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Fintech regulation: Looking ahead to 2018

2017 was an exciting year for fintech but 2018 promises to be even more eventful. This briefing considers some of the regulatory developments that took place in 2017 and what these are likely to mean for fintech regulation in 2018.

Initial Coin Offerings

One of the most active areas of fintech in 2017 was Initial Coin Offerings (**ICOs**). Regulators grappled with whether the underlying tokens were securities, commodities or something else. Some jurisdictions, such as China and South Korea, prohibited them entirely.

In general, regulators are wary of ICOs and particularly the risks that they present for investors. A number of regulators, such as the Financial Conduct Authority in the UK and the European Securities and Markets Authority, have issued warnings both to the persons undertaking the ICOs and any potential investors. However, it is unlikely that regulators will be satisfied with simple warnings and the current approach of a case by case analysis of ICOs. Therefore 2018 will see further regulatory scrutiny and possibly new regulation. This has already been seen in France, where the Autorité des marchés financiers has issued a consultation on a proposed ICO regulation. The FCA has also recently said that it will examine further the ICO market with a view to considering whether further regulatory action is needed.

Enforcement is also likely to be another area of activity. There has not, to date, been any enforcement action taken by the FCA but the Securities and Exchange Commission in the US has already brought action in respect of a number of ICOs. In light of the lack of official conclusions on the regulatory classification of ICOs and the severe penalties which could attach if an ICO is deemed to have breached applicable law, this is an area in which persons undertaking ICOs should continue to take great care.

The lack of official regulatory regimes is also starting to give rise to proposals among the fintech community for self-regulation. Some elements of this can already be seen, for example, for ICOs which voluntarily adopt elements of the anti-money laundering regime (particularly Know Your Customer procedures). This is another area which we would expect to be developed further in 2018.

The EU is also currently considering whether to introduce a crowdfunding regime which may have an impact on many ICOs (although the UK already has a relatively well-developed regime in place). Further detail on this is expected in 2018.

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Crypto-currencies

The use of crypto-currencies is a particularly divisive area of fintech but, despite wide criticism, it seems that they are here to stay. Even certain central banks have been considering whether they should be issuing their own crypto-currencies.

The President of the European Central Bank has said that regulation of crypto-currencies is not currently necessary. Other countries have been less sanguine and it seems likely that 2018 will see further prohibitions on the use of Bitcoin and other crypto-currencies in some jurisdictions. Even in jurisdictions where the use of crypto-currencies is permitted, it is probable that regulators will want to exercise some form of control over their use, particularly given that their anonymity makes them attractive for criminal activity.

One aspect of crypto-currencies which is currently causing confusion is whether they are a currency, a commodity or neither. The Commodity Futures Trading Commission has said that they are commodities and there seems to be a general reluctance to call them a currency. This can have knock-on effects, for example, with certain regulators being unsure how to classify crypto-currency derivatives. However, given that this classification of crypto-currencies is potentially crucial in determining the applicability of many regulatory provisions, this is something that will need to be addressed.

Crypto-funds

Given the speculative opportunities presented by ICOs and crypto-currencies, it is no surprise that crypto-funds have also become increasingly prevalent over the past few years. Crypto-funds include funds which invest in initial coin offerings and also directly into crypto-currencies. Regulators in 2018 are expected to be keen to ensure that the risks in these types of fund are clearly explained to investors.

Funds and fund managers will also need to ensure that these new types of funds are able to comply with regulatory requirements which are better suited to more traditional asset classes. These include the depositary requirements in the Alternative Investment Fund Managers Directive and the UCITS Directive, which are primarily focussed on dematerialised securities rather than tokens and other assets held on a blockchain. Further guidance on this in 2018 would be welcome.

Trading

As people increasingly invest in crypto-assets for speculative purposes, 2018 is likely to see an increase in related trading venues. Trading venues for traditional financial instruments are generally subject to high levels of regulation and therefore we expect that crypto-trading venues will come under regulatory scrutiny in 2018.

One particular area of growth in 2017 was crypto-currency exchanges. As with ICOs some countries, such as China, banned them while others, such as Australia, are regulating them. The EU appears to be adopting the latter approach for the moment and intends to include virtual currency exchange platforms and custodian wallet providers within the scope of the anti-money laundering regime in its forthcoming fifth Money Laundering Directive.

In December 2017, the Chicago Board Options Exchange and Chicago Mercantile Exchange began trading Bitcoin futures. The French government has also adopted new legislation to permit the establishment of blockchain platforms for trading unlisted securities.

While crypto-asset derivatives may, in many jurisdictions, fall within the scope of existing legislation, this is not always clear. As trading activity in such instruments increases, it is to be hoped that regulators will step in with guidance.

Distributed Ledger Technology

Finally, in addition to raising regulatory compliance issues, Distributed Ledger Technology (DLT) such as blockchain may also be part of the solution.

2017 saw financial institutions proposing the use of DLT to assist with the requirements for Legal Entity Identifiers (LEI) under the revised Markets in Financial Instruments Directive. Even the Bank of England has said that its next generation RTGS will be compatible with settlement in a distributed ledger.

Often mooted applications for DLT also include the areas of Know Your Customer requirements and insurance, where the use of decentralised records and smart contracts could allow substantial efficiencies to be made.

However, as DLT becomes increasingly embedded in market infrastructure, regulators are likely to want to exercise some control over its use. This can already be seen in Gibraltar, which has introduced a new regulatory framework for certain activities which make use of DLT, and other regulators may choose to follow its example.

Fladgate has already been advising on a wide variety of fintech matters including ICOs and crypto-currency related issues such as crypto-currency exchanges and the regulation of crypto-assets. Fladgate's regulatory team, therefore, has specific regulatory expertise in, and market insight into, this fast-moving area.

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