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Who Does India's Draft Enabling Framework for Regulatory Sandbox actually Enable?

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The Reserve Bank of India (RBI), India's central banking institution created an inter-regulatory Working Group (WG) in July 2016 to study the scope and potential of FinTech and review the regulatory framework with which the industry has to comply. The goal of this exercise was to make rules and regulations more suitable for the ever-evolving demands of the FinTech industry. The Working Group's Report was released for public comments on February 08, 2018. One of the salient recommendations of the Working Group was to introduce a regulatory sandbox in India.

A regulatory sandbox is an innovative tool which allows market players to test new financial services or business models with customers in real time, subject to certain safeguards and oversight. These sandboxes have become abundantly popular across the globe and frameworks to enable their use are already live or in the pipeline in over 50 jurisdictions across the world. (Pg. 3, UNSGSA 2019 Report on Early Lessons on Regulatory Innovations to Enable Inclusive FinTech: Innovation Offices, Regulatory Sandboxes, and RegTech)

The Working Group included representatives from RBI, Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA), and Pension Fund Regulatory and Development Authority (PFRDA) and from select financial entities regulated by these agencies, rating agencies such as Credit Rating Information Services of India Limited (CRISIL) and FinTech consultants/companies. It is relevant to note that the group did not include representatives from the Competition Commission of India (CCI), the statutory body responsible for enforcing The Competition Act, 2002. This lack of inclusion is evident in the criteria that have been laid down for the eligibility of applicants in the 'Draft Enabling Framework for Regulatory Sandbox' released by the RBI on April 18, 2019. On 20th May, 2019, insurance regulator IRDAI and markets' regulator SEBI also announced similar initiatives.

Objectives of Introducing the Sandbox

The first regulatory sandbox was launched only in 2016 in the United Kingdom. The UK Financial Conduct Authority's (FCA) regulatory sandbox has been hailed as a great success for bolstering financial innovation (UK Parliament, 2017) and achieving the FCA's objective of promoting competition by reducing barriers to entry for innovators by minimising the time and costs of launching products into the market while ensuring that consumer welfare remains paramount.

(FCA, 2017a). According to the annual Report of the United Nations Secretary-General's Special Advocate (UNSGSA) for Inclusive Finance for Development, 2017, the list of safeguards required in innovative FinTech solutions should tackle data privacy, cybersecurity, digital identification, connectivity, interoperability, financial and digital literacy as well as fair competition concerns.

As per RBI's Draft Enabling Framework, Indian start-ups must be worth Rs 50 lakhs or more to be eligible for testing[1] under the regulatory sandbox, apart from providing an innovative solution for an "existing gap" in the financial ecosystem.[2] In its first phase of testing, the RBI would choose 10-12 start-ups[3] functioning in spaces such as microfinance, innovative small savings and micro-insurance products, remittances, mobile banking and other digital payments etc.[4] This excludes start-ups which may have path-breaking innovative ideas but otherwise lack investment to qualify for applying for the regulatory sandbox. The 10-12 entities so chosen will certainly gain a competitive edge in the market over these smaller players.

This post will argue *firstly*, that such a criterion may be challenged under Article 14 of the Indian Constitution on the ground that the classification between start-ups below the net worth of Rs.50 lakhs and those above such net worth has no rational nexus with the object of the introduction of the sandbox; and *secondly* highlight the effect of such discrimination among applicants upon free and fair competition in the FinTech sector.

Reasonable Classification/Classic Nexus Test

The classic nexus test was evolved from the US Supreme Court's jurisprudence under the 14th Amendment and enunciated by Justice S.R. Das in the case of *State of W.B.* v. *Anwar Ali Sarkar**[5]***, noting:

"In order to pass the test of permissible classification two conditions must be fulfilled viz. (*i*) that the classification must be founded on an intelligible differentia which distinguishes those that are grouped together from others left out of the group, and *(ii)* that the differentia must have a rational relation to the objects sought to be achieved by the Act. The differentia which is the basis of the classification and the object of the Act are distinct and what is necessary is that there must be nexus between them."

