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FCA Launches Discussion on Distributed Ledger Technology

UK regulator calls for submissions on potential uses, risks and benefits of distributed ledger technology in the financial services sector.

The Financial Conduct Authority (FCA) published a Discussion Paper (DP17/3)[1] on 10 April 2017 to start a dialogue about the potential uses of distributed ledger technology (DLT) in the financial services sector. The FCA has called for submissions, by 17 July 2017, on 17 different questions about DLT; including topics such as security, financial crime, "smart" contracts and digital currencies.

DLT is defined by the FCA as a "set of technological solutions that enables a single, sequenced, standardised and cryptographically-secured record of activity to be safely distributed to, and acted upon by, a network of varied participants". DLT is a decentralised ledger system that allows participants (with or without permission) to process, store and share data across multiple points in a network. Therefore, the FCA believes that benefits are likely to emerge in sectors where multiple participants need to share data and/or processes quickly and securely.

DLT, best known for underpinning the digital currency Bitcoin, is also considered to be useful for a number of different applications across the financial services industry, including keeping accurate client records in the asset management sector and assisting with the management of contracts and risk data in the insurance sector. Blockchain is another example of the use of DLT, in which records are grouped into blocks and linked using a cryptographic signature.

The Discussion Paper aims to "invite debate and clarify what the real benefits and risks of DLT may be" in order to determine how regulatory requirements ought to apply to the new technology. While the FCA generally takes a "technology neutral" approach to regulating financial services, as part of this discussion the FCA seeks to discover whether DLT has distinctive aspects that would require a change in its usual approach. The FCA notes, however, no clear need to consider changes to its existing regulatory framework at this stage.

Uses, Risks and Benefits

The FCA's Discussion Paper provides numerous examples of what the FCA sees as the potential uses, risks and benefits of DLT in the financial services sector. The FCA paper specifically invites discussion on the following two points:

- What new risks and opportunities does DLT present to the FCA's statutory objectives of market integrity, consumer protection and competition? Can DLT support more effective competition, financial system integrity and deliver better consumer outcomes? How can regulated firms mitigate any risks?

- Do any of DLT's characteristics make it challenging to fit DLT solutions into the regulatory framework, despite the FCA's approach of "technology neutrality"?

Throughout the Discussion Paper, the FCA outlines a number of examples about the potential benefits and risks of DLT and requests stakeholders' views on the following topics with the above points in mind: (i) governance and technology resilience; (ii) DLT and distributed data; (iii) recordkeeping and auditability; (iv) smart contracts; and (v) the use of digital currencies to deliver financial services.

The FCA outlines a number of benefits DLT could offer to firms and consumers, including:

- Improved efficiency and transparency.

- Better collaboration between firms to share customer due diligence information for anti-money laundering efforts.

- Faster updating and viewing of shareholdings for investor relations purposes.

- More efficient cross-border payments underpinned by DLT solutions.

- Improved business resilience and continuity without the need for a second back-up system, and the ability to "cut-off" compromised records in the event of a cyber-attack.

The FCA also addresses a number of risks associated with DLT and its decentralised nature, notably:

- Security concerns and potential risks associated with coding errors, which, due to the decentralised nature of DLT, would affect all participants in the ledger system rather than just a single firm.

- Concerns about governance, allocation of responsibility and regulatory oversight given the lack of centralised authority.

- Potential competition issues in relation to closed permissioned networks operating at the exclusion of competitors.

The Discussion Paper also focuses on how DLT may enable greater use of so called smart contracts; contracts under which systems may automatically move digital assets based on pre-specified rules, thus creating improved efficiencies in back-office operations. While the FCA acknowledges the improvements that could be gained, especially in light of manual systems that are prone to error, the FCA states that it is unclear how smart contracts on DLT constitute a significant improvement on currently available systems given that "the execution of commands conditionally on an event occurring pre-dates DLT and there are a wide range of vendor offerings which automate certain practices such as collateral management".

Notably, the FCA does not mention the benefits of DLT in creating a single golden source of data from which smart contracts can operate without the need for manual reconciliations between counterparties. Additionally, while the FCA recognises industry commentary that DLT could significantly impact post-trade infrastructure if the standard settlement cycle of T+2 was reduced to a near instantaneous settlement cycle, the FCA comments that this speed may not reflect market preference due to other aspects of trading that need to be considered (such as collateral management).

Why Now?

The timing of this Discussion Paper is not incidental, coming at the start of UK Fintech week, amidst a flurry of speeches about the UK's drive towards becoming a leading global Fintech centre.

The FCA has been pushing to encourage greater competition and innovation in the UK financial services sector for some time now, having launched Project Innovate in October 2014 with the aim of removing unnecessary barriers to innovation in the UK financial services sector. A number of the example DLT uses noted in the paper come from the FCA's experiences with the first cohort of firms using its Regulatory Sandbox, a limb of Project Innovate. The Sandbox, which allows businesses to test new technologies in a live environment without incurring all of the normal regulatory consequences, has proved exceedingly popular. The FCA has announced that it will nearly double the number of firms in its second cohort, which should start testing in late May 2017.

Another reason for the timing of the paper is that the FCA has become aware that DLT use in the financial services sector may become widespread as soon as the second half of 2017 or early 2018. The FCA has observed a growth in technology companies providing DLT-based solutions, increased investment in DLT by regulated firms, and increased industry efforts to investigate these technologies that are likely to shift into real-world deployments.

The publication also comes quickly on the heels of other reports into DLT and other financial technologies, including reports published by the US Financial Industry Regulatory Authority (January 2017)[2], the European Securities and Markets Authority (February 2017)[3] and the International Organization of Securities Commissions (February 2017)[4]. As part of its Discussion Paper, the FCA notes that ensuring DLT is used appropriately and securely will require cross-border collaboration and opportunities for innovation.

Submissions and Next Steps

The FCA has called for responses to its questions from both users and providers of DLT in the financial services sector. Individuals may submit responses through an online response form available on the FCA website or via email or post. Following the submission deadline, the FCA will review the responses in order to determine the next steps. The FCA may then publish either a Summary of Responses or, if it decides that it needs to consider changes to its rules, a Consultation Paper.

Fintech community stakeholders are encouraged to submit responses to the points raised in the paper and contribute to the discussion about the regulation of DLT in the UK. The interest the FCA has shown in new technologies indicates that it considers itself to be a progressive and forward-thinking regulator. As the FCA freely admits in the Discussion Paper, its questions are "aimed at enhancing our knowledge in this area", so this is a useful opportunity for respondents to help educate the regulator.

While DLT potentially offers a number of exciting opportunities, those working in the Fintech space will need to present the FCA with real-world examples about how this technology will be implemented — but also equally importantly — how it will not be used. The Discussion Paper offers a unique opportunity to shape not only the FCA's understanding of DLT solutions, but with that, the future of regulation around disruptive technologies.

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Endnotes

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[1] Financial Conduct Authority, Discussion Paper on Distributed Ledger Technology (April 2017) *available at* https://www.fca.org.uk/publication/discussion/dp17-03.pdf.

[2] Financial Industry Regulatory Authority, Distributed Ledger Technology: Implications of Blockchain for the Securities Industry (January 2017) *available at* http://www.finra.org/sites/default/files/FINRA_Blockchain_Report.pdf.

[3] European Securities and Markets Authority, Report on the Distributed Ledger Technology Applied to Securities Markets (February 2017) *available at* https://www.esma.europa.eu/sites/default/files/library/dlt_report_-_esma50-1121423017-285.pdf.

[4] International Organization of Securities Commissions (IOSCO), Research Report on Financial Technologies (Fintech) (February 2017) available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf.