

# Utah Innovates: Regulatory Frameworks for the Future

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## SUMMARY

Individuals and companies are innovating at an ever increasing pace, and regulators are struggling to keep up with all the new goods and services that are being introduced; antiquated laws don't always apply to new, dynamic businesses.

With the emergence of innovative companies that often involve new business models, some governments are rethinking how they should regulate these entities. Rather than trying to fit a square peg in a round hole, some agencies

have turned to regulatory sandboxes in an effort to address the issue.

Regulatory sandboxes allow companies and agencies to work together in introducing new goods and services with the potential to improve market conditions for countless consumers.

Utahns would greatly benefit from regulatory sandboxes as companies try out new products and business models as they try to scale their goods and services in a dynamic marketplace.

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Innovative companies should not be artificially held back by regulations that do not fit their business models.

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Alex Carter trained and worked as a mechanic for an auto dealer, and through his experience, came to the conclusion that there was a better way to offer consumers extended warranties and vehicle service contracts. Inspired by the health care sharing ministries business model, he started his own company called Otmo.com, which used the same model to offer his customers better service at a lower price.<sup>1</sup>

The idea was simple: pay a monthly subscription to pool your money together with other customers, and in return receive protection through a vehicle service contract that was written in a way to help customers, rather than gouge them. Alex successfully operated his business for a full year with happy customers and no complaints.

But after a time, the Utah Department of Insurance caught wind of what Alex was doing through an anonymous complaint, likely from a competitor. Before long, regulators told Alex to shut down his business if he was unwilling to conform to current insurance regulations. However, those regulations didn't apply well to the new model Alex had developed. Alex was faced with a no-win scenario: Either significantly change his pricing to comply with the Department of Insurance and engage in business practices similar to the current market, or simply close up shop.

Having been denied the opportunity to continue to pursue the innovative idea that compelled him to start his business in the first place, Alex made the excruciating decision to shut down his business, cover all outstanding claims, and take a loss of hundreds of thousands of dollars. In the end the central

issue for regulators was consumer protection and acceptable risk levels for this business model.

This policy brief will explain how regulatory sandboxes can provide solutions to these important questions and propose a framework for their implementation in Utah that will allow for unique goods and services to be introduced that have the potential to improve our quality of life.

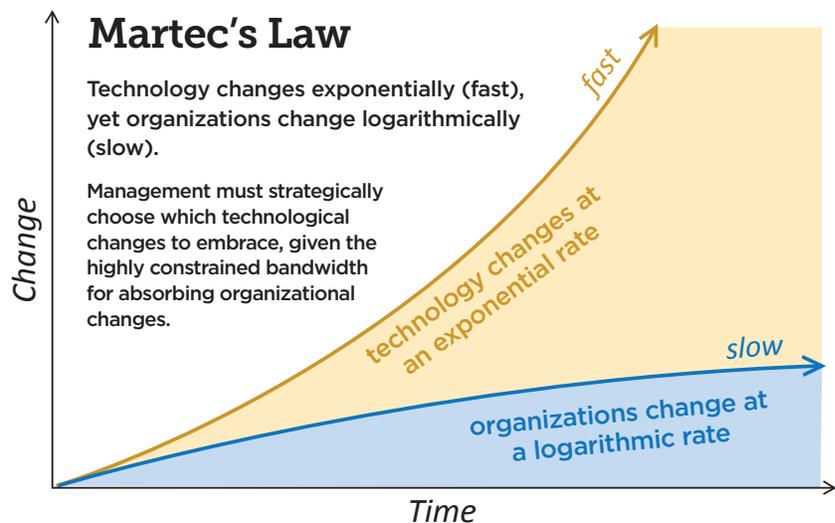
## Regulation in the Digital Age

The internet has brought an unprecedented level of change, with endless opportunities. As the new industry emerged, the Clinton administration recognized that with the commencement of the digital age, there would be things we never could have imagined as possible becoming a reality. That is why President Clinton's chief policy advisor, in crafting the *Framework for Global Electronic Commerce*, placed an emphasis on allowing the private sector to take the lead rather than regulate the industry before it took its true form. Clinton's team went as far as advocating for governments to allow the industry to self-regulate.<sup>2</sup>

