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American Regulators Playing FinTech Catch-Up

By **Carmen Germaine**

Law360, New York (June 15, 2017, 11:08 PM EDT) -- U.S. regulators are finally arriving at the financial technology party, and experts say two agency initiatives announced in the past month are an encouraging sign the regulators are catching up with their global counterparts when it comes to fostering fintech innovation, but still have a ways to go.

The U.S. Commodity Futures Trading Commission announced in mid-May that it will launch LabCFTC, an initiative consisting of two programs designed to help fintech innovators engage with the agency and in turn enable the agency itself to understand and adopt new technologies.

Not to be outdone, the Financial Industry Regulatory Authority followed in the CFTC's footsteps this week with its Innovation Outreach Initiative, a program that among other things will create a committee to facilitate discussion on how FINRA rules interact with technology innovations and conduct roundtables to collect industry feedback.

Both initiatives come after the U.S. Securities and Exchange Commission held a fintech forum in November and announced the creation of an internal fintech working group to review how the agency can provide clarity on existing requirements and foster responsible innovation.

Covington & Burling LLP partner Michael Nonaka, co-chair of the firm's fintech initiative, said the CFTC and FINRA initiatives are important steps to get the agencies up to speed on fintech issues.

"It's certainly a step forward, it's a step in the right direction for the regulators to be able to do new initiatives that will help the fintech industry," Nonaka said. "But it's by no means assured that what the CFTC and FINRA are doing will ultimately help the fintech industry. This is a first step."

CFTC Acting Chairman J. Christopher Giancarlo announced LabCFTC on May 17, calling the program a bid to bring a 20th-century regulator into the 21st century.

Giancarlo emphasized that, while financial firms have embraced new technology in the form of automated trading — which he said now accounts for 70 percent of regulated futures markets — and distributed ledger technology or blockchain, the CFTC has remained "an analog regulator of rapidly digitizing global markets."

To remedy that gap, Giancarlo said, LabCFTC will create a hub for the agency to engage with fintech innovators. The initiative will consist of two components: GuidePoint, which will provide a point of contact for firms and innovators to engage with the CFTC, and CFTC 2.0, which will establish a lab to explore ways to enhance the agency's use of fintech.

The GuidePoint component includes a dedicated office suite through which innovators can contact a LabCFTC team in order to seek regulatory guidance about their proposed use of new technologies.

CFTC 2.0, meanwhile, will establish an internal lab to explore new technologies and identify potentially useful applications. Giancarlo said such tests could include experimenting with distributing existing CFTC reports using blockchain technology, or collaborating with other regulators on developing "regulator nodes" on distributed ledgers.

FINRA President and CEO Robert W. Cook announced his organization's program, the Innovation Outreach Initiative, on June 13, saying the initiative will enable FINRA to "better track fintech developments across the rapidly changing industry environment in order to support innovation in the industry while maintaining investor protection and market integrity."

A cross-departmental team led by FINRA's Office of Emerging Regulatory Issues will carry out the initiative and work with industry participants, FINRA said. Among other things, the team will have responsibility for creating a Fintech Industry Committee to facilitate discussion of how FINRA rules and programs interact with fintech innovation, conducting roundtables to provide a forum for market participants, and using FINRA's existing processes to effectively communicate with the industry.

FINRA said in the announcement that it expected the information gathered through the initiative will help the organization consider whether additional steps are necessary to further facilitate fintech innovation in the securities industry.

On the SEC side, former SEC Chair Mary Jo White said at the agency's FinTech Forum in November that she had directed the creation of a fintech working group within the SEC composed of staff from across the agency.

That group is tasked with creating "specific, tailored recommendations" about how the SEC can clarify existing regulatory requirements and foster innovation, White said, and will solicit additional input from investors, innovators and other stakeholders.

The Office of the Comptroller of the Currency has waded in as well, announcing in December that it would issue special-purpose national charters to fintech firms, allowing them to skip state regulation in favor of strict national oversight.

Schiff Hardin LLP partner Kenneth W. McCracken said the buzz he's heard from the industry has been positive so far.

As the CFTC implements its LabCFTC program, the agency has been reaching out to the industry and has generally been impressed with its knowledge of the fintech area, McCracken said.

"The fintech industry is happy that regulators are looking at innovation and understanding that innovation is good for the market and that regulation should be interpreted to support innovation," McCracken said.

While government regulators will inevitably find themselves keeping up with industry innovations, McCracken said, the latest regulatory fintech initiatives are “really good steps in that direction," signaling the agencies are trying to learn more about fintech and providing an avenue for engagement.

Quinn Emanuel Urquhart & Sullivan LLP partner Michael Liftik, until recently the SEC’s deputy chief of staff, said the efforts will particularly help to ensure internal coordination within each agency. A particular fintech development could touch different offices of the same agency, while different divisions are responsible for different sectors of the industry, making coordination important.

Liftik said that by focusing on fintech, agencies can help attract innovators to American markets and avoid scaring them off with burdensome or outdated regulation.

