Client Alert Commentary

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What Next for Distributed Ledger Technology?

The FCA has published a Feedback Statement on Distributed Ledger Technology, setting out its views and proposed next steps.

Key Points:

- Respondents to the FCA's initial Discussion Paper were supportive of the FCA maintaining its "technology neutral" approach to regulation.
- Some issues were raised about the compatibility of new solutions with the existing regulatory framework, but the FCA is of the view that no regulatory change is required at present.

Background

On 15 December 2017, the FCA published a <u>Feedback Statement</u> (FS) to its April Discussion Paper (DP) on Distributed Ledger Technology (DLT) (see Latham's related <u>Client Alert</u>).

The FCA launched the DP in order to better understand the potential uses, risks, and benefits of DLT in the financial services sector. The FCA was seeking to achieve a greater appreciation of how DLT might be employed, and whether the current regulatory framework — which is technology neutral in its approach — might need any adjustment to remove undue limitations on the development of DLT.

As well as gathering feedback from the DP and industry events, the FCA has also developed its understanding of DLT by supervising live-use cases in its Regulatory Sandbox. The FCA notes that 22 of 58 firms that have used the Sandbox to date have utilised DLT, making it the most popular type of technology employed in the Sandbox.

FCA Feedback

The FCA reports that the DP was received positively, with respondents praising the FCA's "open and proactive approach to new technology". Many respondents felt that the FCA's current rules are flexible enough to accommodate DLT, and that there are not substantial barriers to adopting DLT under the current framework. The FS focuses on a number of specific areas raised in the DP, explaining the feedback received, issued raised, and the FCA's response to the feedback.

Operational Risk

The FCA notes that respondents highlighted the operational benefits of DLT networks. However, many respondents also raised concerns about "permissionless" DLT networks (networks that are open for broad participation, and do not have a "gatekeeper" controlling access), and the potential consequent increase in operational risks.

The FCA highlights that use of DLT may affect firms' exposure to operational risk through changes to, and potentially reduced control over, people, processes, and systems. The FCA does, however, hold the view that use of DLT has the potential to enhance operational soundness, provided that firms implement appropriate operational risk management measures.

The FCA stresses that the specific risks will depend on the actual application of DLT in any given scenario, but firms need to ensure that they allocate responsibilities appropriately, mitigate risks effectively, and conduct suitable due diligence before engaging particular solutions.

Although some respondents believed that DLT networks may be incompatible with the FCA's outsourcing requirements, the FCA does not consider there to be any fundamental incompatibilities in relation to either permissioned or permissionless DLT networks.

The FCA expresses the view that, provided firms properly identify and mitigate the relevant operational risks, they should be able to use DLT networks. So, firms must assess whether using a DLT network amounts to a regulatory outsourcing in each case. The FCA explains that it does not consider use of a permissionless network to necessarily always amount to a regulatory outsourcing, so a case-by-case analysis is always required.

It is positive to see the FCA being so open-minded on this aspect, clearly trying hard to balance regulatory protection with the desire to foster innovation.

Digital Currencies

The FCA notes that it is watching developments in relation to digital currencies closely. While the Bank of England and European Central Bank do not see clear evidence of financial stability or systemic risks at the moment, the FCA is monitoring potential market integrity and consumer protection issues.

One specific area of interest for the FCA is the use of digital currencies as an underlying or reference asset. The FCA is particularly concerned about contracts for differences (CFDs) that reference digital currencies as their underlying asset. The FCA does not consider such CFDs to be suitable for most retail clients due to their high-risk and speculative nature, and issued a warning for investors last month.

The FCA also uses the FS to announce a further examination of the Initial Coin Offering (ICO) market, which it is undertaking to establish whether any regulatory intervention is required beyond the FCA's consumer warning (see Latham's related *blog post*).

Digital Asset Trading and Smart Contracts

According to the FS, both respondents and the FCA recognise the potential for deploying DLT in various areas such as collateral management, corporate actions, loan syndication, short-term debt, and standardised securities processing. However, the verdict seems to be that developments are not yet far enough advanced to present a real opportunity.