The digital world, which is disrupting legacy industries in a domino-like fashion, has taken an ever-increasing role in our daily lives. Regulators have often found themselves a step or two behind when trying to regulate this world, despite its increased presence and utilization in the economy.<sup>3</sup> This is explained by a concept called Martec's Law, which states that technology will grow exponentially while organizations tend to grow at a slow rate.<sup>4</sup>

When regulators are adapting at a slow rate while the pace of innovation is much faster, the propensity for conflict is only exacerbated. For example, Airbnb, the popular property rental app, has also been targeted by regulators for a host of different issues. Airbnb has engaged with dozens of local municipalities over the collection of taxes and resorted to establishing Voluntary Collection Agreements (VCAs) with hundreds of communities as a result of a lack of enforcement for the collection of occupancy taxes.<sup>5</sup> In 2015, Airbnb clashed with multiple cities in Utah, stemming from the site being banned in St. George, Moab, and Provo.<sup>6</sup>

Uber and Lyft, for their part, have clashed with and been targeted by



regulators over the years (Utah being no exception). Former Uber CEO Travis Kalanick stated back in 2012, “Every city we go to, eventually the regulators will make something up to keep us from rolling out or continuing our business.” Uber is currently being targeted by regulators in New York for their food delivery service, Uber Eats. In New York, regulators are proposing a rule that would cap delivery fees at 10%. By comparison, most delivery companies take a 25% cut. Simultaneously, California passed legislation aiming to reclassify Uber and Lyft drivers as employees of the ride-sharing companies, thus requiring them to provide benefits to their drivers. Regulators’ actions are often a negative reaction to the disruptive force these innovative services have been in their states.<sup>7</sup>

Turo and Getaround have faced similar regulatory resistance. These apps allow people to find other individuals with whom to share their car for a rental fee. These services recently clashed with the airport regulators in Utah, who sent a cease and desist letter and began citing vehicle owners for operating an illegal business.<sup>8</sup>

One common theme with all these companies is that they are all platforms with an immense amount of resources. It is because of the healthy amount of resources backing them that they are able to battle regulators directly over the regulations impacting them, overwhelming and forcing change in the process. Some companies, such as Uber, have used these resources to offer their services despite the legal conflict; they told drivers they would pay for any fines they incurred. This allowed them to operate, build a new constituency and public support, and then use these

people to support their political battle against lawmakers to enfranchise their new business model.

While this risky (and costly) approach has paid off for Uber and some others, the average company does not have a huge concentration of capital to battle their own government. The system as it currently exists favors conglomerate corporations or companies that have accrued a massive amount of capital. Something needs to be done to bridge the gap between companies that can compel change with the force of their capital and companies that don’t have the resources to take on these kinds of fights.

### **The Hidden Costs of Over Regulation**

Regulations serve as the rules that govern how certain spaces are supposed to operate. The legitimate purpose of regulation is intended to protect the health, safety, and welfare of consumers and workers in that industry.

Companies that want to operate in a marketplace for an extended period of time need to be compliant with the rules set by the regulators in the space. However, while regulators may act in good faith in trying to protect the consumer, sometimes their actions can inhibit innovation and risk-taking. For example, in the early 2000s an American company known as Free World Dialup (FWD) tried establishing a new product that would enable free peer-to-peer voice communications between people around the world. FWD’s US attorneys held the reins on the company while taking the appropriate compliance steps by waiting for FCC approval. While the FCC moved at lightning speed for a regulator (18

months) to green light FWD, a small European company named Skype emerged without any regard for the American regulators and their approval. The end result was Skype having an enormous “first mover advantage” during which time they built a solid embedded base of users. FWD struggled to compete, resulting in the company shutting down. Just as was the case with Alex Carter, the action of the regulator, driven at times by industry incumbent protectionism, ultimately killed an innovative business in favor of the traditional model. Even if a regulation is well intended, it can have drastic consequences.

The costs of heavy regulatory compliance are often hidden and unknown. However, regulatory rules can be very costly in unexpected ways. The Competitive Enterprise Institute (CEI) found in 2015 that the federal government had issued over 86,000 pages of rules, including 76 “major rules” that had an estimated impact over \$100 million dollars to implement.<sup>9</sup> This obviously doesn’t account for state rulemaking and compliance burdens.