Though, J. Das wrote the minority opinion in *Anwar Ali Sarkar*, His Lordship encapsulated the principle cogently and the nexus test has been applied by various High Courts and the Supreme Court of India in numerous cases ever since.[6]

Effect, not intention, is relevant

The Attorney General argued in *Anwar Ali Sarkar* that the party assailing constitutionality of a measure under Article 14 (Equality before law) must demonstrate the Legislature's intention to discriminate against a particular group, animated by prejudice or bias. Negating this argument, the J. B.K. Mukherjea in his separate concurring opinion held that the intention in such cases is immaterial and only the **discriminatory impact of the law is relevant for an Article 14 violation**.[7] Thus, the legislature could have been motivated by all things just and proper but if the

impact of a measure is discriminatory, Article 14 has been violated. The Supreme Court of India took a similar position in *Bennett Coleman vs. Union of India*,[8] reiterated more recently in *Navtej Johar*[9].

Thus, the criteria for applications for a sandbox cannot be saved on the ground that the Government actually intended to promote competition by facilitating start-ups above the net worth of Rs. 50 lakhs with a view to offering more substantive competition to mega industries with deep pockets, selling at sustained losses and never falling short of investors to back them up. The discriminatory impact on start-ups, which meet the rest of the criteria but are valued at less than Rs. 50 lakhs, cannot be justified for any other overarching benevolent governmental concern.

The draft provides an indicative list of areas which could be considered for testing under a regulatory sandbox such as retail payments, money transfer services, smart contracts, cyber security products, data analytics etc.[10] Now, even existing start-ups worth Rs 50 lakhs or more functioning in areas other than the ones indicated in the Draft's list will find it easy to enter these indicated areas and pivot, while start-ups trying to start in these indicated areas will be excluded from the get go.

Applying the Test via Moral Reading of the Constitution

Tarunabh Khaitan critiques the nexus test by noting its formalistic nature and deferential application. The test is too doctrinaire and pedantic and fails to capture completely the essence of a substantive right such as the right to equality. It is deferential because the Court gives inordinate weightage to the "State's claim about what the facts are, how they ought to be evaluated, and whether they breach certain norms." Thus, the Courts have substantial leeway in determining both the object of the legislation as well as the existence of a rational nexus pertaining to the object.

Such inevitable subjectivity in constitutional adjudication and interpretation, according to Dworkin, should be navigated via a "moral reading" of the constitution by judges, lawyers and citizens within the limits of the abstract moral principles of political decency and justice and the language of the Constitution. The moral reading, therefore, invokes political morality within constitutional law. Similarly, Andrei Marmor questions the legitimacy of judicial review by arguing that rights-based adjudication is not a matter of legal expertise but requires moral deliberation at its core. Since judges are not necessarily better equipped to conduct sound moral deliberation than legislators, the claim that the judiciary should be the final arbiter of rights-based review of legislation is misplaced.

Vivian Bose's separate and concurring opinion in *Anwar Ali Sarkar*, noting that the classification test is a subjective test, belongs to a similar school of thought. To illustrate his point, J. Bose offers an example:

"in which a State legislature considers that all accused persons whose skull measurements are below a certain standard, or who cannot pass a given series of intelligence tests, shall be tried summarily whatever the offence on the ground that the less complicated the trial the fairer it is to their sub-standard of intelligence. Here is classification. It is scientific and systematic. The intention and motive are good. There is no question of favouritism, and yet I can hardly believe that such a law would be allowed to stand. But what would be the true basis of the decision? Surely

simply this that the judges would not consider that fair and proper. However much the real ground of decision may be hidden behind a screen of words like ‘reasonable’, ‘substantial’, ‘rational’ and ‘arbitrary’ the fact would remain that judges are substituting their own judgment of what is right and proper and reasonable and just for that of the legislature; and up to a point that, I think, is inevitable when a judge is called upon to crystallise a vague generality like article 14 into a concrete concept.”