“It seems like this country really should be the hub for fintech innovation, it’s just a matter of getting there and making sure that happens while protecting investors and the markets,” Liftik said.

CFTC Chairman Giancarlo recognized the importance of catching up during recent testimony before a subcommittee of the U.S. House Committee on Appropriations, telling lawmakers that the U.S. government is behind foreign counterparts who have sought to encourage innovation.

Giancarlo recounted meeting an investor who had been prepared to invest in a fintech-related startup, but found after due diligence that the startup may have a regulatory issue with another agency.

The startup reached out to the other agency for clarification and potentially regulatory relief, but had yet to receive a response after 18 months and the investor had moved on, Giancarlo said, expressing disbelief that an innovator was “not going to get funding because a U.S. government agency couldn’t give them a response in 18 months.”

McCracken said the latest initiatives are an encouraging beginning.

“It certainly looks as if these initiatives are the first step and that a regulatory sandbox is probably a few steps down the road,” he said.

Sandboxes have been unveiled by foreign regulators including the U.K.’s Financial Conduct Authority, the Hong Kong Monetary Authority, and agencies and banks in the United Arab Emirates, Singapore and Malaysia, among other jurisdictions. Regulators in Canada and Australia have also announced plans for their own sandboxes.

The sandbox model typically operates as a supervised space where firms can test new products and business models, in real time with real customers, within a safe space that includes safeguards to protect consumers.

The FCA sandbox has proven particularly popular; the agency announced its second cohort of approved firms on Thursday, saying it has accepted 24 firms that met the eligibility criteria and were ready to start testing out of 77 applicants.

The cohort includes Experian, which will test a tool to increase consumers’ awareness of their eligibility for a mortgage. Other firms are planning to test products including a secure online register consumers can use to catalogue their assets, a blockchain-based bond origination and private placement platform, and a flood insurance program that would pay settlements as soon as sensors detect flood waters exceed a certain depth.

Liftik cautioned that it's important to understand what the FCA's sandbox is, and what it isn't. The agency isn't providing a regulation-free environment, he emphasized.

"They'll tailor the requirements, but they're not necessarily lowering thresholds or doing away with regulations," Liftik said.

While American regulators aren't at the sandbox stage yet, Liftik said, the kind of information-gathering contemplated by each of the initiatives is an essential step. They first need to understand what the industry needs from regulators — what hurdles are in the way of innovation, what regulations have prevented firms from testing a new product.

"Before you have that understanding, it's hard to craft a sandbox," Liftik said.

And until the agencies take that step, Nonako said, it's difficult to forecast how helpful subsequent initiatives will actually be for the industry.

In the meantime, American regulators face another challenge — they'll have to coordinate fintech efforts not only internally, but also between agencies. With the CFTC, SEC and FINRA — as well as other agencies — each overseeing different segments of the market, firms could face overlapping or even contradictory regulations.

Both the CFTC and FINRA appeared to recognize the need for coordination in announcing their initiatives. The CFTC said it would continue to engage with other agencies both domestically and internationally to "further regulatory interest in fintech innovation," while FINRA's fintech team is also responsible for increasing collaboration with other regulators.

The OCC, meanwhile, has faced sharp criticism and even a lawsuit from state banking regulators arguing the agency's fintech charters allow firms to evade potentially stricter state regulation and potentially harm consumers.

Liftik said it is "critically important that the regulators harmonize their efforts," and said that as things move forward, the agencies are likely already communicating to make sure they're on the same page.

But Nonako said there's room to grow.

"I don't think that the level of coordination needed among regulators to effect truly helpful fintech innovation has been achieved or is close to being achieved," Nonako said.

And regulators could soon face another challenge. While FINRA is self-funded through fees paid by member firms, the SEC and CFTC are both facing flat or even reduced budgets as the Trump administration and Congress seek to rein in government spending.

Because the SEC's fintech work is largely done by existing staff on top of other responsibilities, Liftak said, it likely has a small budgetary impact and is unlikely to be significantly curtailed by budget cuts.

The CFTC's initiative will similarly be staffed largely by concentrating and centralizing existing staff, Giancarlo told reporters on a press call over the LabCFTC initiative.

But the expanded scope of the project, which Giancarlo said is a budget priority, still requires extra funds. The chairman said the agency won't be able to do the initiative at all if it doesn't receive the $57 million he requested on top of last year's $250 million budget — an increase Republican lawmakers have indicated the CFTC is unlikely to receive.

With politicians on both sides of the aisle eager to boast that they support innovation, the agencies still have some hope there will be enough room in the budget for fintech programs.

In the meantime, McCracken said, it's still significant that regulators are reaching out and telling fintech firms they're interesting in facilitating progress.

"The encouraging part for a lot of the fintech firms is now they're actually being able to enjoy some active engagement with the regulators," McCracken said.

--Editing by Pamela Wilkinson and Philip Shea.

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