Many of these rules hit small businesses the hardest, as they don’t have the resources to dedicate to having someone to make sure the business stays in compliance with regulation. Over 70% of small business owners have to manage compliance themselves, increasing the cost of these regulations the longer they have to spend reviewing and complying with them.<sup>10</sup> In a Small Business Regulation Survey, conducted by the National Small Business Association, 44% of small businesses spend over 40 hours a year focusing on regulations. Additionally, 29% of the businesses

spend at least the same amount of time, if not more, on state and local rules.<sup>11</sup>

More often than not, state agencies do not conduct a cost-benefit analysis to see if the costs of their regulation are outweighed by the benefits.<sup>12</sup> The average cost to small businesses to comply with regulations is about \$12,000 a year. For a startup, the initial costs of compliance with regulation are \$83,019.<sup>13</sup> Allowing the status quo to continue is a costly proposition. Policymakers should embrace a framework that reduces this burden by encouraging innovation.

## What is a Regulatory Sandbox?

A regulatory sandbox is a unique legal classification that creates space for regulators to temporarily freeze regulations and penalties. 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.

The concept of the regulatory sandbox can be molded into industry specific or general forms, depending on how legislators and regulators want to pursue innovation. A significant common feature is that a regulatory sandbox facilitates the necessary dialogue between market participants and regulators to inform regulatory actions that strike the right balance between facilitating innovation and mitigating potential risks.

## History of Regulatory Sandboxes

Regulatory sandboxes originated in 2014 in the UK at the Financial Conduct Authority as a part of a larger

initiative called Project Innovate. The goal of Project Innovate was to create competition for the betterment of the consumer. Those involved were trying to improve concrete issues facing consumers in the world of finance via financial inclusion and flexible pilot testing programs. The result was the first regulatory sandbox specifically geared at financial tech (fintech) companies.<sup>14</sup> Experiencing tremendous success with its early cohorts in 2018, the FCA announced that it was expanding its sandbox to an international scale, allowing companies from all over the world to apply.<sup>15</sup>

Regulatory sandboxes have since been launched around the world in places like Abu Dhabi, Denmark, Canada, and Hong Kong. Singapore, the second country to formally launch a fintech sandbox, took on a formal “never say no approach,” encouraging their regulatory agencies to allow piloting to happen, even in industries that are normally subject to tightly regulated conditions.

South Korea took it a step further by creating a general sandbox. Their goal was to provide local companies with more freedom rather than pre-emptive regulation. The South Korean government set up the broad sandbox in the hope of encouraging new startups and

fostering new economic growth.<sup>16</sup> The government’s regulatory sandbox aimed to pave the way for success by having companies launch new goods and services first, and retroactively apply reasonable regulations later.

The US government has also experimented with sandboxes. In 2017, the Federal Aviation Administration set up a drone sandbox in an effort to pair state, local, and federal regulators with private actors to work on drone integration.<sup>17</sup>

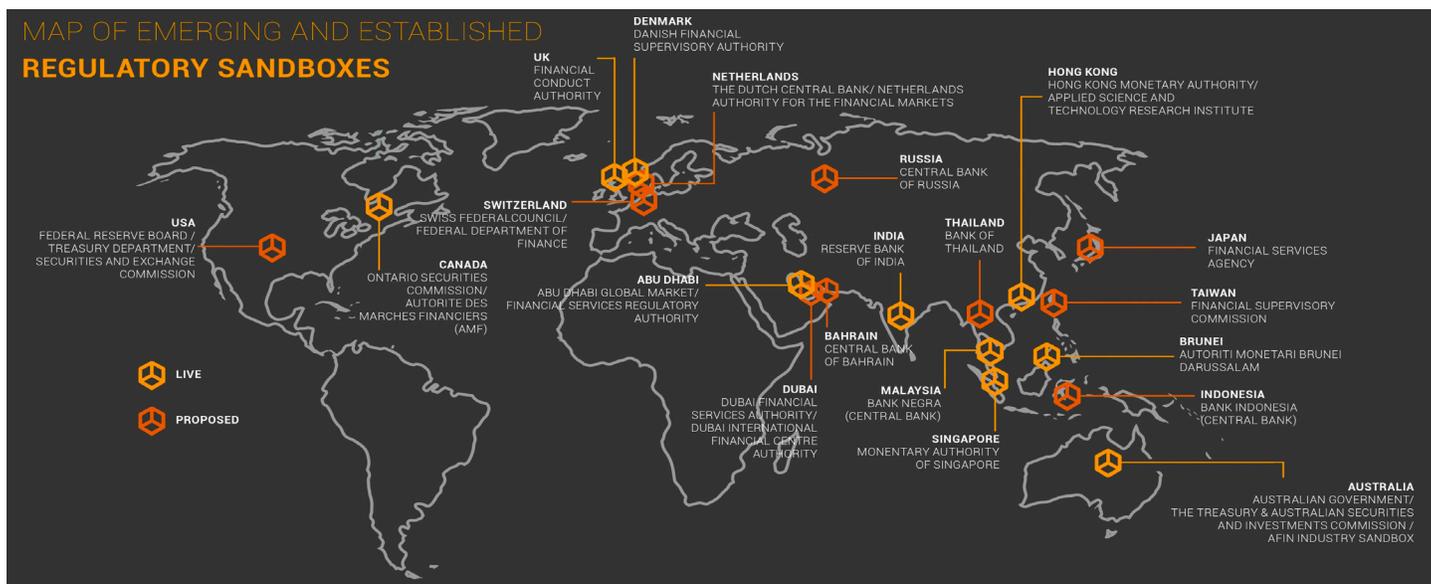
In 2018, Arizona became the first state to launch a fintech sandbox, allowing companies to remain in the sandbox for up to two years and service up to 10,000 clients before having to apply for a formal license.<sup>18</sup>