The FCA believes that, among other things, DLT could bring various benefits to securities markets, notably more efficient post-trade processes, and enhanced reporting and data management capabilities — as well as the possibility of reduced costs. The FCA's view, however, is that a number of hurdles need to be overcome before substantial benefits can materialise, such as clarifying the legal status of digital assets and the enforceability of smart contracts. The FCA is unsure at present whether the use of DLT in securities markets will remain a niche endeavour or become more widespread.

Consequently, the FCA will continue to monitor market developments, but does not intend to propose any DLT-driven rule changes in this area at present.

Regulatory Reporting and Financial Crime

Respondents suggested that DLT systems have the potential to facilitate the delivery of regulatory requirements more efficiently than current systems. Respondents did, however, highlight that the FCA must develop its own technological capabilities and bolster its roster of technology experts if such systems are to be deployed successfully.

The FCA acknowledges that using DLT for regulatory reporting purposes could reduce costs to both firms and regulators, and significantly improve the FCA's access to data. The FCA explains that it is involved in project BARAC (Blockchain Technology for Algorithmic Regulation and Compliance), which is investigating legal and regulatory implications of the use of DLT for automation of regulation and compliance.

The FCA also continues to explore other technologies that might improve regulatory reporting, such as model-driven machine-executable reporting. The FCA notes the potential benefits and the level of engagement, and states that it will continue to prioritise such "RegTech" initiatives.

In relation to financial crime, the FCA reports that many respondents argued DLT could facilitate more effective financial crime monitoring systems — particularly by facilitating the secure sharing of data such as transaction records, concerns about suspicious activity, and customer due diligence data between firms. However, respondents also argued that current reliance provisions — specifically the liability rules in the Money Laundering Regulations 2017 — do not incentivise firms to share customer due diligence information or cooperate between themselves.

The FCA states that it is "very keen" to see how DLT might help the fight against financial crime. The regulator also acknowledges some of the difficulties for firms, particularly in relation to sensitivities around firms sharing information, and the interplay with data protection requirements. The FCA recognises that the regime may need to evolve, and believes it is worth exploring the potential for change. The FCA accepts, however, that any change in this area would be a longer-term project, as it would require renegotiating international standards.

Once again, the FCA's openness to DLT is reflected in the statements it makes about DLT and financial crime. The FCA notes that, in its view, using DLT does not automatically introduce or increase fundamental financial crime risks. Yet it has been disappointed to see firms that employ DLT solutions being denied banking services.

Next Steps

The FCA has not issued a Consultation Paper at this stage, and does not consider it necessary to propose any changes to the regulatory framework in light of the feedback received — at least for the time being.

The regulator's restatement of its position on keeping FCA rules technology neutral can be seen in different ways. It is positive in that it increases regulatory certainty and allows firms to depend on the current framework remaining in place when investing in new systems. However, the current framework was largely informed by the technology around at the relevant time, and so in this sense the rules are not truly technology neutral. This becomes evident when application of these rules to new technologies produces incongruous results, or even appears to prohibit new technologies (for example, the requirement for a central counterparty would appear to prohibit a distributed clearing network on the blockchain). While some concerns may be overcome by the FCA issuing guidance as to how the existing rules should apply to new technologies, every issue cannot be fixed without changes being made to the underlying rules.

The FCA explains that the feedback received has helped it determine future areas of focus and some immediate next steps, including:

- Continuing to monitor market developments in relation to DLT and other technologies
- Engaging with the market and hosting more industry events
- Conducting a deeper examination of the ICO market
- Collaborating with other regulators both domestically and internationally

The FCA was quick to launch a discussion around DLT, and the feedback seems to suggest that perhaps the regulator was a little premature in exploring the impact on the financial services sector. The use of DLT remains fairly limited, and so one key action the FCA must take is to simply keep a close eye on developments. However, the FCA's proactive engagement on this issue — as well as the regulator's positive attitude toward firms looking to employ DLT-based solutions — are commendable. Given that the FCA has clearly sought to understand the potential risks and benefits of DLT, it is to be hoped that the regulator is well-positioned to respond appropriately, rather than reactively, when DLT use does increase.

The FS will be helpful for firms considering using DLT, not only as an indication of the issues that may arise, but also as a guide to how the FCA considers firms can navigate the regulatory framework successfully. The emphasis is on carefully assessing all relevant risks and putting appropriate mitigating arrangements in place, and so firms should pay particular attention to these points before making employing DLT solutions.

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