It seems like J. Bose is urging us to apply the classification test only upon a principled Dworkinian moral reading of the Constitution. In applying the classification test, it is essential to determine the principles enshrined in Article 14 since these constitutional principles cannot possibly be reduced to a formalistic classification.[11] The adjudication cannot be limitedly engaged with narrow technical questions of determining the classification and its rational nexus but must inquire into whether the impugned classification should exist in a sovereign democratic republic.[12] The test and the moral choices that its application entails, should be applied within the limits and in consonance with the broad ideals of the Constitution.

Criteria regarding minimum net worth of Rs. 50 Lakhs violates A.14

Using the reasoning and analysis in the previous part to test the criteria of application for the regulatory sandbox in the immediate case at hand, there appears to be no rational nexus for the exclusion of market players with a net worth below Rs. 50 lakhs from eligibility for testing. The requirements of a robust IT infrastructure[13] and safeguards to comply with the existing regulatory framework[14] along with satisfactory credit scoring[15] and demonstrable innovative ideas to promote financial inclusion[16] suffice to fulfil the government’s broader objectives of introducing the sandbox- to promote greater financial inclusion, reduce market barriers for innovators and promote consumer welfare via the launch of affordable and accessible products. Therefore, any start-up fulfilling the criteria specified, other than that pertaining to net worth, should be allowed to benefit from the sandbox and applications should not be restricted to only 10-12 entities because such exclusion would also impede fair competition. As per the UNSGSA 2019 Report, a regulatory sandbox is an expensive tool to use for financial inclusion, particularly by underfinanced regulators in developing countries with large unbanked populations.[17] Thus, it is reasonable to assume that a cap is indeed necessary for testing start-ups under the sandbox due to resource constraints. However, methods to ensure minimal exclusion of competition must be devised and set criteria for selection must be notified to distinguish among start-ups fulfilling all the listed requirements to preclude arbitrariness and ensure transparency in selection.

As the Working Group notes, Asian sovereigns and regulators are supporting disruptors ostensibly for promoting competition and transparency in the financial service industry.[18] It suggests that similarly, the Indian government may also back up and encourage FinTech start-ups for preserving competition among providers, encouraging financial inclusion and consumer welfare by making services affordable, available and accessible to large swathes of the Indian unbanked populace. The government’s legitimate democratic objective to promote FinTech solutions is to make products and business processes cheaper, faster, and more customer-centric, which can be achieved by encouraging competition and collaboration among traditional players, start-ups, and tech companies.

Mathhew, in his dissenting opinion in *Bennet Coleman vs. Union of India*, noted in the context of

restrictions on free speech of newspaper dailies that "one cannot promote competition by making the strong among the competitors stronger or the tall, taller but by making the weak among them strong and the short, tall."[19]

Therefore, it is the less resource-intensive start-ups that require more support to benefit from a less expensive and faster roll out in the market with a lower and customized regulatory burden than start-ups with a net worth of Rs. 50 lakhs and above. The regulatory exclusion of small innovators with the same or better technologies than large innovators from reaping the competitive benefits that a sandbox promises, would deter smaller start-ups from entering the market of experimentation for want of financial resources. RBI was held to be "State" within the meaning of Article 12 of the Indian Constitution by the Supreme Court in *Reserve Bank of India v. N.C. Paliwal.* In this case, one of RBI's employment schemes was challenged for violation of Articles 14 and 16 of the Indian Constitution. Thus, fundamental rights can be enforced against the RBI and the discriminatory impact of its regulations and criteria to test the sandbox, falls foul of Article 14 and cannot be said to have a reasonable nexus with the government's democratic objectives of promoting FinTech solutions.

