. This was part of CySEC’s “compliance-first” approach to innovation, fintech and regtech. The exchange would also benefit the regulator; innovative entities would introduce CySEC to a new understanding of all risks, opportunities, benefits, and features of novel technologies and innovation. The objective was to enhance the regulatory landscape and lead to a mutually beneficial transfer of knowledge and expertise between the regulator and innovative entities and entrepreneurs.

### ***Regulatory Sandbox – next regulatory step***

The Innovation Hub was a significant initiative and a valuable regulatory knowledge hub. Entities were guided (albeit unofficially) on whether their fintech and regtech services and end-products fell within the regulatory perimeter and supervision of CySEC.

Still, the Hub’s operations and competence were limited resulting in constricted prospects for regulatory and innovation development. The Call for the setup of a Regulatory Sandbox is, thus, the next step toward a more extensive and compliant development of fintech and regtech. Besides, this is the regulatory approach of other jurisdictions and experienced regulators (such as the UK). The prospects and potential effect of a Regulatory Sandbox are much wider.

CySEC describes a Regulatory Sandbox as “*a controlled environment operated by a regulator, enabling the testing of innovative technologies, products, services or approaches, ensuring that appropriate safeguards are in place*”. CySEC indicates a more focused and practical approach to examining and growing innovation.

International experience displays significant differences in how sandboxes operate. In general, though, regulatory sandboxes in financial services offer a safe and controlled environment for innovative fintech and regtech entities to operate their activities and offer their services/products. These entities can test their services/products without fearing regulatory penalties and actions for lack of compliance. The benefit is obvious. Entities can test fintech and regtech innovative products/services, over which regulation is still developing and uncertain. Usually, sandbox participants are protected from regulatory consequences that would normally emerge or are allowed to operate based on certain exemptions from the applicable regulatory framework. This gives them confidence and certainty in testing their products and services.

Of course, the safe and controlled space in the sandbox is not free from rules and obligations. Typically, entry to regulatory sandboxes is subject to a list of defined criteria ensuring the participants’ capability to implement safeguards to protect the market and protect investors. Also, sandboxes usually welcome innovative solutions that seem to offer true value to the market and consumers. At the same time, sandbox participants may face restrictions in their activities (e.g., services/products offered to a limited number of investors) or be exempted from regulatory compliance only to a limited degree or time. Keeping a *controlled* environment is important to avoid any negative impact on the industry that would also harm investors or a race-to-the-bottom approach to regulation.

Since the process is now opening in Cyprus, it is still early to judge how effective the entry requirements are or how the sandbox operation and any applicable safeguards guarantee the protection of market integrity, and investors, and enhance innovation and competition in financial services.

We are confident that a properly structured sandbox in Cyprus will:

- foster the industry and innovation,
- attract investors in fintech and regtech,
- help fintech and regtech grow,
- assist the development and dissemination of valuable regulatory feedback to the whole industry.

### ***Regulatory Sandbox – prospects and opportunities***

Drawing from the UK and the FCA (domestic regulator) five benefits and prospects may be expecting sandbox participants:

1. Ability to test products and services in a controlled environment;
2. Reduced time to market at a lower cost;
3. Support to identify proper means for consumer protection;
4. Support to identifying safeguards to build into new products/services; and
5. Better access to finance.

A regulatory sandbox might be the **ideal space to test fintech and innovative solutions, especially in the face of increasing regulation.**

Financial services regulation is very extensive and cumbersome for industry participants. Complying with the capital markets laws is a costly and demanding exercise. The emergence of fintech and regtech was bound to challenge the existing regulatory norms and supervisory approaches. Regulators have faced challenges in how to treat, supervise, and assess business models, activities, services, and products that use technology, especially emerging technologies. This has led to a significant lack of certainty and hesitance to innovate for fear of facing regulatory consequences.

Also, recent legislative developments call for further assessment of the financial innovative solutions. CySEC, in specific, draws attention to the latest:

- Crypto-Asset Service Providers regime, established under the 5th AML Directive (EU),
- the upcoming pilot regime for market infrastructures based on distributed ledger technology (DLT), and
- the upcoming regime on operational resilience for the financial sector (DORA).

According to CySEC, these latest developments in the legal and regulatory framework necessitate the assessment of innovative solutions from an operational perspective. Other legislative initiatives are also on the way, such as the Market in Crypto-Assets Regulation (MiCA) which will comprehensively regulate crypto-assets and other wider initiatives of the EU in the field of digital services.

Following the above, regulation might hinder innovative businesses from developing their products. With a regulatory sandbox where regulatory requirements will probably be relaxed, participants will have the opportunity to test their products/services with a relative degree of certainty and CySEC will get a better understanding of how to regulate and supervise these new products/services. By testing their products, the sandbox participants, and the regulator, for that matter, will be able to understand the value and positive effect generated for consumers. This, in turn, will allow participants to **market**

**their products/services in an accelerated way** (if any positive value is identified) **at lower costs** since **the regulator will be willing to open the market to these new, tested products/services**.

The knowledge and valuable regulatory feedback exchange will also come into play. The interaction between participants and CySEC will produce a new knowledge stream from a regulatory perspective. Building on the Innovation Hub operation, the exchange between the fintech entities and CySEC will generate even more reliable results and a wide source of use cases due to the actual testing taking place. Such knowledge may be directed to **build more robust innovative solutions to CySEC's satisfaction. Fintech and regtech entities will be able to develop means, safeguards, and procedures to protect the market and consumers in a compliant manner.**

Research shows that the operation of regulatory sandboxes in financial services may foster innovation in a way that **attracts investment**. According to the same research analysing existing sandboxes, jurisdictions with such sandboxes showed a **“remarkable increase in the size of venture investment”**. (Jayoung and Joo-Yeun, 2020). This is especially useful for startups that have difficulty developing their products/services due to capital restraints.

### ***Final Remarks***

The Call for a Regulatory Sandbox conveys a positive message for the fintech and regtech industry. CySEC acknowledges the regulatory and compliance challenges facing regulated entities seeking to venture into fintech and regtech, and startups, entrepreneurs and innovative entities developing financial services solutions. This is especially the case because of the upcoming legal and regulatory frameworks regulating fintech activities and digital services.

In the face of these challenges, developing the Innovation Hub into a Regulatory Sandbox seems a fitting solution and approach to regulation. The sandbox is bound to offer multiple benefits to both CySEC and the sandbox participants. This in turn will benefit the market.

We encourage startups, innovative businesses, entrepreneurs and also regulated entities to submit their fintech and regtech solutions to the Regulatory Sandbox once established. The controlled environment of the sandbox and the interaction with CySEC will offer a structured and safe space to test and, ultimately, safely market their products and services to the public. Importantly, participation in the sandbox might open access to finance by attracting significant investments.

