

Blockchain and the financial markets: Will 2017 be the year of the regulators?

New rules covering blockchain and distributed ledger technology could be on the horizon following a flurry of consultation papers by leading financial regulators.

In 2016, policy makers and regulators started to take an active interest in blockchain and distributed ledger technology (DLT). However, many adopted a “wait and see” approach rather than producing binding regulations. 2017 is shaping up to be the year of the regulators. The focus on DLT has intensified with a slew of reviews, such as a new report by the European Securities and Markets Authority (ESMA), a consultation started by the Financial Industry Regulatory Agency (FINRA) in the US and the report by the International Organisations of Securities Commissions (IOSCO). This increasing scrutiny places an onus on market participants when assessing the technologies they intend to use. This requires them to monitor the legal and regulatory developments that may affect them at a national and international level and to proactively engage with the regulators to help develop clear and balanced regulation.

Global trends

The Financial Stability Board (FSB) discussed DLT in March 2016, indicating that it wants to better understand the implications of the new technology. IOSCO also made a commitment to analyse the impact of DLT. The Financial Action Task Force on Money Laundering (FATF) and IMF also published reports on virtual currencies and DLT. The Bank of International Settlements (BIS) indicated its interest in investigating the impact of DLT and virtual currencies on the role of central banks.



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Pan-European trends

The European Parliament has recognised the importance of the technology, indicating that existing regulation will continue to apply, but also called for “smart regulation fostering innovation and safeguarding integrity, while taking seriously the regulatory challenges that the widespread use of virtual currencies and distributed technology might pose.”

The Parliament identified risks related to money laundering and terrorist financing and created a task-force to study the technology, but so far it has not adopted a hands-on approach.

- In June 2016, ESMA launched a public consultation on the use of distributed ledger technology applied to securities markets.
- In July 2016, the European Commission published proposals to bring virtual currency exchange platforms and custodian wallet providers within the scope of the 4th Anti-Money Laundering Directive (these proposals have

been adopted in the Parliament in 2017) and also set up an internal task force on financial technology.

- Other EU bodies, such as the European Central Bank (ECB), also started investigating the impact of DLT and its regulatory implications.

US trends

While no form of “binding” federal regulation was adopted in the US, various policy makers such as the OCC, CFTC, SEC, Federal Reserve and US Congress indicated their interest in further investigating the opportunities, risks and implications of DLT. In addition, at the state level, various states, such as Vermont and Delaware started investigating state laws, with the aim of facilitating the adoption of DLT.

Result of the ESMA Consultation

ESMA recognised the benefits DLT could bring to the securities markets, notably more efficient post-trade processes, enhanced data reporting and data management. The consultation paper also highlighted a number of risks and challenges such as interoperability and the use of common standards, governance, privacy issues and scalability. ESMA stressed that the presence of DLT does not liberate users from complying with the existing regulatory framework.

In terms of applying the existing legal framework, it will be particularly important to assess whether a DLT-enabled platform would fall within the scope of EU rules on post-trading activities, such as the European Markets and Infrastructure

Seven observations regarding DLT and the developing regulatory framework:

- **Early days** – It is still “early days”, as the technology is still in evolution and regulators are still familiarising themselves with the technology. While regulators are clearly taking a more active interest in the technology, this does not mean that they immediately plan to issue “DLT-specific” regulations. However, given the speed of technological developments, this may change more rapidly than expected. Regulators signal that they are open to dialogue on the topic, and it is important to engage with them.
- **All about the model** – The type of model adopted may influence the application of the existing legal and regulatory framework. A ‘permissioned blockchain’, which is privately owned and operated by vetted participants, may give rise to fewer questions than the use of DLT in the context of a ‘permissionless’ or public network. However, permissioned blockchains may take away some of the potential benefits the technology may have.
- **Watch the status quo** – Even though there may be no “DLT-specific regulations” for specific applications of the technology, the impact of the existing regulations cannot be underestimated. This may make the implementation of the technology in certain highly regulated areas, such as post-trade settlement for securities, more complex. Developments in these areas may be slower.
- **Niche developments** – We are likely to see faster developments in specific areas such as trading of securities that are not listed on a regulated market, trade finance or commodities trading.
- **Enabling legislation** – The importance of “enabling legislation” is not to be underestimated, i.e., where legislators actively create a legal framework enabling the use of technology. Examples of this are the French Sapin II legislation that will allow the issuance of certain securities on the blockchain, as well as initiatives in Vermont and Delaware.
- **Beyond financial regulation** – The impact of data protection regulations, e.g., the application of the “right to be forgotten” under GDPR, require specific attention and further clarifications. Also, the importance of intellectual property protection should not be underestimated. Some have mentioned that there are signs that a “patent race” is underway. The use of “smart contracts” enabled by DLT will raise new questions regarding liability at the intersection of code and law.
- **Beyond legal aspects** – Beyond the purely legal aspects, issues around governance and standard setting will be of key importance for the further application of DLT in the financial sector.

Regulation (EMIR), the Settlement Finality Directive (SFD) and the Central Securities Depositories Regulation (CSDR).

While ESMA indicated that DLT may create or exacerbate some risks, it is premature to assess the exact nature and level of these risks. ESMA anticipates that legal questions will arise as the technology develops and its applications become more visible. It believes that it is too early to gain a complete understanding of the changes that the technology may introduce and that any regulatory action would be premature.

FINRA consultation

Published in January 2017, the FINRA report “Distributed ledger technology: implications of Blockchain for the Securities Industry”, also recognises the potential benefits of DLT for financial market infrastructures, such as additional efficiencies and increased transparency. FINRA also refers to novel risks, such as data security and privacy. Moreover, FINRA refers to the continuing relevance of the existing legal framework, e.g., a DLT application that seeks to alter clearing arrangements or serve as a source of recordkeeping by broker-dealers, may fall under its existing rules related to carrying agreements and books and records requirements.

DLT may also have implications for FINRA rules such as those related



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to financial condition, verification of assets, anti-money laundering, know-your-customer (KYC), supervision and surveillance. Fees and commissions, payment to unregistered persons, customer confirmations, materiality impact on business operations, and business continuity plans also may be impacted depending on the nature of the DLT applications. FINRA has invited market participants to take part in an open dialogue.

IOSCO report on fintech

The IOSCO report on financial technologies (fintech), including its intersection with securities markets regulation, which was published in February 2017, recognises the benefits of the use of DLT in financial services, such as cost reduction in settlement, faster speed of settlement, reliability and traceability of records, as well as the possibility to facilitate automatic and real-time filings to regulators, efficiency enhancement and enhancement in security.

IOSCO identifies various technological challenges such as scalability, interoperability, cyber resilience, as well as operational challenges such as issues regarding governance and risks associated with the use of smart contracts (the coding error). IOSCO refers to legal challenges regarding KYC and AML. IOSCO has not yet proposed any specific regulation to address technological challenges such as scalability, interoperability, cyber resilience, or operational challenges such as issues regarding governance and risks associated with the use of smart contracts (the coding error). IOSCO refers to legal challenges regarding KYC and AML. IOSCO has not yet proposed any specific regulation.



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