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FinTech Regulation is Not a Zero Sum Game

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In this Issue:

Regulation and innovation is not a zero sum-game – that is what a Senior Advisor to the Chair of the Securities and Exchange Commission (the "SEC") said at the Financial Industry Regulatory Authority's ("FINRA") inaugural symposium on distributed ledger technology ("DLT"). A panel of representatives from the Federal Reserve Board, Office of the Comptroller of the Currency (the "OCC"), the Commodity Future Trading Commission (the "CFTC") and FINRA echoed this sentiment as the agencies take steps to regulate financial technology ("FinTech). **The representatives of the regulators acknowledged the promise of FinTech to revolutionize financial services and the challenges they face in regulating an industry that is being disrupted by FinTech.** These challenges have led to a slow start for regulatory agencies with FinTech in their jurisdictions, but speakers at the FINRA conference indicated a promising openness from regulators to develop supervisory solutions that are mutually beneficial.

Views of Regulators

Representatives from each regulator at the symposium made it clear they are not in the market to stifle innovation. The panel expressed their beliefs, shared widely by those in attendance, in the potential that DLT has to revolutionize financial services globally. They cautioned, though, the disruptive technology is not without its risks. Assessing these risks has posed a challenge to regulators as DLT and its applications have developed and changed at a rapid clip over the past several years.

The representative from the CFTC noted the regulator began observing the growth of FinTech with a self-professed "do no harm" approach as the industry was developing from 2015 through 2016. The Founding Director and Architect of LabCFTC, said the CFTC is now seeking a more active role, with a desire to promote innovation. This is evidenced by the development of LabCFTC, a regulatory sandbox that looks to be a promising approach to sustainable innovation. Critically though, he noted the success of LabCFTC and the CFTC's broader regulation of the FinTech is dependent on participation and feedback from the industry to help the agency learn where the technology is headed and to develop the regulatory framework that will be most beneficial for both the industry and consumers.

The representative from the SEC noted that so far all cases of abuse the agency has seen in FinTech have taken three forms:

- **Ponzi schemes,**
- **Unregistered offerings and**
- **Investment frauds.**

All such cases are of the same types as traditional, non-FinTech SEC enforcement actions, but facilitated through new technology. The SEC representative believes it is critical those developing new technologies in FinTech be aware of the risks associated with their business plans and their potential effects on consumers in order to help minimize risk. He expressed a strong desire on behalf of the SEC to engage with the FinTech industry and individual participants to both learn about the technologies and to help advise on risks and potential regulatory pitfalls of proposed business models.

Representatives from FINRA, the OCC and the Federal Reserve, along with the CFTC and SEC, all presented a consistent message: a desire for innovation that is responsible.

The tone of the panel was one of cautious optimism. The regulators noted that while there is great potential for DLT to streamline and disrupt the industry, there are often foreseeable unintended consequences. The SEC representative cited the collapse of the Distributed Autonomous Organization (the “DAO”) as a key example of why DLT is not currently ready for widespread adoption.

Just the Facts and Circumstances

Since the regulators have not published regulations that focus on FinTech, they all view developments through a facts and circumstances analysis under existing, ill-suited regulatory frameworks. The diverse applications of DLT do not lend themselves easily to regulations that were originally put in place in the 1930s. While the regulators acknowledged this, as well as their desire to develop more tailored regulations, industry actors must be aware of what currently exists and take an affirmative step to protect consumers.

As change continues and new technologies are developed, the regulators expressed a desire to interact with the industry to learn more, to help actors identify risks, and to help the regulators develop regulations that are well-suited to FinTech.

Impact on the Industry

FinTech is subject to existing regulations that are ill suited to the regulation of FinTech. However, representatives from each regulator expressed a strong desire for this to change. The agencies are seeking to learn more about FinTech and where the industry may be headed in order to develop tailored and sustainable regulatory frameworks that both foster innovation and protect consumers.

It is critical industry actors communicate with the regulators to help the agencies as they work to develop regulations that are better suited to FinTech. FinTech companies should discuss their particular business models and learn more about what the regulators may see as risks involved with them. Importantly, this also creates an opportunity to educate the regulators on the needs of the industry. Outreach will provide both a short term benefit in identifying risks for industry actors under existing frameworks, and also aid the agencies in developing more tailored regulations in the future.

There are currently formal and informal channels for communicating with each agency. The CFTC has developed LabCFTC with a specific outreach function through which industry actors can interact with regulators. FINRA is developing a committee on FinTech and announced an outreach program in June, and though the SEC does not have a formal FinTech communication channel, the agency has sought more interaction with the industry. These are all excellent opportunities for industry to actors to reach out to the agencies regulating their businesses to ask questions of the regulators and make sure that their interests are represented as regulatory frameworks are being developed.

Looking Forward

Regulators have expressed their belief in the promise of FinTech and their desires to learn more about the technology. This presents a unique opportunity for the industry to help in the creation of a new regulatory framework. Whether through formal or informal channels, it is critical the FinTech industry engage in a constructive dialogue with regulators. The regulator have expressed their desire to learn from the industry, which makes this an invaluable time for the industry to ensure the regulations are well suited for the new technology.

LabCFTC and the OCC's FinTech chartered bank framework will likely help the industry deal with existing regulations. The SEC's recent Investigative Report on the DAO will also increase the willingness of the industry to engage the regulator in a dialogue on how to effectively regulate FinTech. The regulatory landscape is changing as regulators in the United States, Europe and Asia strive to establish the best model for regulating FinTech.

Conclusion

What additional actions the SEC, the CFTC, the Federal Reserve, the OCC and FINRA will take with regard to the regulation of FinTech is unclear. It is likely the SEC and the CFTC will initiate enforcement actions against FinTech. Any firm that is planning to develop FinTech or to offer services built on FinTech, should proceed with caution. Due to the lack of clearly defined guidance with respect to how existing laws, rules, and regulations apply to FinTech, it is important that you engage experienced counsel to assist you in navigating the regulatory requirements that may apply to FinTech.

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