In 2019, Utah became the second state to launch a fintech sandbox, allowing companies to test new and innovative ideas in the field of financial products and services without being licensed. Additionally, in August of 2019, Utah’s Supreme Court approved a pilot program allowing for non traditional legal services. They approved this measure to “profoundly reimagin[e] the way legal services are regulated in order to harness the power of entrepreneurship, capital, and machine learning in the legal arena.” One of the potential reforms for this “sandbox” of sorts is to enable non-practicing lawyers to have investments and even ownership in law firms.<sup>19</sup>

## Concerns About the Sandbox

In order for regulators to learn more about, and allow, innovative products and business models, they need to be flexible and adaptable. As Rob Morgan of the American Bankers

**Utah should have a presumption of innovation rather than a presumption of regulation.**



Association said, “You’re only as innovative as your least innovative regulator.” A primary benefit of being inside a sandbox is exemption from enforcement if a company violates regulations that would normally require the business to cease its legally problematic operations. However, regulators need to be able to address the concerns raised about sandboxes in order to move forward. Most notably, the regulator needs to establish the balance between promoting innovation and protecting consumers.

There are multiple criticisms about sandboxes. The primary concern is consumer protection. What steps can be taken in order to make sure the consumer is not being victimized by a company in the sandbox? Additionally, another criticism is the method of selecting someone to be in charge of such a program, and how they will hold participating companies accountable. Another problem lies in the stability of the program itself. How do we make sure any sandbox program is set up for long-term success? Furthermore, there are often concerns with the number of consumers exposed to

these fringe and frontier technologies, how is the risk minimized in these circumstances? Finally, there are concerns about how these programs are affected by federal programs and pre-emption. How can the state put itself in a position to be successful and protect consumers while federal programs may prevent them from doing so?

Legislators can help regulators strike this balance by focusing on five core areas in policy:

### 1. Transparency & The Buyer Beware Doctrine

Companies that are going to partake in the sandbox need to be perfectly clear about the product they are offering consumers. If a company is being disingenuous about what they are trying to do, it dissolves trust in the system.

### 2. Accountability

When a company causes harm to Utahns, it is important that there are steps that can be taken to rectify the harm. If there is no accountability to the system, then the institution will be weak.

### 3. Institutional Soundness

A challenge facing sandboxes is that the regulatory institutions managing the sandboxes have to be supported. They need to be well funded, and they need to be in a position to optimize the lessons learned from previous cohorts to be able to adapt for future cohorts.<sup>20</sup>

### 4. Exposure Control

Risk should be mitigated by limiting the number of Utahns exposed to the companies involved in a sandbox. In the event a harm is caused, it is preferred to be on a smaller, controlled population in order for the incident to be resolved in a quick and timely manner.

### 5. Federal Interaction

Some sandbox companies may be involved or want to be involved with programs offered on a federal level. Legislators worry about pre-emption potentially interfering with their responsibility to protect their citizens, so working with the respective federal agencies is important to find common ground.

When thinking about the sandbox, naturally the protection of the consumers who would be exposed to the frontier technologies should be at the front of mind. It is important to establish buy-in from the consumer, as it helps establish trust in the system—otherwise the sandbox could be seen as questionable.

Another way to protect the consumer is to require the businesses in the sandbox to take out some added liability protection (within reason). This would mitigate the risk of consumers being harmed and being in a position where they are not able to get some restitution for the harm that has been done to them by a participating company. In the event a company has been found to cause significant harm, the regulator can reserve the right to remove the company responsible from the sandbox altogether. This accountability measure would increase credibility in the system, and also be a potential barrier against bad actors who might wish to exploit the sandbox.

Regulation and fear of the unknown should not come at the expense of innovation. Historically, the United States has been viewed as a haven

of innovation and progress, paving the way with the industrial revolution and transitioning to the age of technology. By giving in to technophobics and trying to restrain innovation in an increasingly dynamic and competitive global market, innovators will be chased out of Utah, and the country, to more friendly environments.

### How Would it Work in Utah?

When considering a regulatory sandbox, policy makers should clearly define the objectives and the challenges that need to be addressed. Some of the key factors when setting up a sandbox in a state are:

1. Consumer protection is critical.
2. The ultimate benefactor of the sandbox in question should be the public, not the participating companies.
3. Sandboxes should be as accessible as possible.
4. Sandboxes should be voluntary.

Utah already has a sandbox established for fintech companies. After obtaining a critical mass of companies in a cohort, the Department of Commerce should conduct a retroactive “lessons learned” analysis. This would allow the Department

to make adjustments to the sandbox according to what has been learned so the process can become more streamlined for future cohorts and new sandboxes. Policy makers should also look at other industries that could benefit from the existence of a sandbox and work through a similar process (i.e. in the health and insurance industries).

The framework needs to work both for companies who directly apply to operate in the sandbox and for companies who have no knowledge of existing government regulations and that, at some point in developing or taking their product to the market, run into government regulators/problems (similar to the model in South Korea). Utah should have a presumption of innovation, attracting businesses to the state who prefer this approach over every other state’s presumption of regulation.

We want Utah’s perception of industry and innovation to be carried out into actual policy for the benefit of safe, new, and dynamic business models and market opportunities, so we can stand out as entrepreneurial pioneers for businesses who want to innovate.

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## PROPOSAL A: THE INNOVATION INCUBATOR

Ultimately, Utah should create a broad sandbox, known as the Innovation Incubator. Aspects would include:

- Companies may apply pre-emptively before launching a product or service into the market, or retroactively apply if they later learn that their business model or practice violates a law/regulation they did not anticipate.
- The Governor’s Office of Economic Development (GOED) will identify which state agencies have oversight over the product or service in question. Each agency will perform a health/safety/fraud analysis to determine if participation in the Innovation Incubator would jeopardize public health, safety, or financial well-being. The agency identified by GOED will oversee and monitor the companies selected in the sandbox in its jurisdiction for the duration of their term in the sandbox.
- If the screening indicates that little to no jeopardy exists, GOED will approve the company’s product or service for the Innovation Incubator for up to two years, with two possible six-month extensions.
- While in the Innovation Incubator, the company and its employees and independent contractors will be shielded from administrative or criminal enforcement actions over the offering of the product or service.

## PROPOSAL B: INDUSTRY-SPECIFIC SANDBOXES

Rather than a general sandbox, Utah can create industry-specific sandboxes. Any state agency can form a sandbox that is relevant to their industry of choice. For example, the Department of Human Health and Services may want to form a healthtech sandbox in an effort to reduce the cost of healthcare in the state. These sandboxes would provide the same benefit as the broad sandbox listed in the first proposal, though would be narrowly tailored to the specific industry involved. These would each require legislation to direct the relevant state agency.

### Endnotes

1. A healthcare sharing ministries model relies on people paying a membership fee that pools their money for covering healthcare costs. If their cost for services is beneath a certain price, the patient is responsible for the bill. However, if the price is higher, the health care sharing ministry covers the cost of the treatment.
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PUBLIC POLICY BRIEF

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RECURRENCE  
===== TO =====  
FUNDAMENTAL  
PRINCIPLES IS  
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THE SECURITY  
===== OF =====  
INDIVIDUAL  
RIGHTS

UTAH CONSTITUTION  
ARTICLE I, SEC 27