Competition Risks Involved within Sectoral Regulation

India has the cheapest mobile data in the world. With over 460 million Internet users, it is the second largest online market, ranked only behind China. Further, it also has the world's second largest unbanked population and around 191 million Indians above the age of 15 do not have bank accounts. This has justifiably given rise to burgeoning corporate interest in FinTech as it promises to be an extremely lucrative industry given India's market conditions.

As per the RBI Working Group's Draft Enabling Framework, one of the stated objectives for the introduction of a regulatory sandbox allows for a bespoke accommodation if the product is found economically viable but is impeded from market entry due to a traditional regulatory framework out of pace with the demands of the evolving FinTech industry.[20] In the past, Indian regulatory bodies have suspiciously relaxed regulatory standards for large market players. The example of Reliance Jio, a mobile network operator and subsidiary of Reliance Industries Limited (RIL)-India's largest private Company, taking over the telecom market by offering services initially for free and subsequently, for negligible prices is a clear instance of the same. A favourable regulatory environment such as elimination of data share from the definition of 'significant market power' by TRAI[21] bolstered Jio's spectacular rise and allowed it to evade scrutiny for monopolisitic practices and drive out competitors. RIL has already announced the launch of its e-commerce platform which aims to bring together the 35 crore customers of Reliance retail stores, the 21.5 crore and ever-growing customers of Reliance Jio and the targeted 5 crore customers of JioGiga Homes, an RIL project to use technology and Fibre-to-the-Home (FTTH) broadband service for phones, televisions, computers and other devices. Most pertinently though, Reliance Jio is set to disrupt the FinTech sector and has already launched its PoS services in six Indian cities (Mumbai, Bangalore, Hyderabad, Chennai, Pune and Kolkata) on a pilot basis. Jio also launched its payments bank in partnership with India's largest bank, State Bank of India. This would also mean that RIL would be privy to large amounts of data providing it further competitive advantage to design its products and services as per market demand and drive out any smaller players lacking comparable investment.

A conservative view of the CCI's jurisdiction had already been taken by the Supreme Court in *CCI*

vs. Bharti Airtel Limited and Others, dismissing CCI's appeal to probe anti-competitive actions against Reliance Jio by industry incumbents in the telecom sector. The Supreme Court while paraphrasing and affirming the order of the Bombay High Court in Vodafone India Limited vs CCI noted, "once there is a determination of the respective rights and obligations under these licenses by the authority under the TRAI Act, which provided an information to the effect that the particular act appears to be anticompetitive, only thereafter the CCI gets jurisdiction to go into the question of such anti-competitive practice." The CCI's role to scrutinise a given conduct through an antitrust lens, and not that of a sectoral regulator is adversely impacted by such a narrow approach as the CCI can exercise its jurisdiction only once the sectoral regulator figures out a prima facie case of anticompetitive conduct. This undermines the function of the CCI as a market watchdog in many regulated sectors such as electricity, insurance and banking.

Thus ironically, the Competition Commission of India could do precious little to check later anti-competitive actions by Reliance Jio itself or undo the damage caused to competition in the telecom sector, once the sector was already disrupted. This makes it important to rope in the CCI at the crucial policy making stage itself. It also ought to alert us to the potential ramifications of the absence of CCI representatives at the drafting stage of the enabling framework for a regulatory sandbox.

Smriti Parsheera suggests in an article that a voluntary memorandum of understanding (MoU) must be signed between CCI and regulators such as TRAI as competition issues emerge within sectoral regulation. She notes, "a voluntary MoU between TRAI and CCI would include CCI's participation in TRAI's consultation processes; review of regulatory provisions to assess their impact on competition; mandatory (non-binding) references on areas of mutual interest and mechanisms for sharing of knowledge and information between the authorities"

As per the National Association of Software and Services Companies (NAASSCOM), the Indian Fintech Service sector is expected to grow to USD 45 billion with a Compound Annual Growth Rate (CAGR) of 7.1%. It is important to pre-emptively analyse the competition concerns that will predictably arise in this sector. The Regulatory Sandbox as an innovative tool must be implemented while taking into account the competition concerns arising out of fewer firms' control over a significant market share, aggressive pricing, tying and bundling and information network effects. Finally, competition law has a pivotal role to play in ensuring that the cost of undertaking FinTech experimentation is not detrimental to the market entry and survival of equally or more efficient, albeit smaller innovators.

Interestingly, the introduction of the Regulatory Sandbox in Taiwan via the passage of the Financial Technology Development and Innovative Experimentation Act (FTDIEA) was criticised by scholars as the safeguarding requirements for protection of information security and participants' interests under the FTDIEA require substantial investments by potential experimenters and will therefore, significantly raise experimentation costs for small innovators and increase barriers to their market entry.[22] More pertinently, another ground of criticism was the exclusion of the Taiwan Fair Trade Commission (TFTC) from the consultation procedure regarding the implementation of the Sandbox, which involved an advisory group consisting of representatives from related government agencies.

It is essential to include the CCI at the policy drafting stage itself because introducing a sandbox in the FinTech sector is not an industry matter devoid of competition concerns. The CCI can offer valuable suggestions and perspective by foreseeing predictable competition hazards and tailoring

policy drafts to better safeguard against them in fulfilling its broad mandate under Section 18 of the Competition Act, 2002 ((hereinafter referred to as the Act)) to 'eliminate practices having adverse effect on competition, promote and sustain competition, protect the interests of consumers and ensure freedom of trade (…) in markets in India.'

It is noteworthy that the CCI already has a mechanism in place to review economic legislations and policies and assess their impact on fair competition in the country. Under S.49(1) of the Act, the CCI has to give its opinion, upon reference by the State or Central Government, on the impact of competition caused by a particular government policy or legislation. As per S.49(3), the CCI is mandated to promote competition advocacy. As part of its advocacy *ex ante* to ensure fair competition and under S.49(1) and S.49(3), the CCI issued Competition Assessment of Economic Legislations and Policies) Guidelines in 2016 to assess "upcoming /existing economic legislations and policies made by the Parliament/ a State Legislature /a Ministry/ Department of Central/ a State Government/ a Statutory Authority"**[23]** from a competition lens and share the assessment with the relevant stakeholders. These guidelines have been in force since January 1, 2017 and the CCI's Advocacy Division must take a more proactive role in enforcing these guidelines and scanning, assessing and identifying such upcoming/existing economic legislations and policies for their potential adverse impact on competition.

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[1] 6.5.1(b), RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[2] 6.5.2 (Fit and Proper Criteria for Selection of Participants in RS), RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[3] 6.4, RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[4] 3.3, RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[5] *State of W.B.* v. *Anwar Ali Sarkar*, AIR 1952 SC 75.

[6] *R.K. Dalmia* v. *Justice Tendolkar*, AIR 1958 SC 538 and *In re Special Courts Bill*, 1978, (1979) 1 SCC 380 summarise the application of the nexus test (as evolved in Anwar Ali Sarkar) to ascertain A.14 violations.

[7] J. B.K. Mukherjea in Anwar Ali Sarkar, MANU/SC/0033/1952 para 48 ("I am not at all impressed by the argument of the learned Attorney- General that to enable the respondents to invoke the protection of article 14 of the Constitution it has got to be shown that the legislation complained of is a piece of "hostile" legislation.)

[8] J. A.N. Ray in *Bennett Coleman vs. Union of India* MANU/SC/0038/1972 para 39 ("The true test is whether the effect of the impugned action is to take away or abridge fundamental rights.")

[9] J. Chandrachud's separate and concurring opinion in Navtej Johar vs. Union of India MANU/SC/0947/2018 para 386 ("The individual is aggrieved because the law hurts. The hurt to the individual is measured by the violation of a protected right. Hence, while assessing whether a law infringes a fundamental right, it is not the intention of the lawmaker that is determinative, but

whether the effect or operation of the law infringes fundamental rights.")

[10] 6.1, RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[11] J. Vivian Bose in Anwar Ali Sarkar para 91, MANU/SC/0033/1952 ("It is therefore impossible to apply rules of abstract equality to conditions which predicate inequality form the start; and yet the words have meaning though in my judgment their true content is not to be gathered by simply taking the words in one hand and a dictionary in the other, for the provisions of the Constitution are not mathematical formulae which have their essence in mere form. They constitute a frame-work of government written for men of fundamentally differing opinions and written as much for the future as the present. They are not just pages from a text book but form the means of ordering the life of a progressive people. There is consequently grave danger in endeavoring to confine them in watertight compartments made up of ready-made generalisations like classification. I have no doubt those tests serve as a rough and ready guide in some cases but they are not the only tests, nor are they the true tests on a final analysis.")

[12] J. Vivian Bose in Anwar Ali Sarkar para 100, MANU/SC/0033/1952 ("What I am concerned to see is not whether there is absolute equality in any academical sense of the term but whether the collective conscience of a sovereign democratic republic can regard the impugned law, contrasted with the ordinary law of the land, as the sort of substantially equal treatment which men of resolute minds and unbiased views can regard as right and proper in a democracy of the kind we have proclaimed ourselves to be.")

[13] 6.5.1 (i), RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[14] 6.5.1 (g), RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[15] 6.5.1 (e), RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[16] 6.5.2 (Fit and Proper Criteria for Selection of Participants in RS), RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[17] Pg. 7, Executive Summary, UNSGSA 2019 Report on Early Lessons on Regulatory Innovations to Enable Inclusive FinTech: Innovation Offices, Regulatory Sandboxes, and RegTech ("Lessons learned from early regulatory sandboxes highlight that they are neither necessary nor sufficient for promoting financial inclusion. Sandboxes do offer benefits but are complex to set up and costly to run. Experience shows that most regulatory questions raised in connection with sandbox tests can be effectively resolved without a live testing environment. Similar results may be more affordably achieved through innovation offices and other tools")

[18] 6.5.1, Investment in FinTech and start-ups, 'Report of the Working Group on FinTech and Digital Banking' (8th Feb, 2018)

[19] MANU/SC/0038/1972 para 127

[20] 2.2 Objectives, 6.5.1(b), RBI's 'Draft Enabling Framework for Regulatory Sandbox'

[21] THE TELECOMMUNICATION TARIFF (SIXTY THIRD AMENDMENT) ORDER, 2018 at https://main.trai.gov.in/sites/default/files/TTO_Amendment_Eng_16022018.pdf amending clause 2 of the Telecommunication Tariff Order, 1999.

[22] Nizan Geslevich Packin & Yaft Lev-Aretz, *Access to Payments and Credit in the Age of Big Data in* Electronic Payment System: Law and Emerging Technologies 259, 263 (Edward A. Morse ed. 2018)

[23] 'B. Objective', Competition Assessment of Economic Legislations and Policies) Guidelines, 2016 (Pg. 2) at https://www.cci.gov.in/sites/default/files/whats_newdocument/Competition%20Assessment%20Guidelines%2C%202016.pdf

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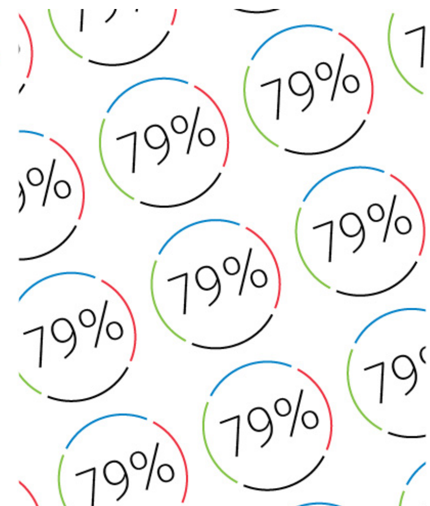

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