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Should the SEC Allow FinTech Firms to Play in a Sandbox?

The growth of financial services technology (“FinTech”) presents tremendous opportunities for the industry. However, the growth of FinTech also poses substantial challenges to regulators including the U.S. Securities and Exchange Commission (“SEC”). While the SEC has provided some guidance on the regulation of FinTech through enforcement actions, conferences, and alerts, the SEC has not published a concept release or proposed rules on the subject. As the SEC considers how to properly regulate FinTech, I encourage the Commissioners to publish a concept release on when digital assets are securities and when the firm’s that facilitate the sale and trading of digital assets must register as a broker-dealer, an alternative trading system (“ATS”), or an exchange. The concept release should also ask whether the SEC should adopt an approach to the regulation of digital assets used in the United Kingdom and Singapore - a regulatory sandbox.

Background

As noted by SEC Chairman Piowar in a recent speech, the SEC’s duties are to: (i) protect investors, (ii) maintain fair, orderly, and efficient markets, and (iii) facilitate capital formation. The development of FinTech offers the SEC and the financial services industry the opportunity to satisfy each of these duties. The development of FinTech over the past several years has seen an accelerating rate of adoption of the technology and the expansion of the number of digital assets. Digital assets have the potential to save \$2 billion each year in the US cash equities markets alone. Digital assets that use distributed ledger technology commonly known as blockchains, exist in a variety of forms and provide the industry with a variety of benefits. Blockchain technology uses a digital ledger to create a secure, distributed network for transactions. Digital assets are becoming more widespread because of their ability to provide increased efficiency, transparency, and investment protection by using distributed ledger technology. Using a distributed network of computer hosts, the distributed ledger is able to create a secure platform for digital assets being bought and sold that eliminates the need for middlemen and prolonged verification processes. These innovations in digital assets harness blockchain to increase the transparency and security of their respective industries. As digital assets become more widely used, however, new regulatory questions arise.

The SEC Should Publish a Concept Release on the Regulation of FinTech and Digital Assets

As was the case with the proliferation of ATSs in the late 1990s, the number of FinTech firms facilitating the issuance, sales, and trading of digital assets is growing rapidly. Rather than publish a concept release or proposed rules on the regulation of digital assets, the SEC has engaged in enforcement actions against FinTech firms that did not know they were potentially violating federal securities laws. The current situation is similar to the late 1990s when a number of electronic communications networks (“ECNs”) had to seek a no action letter from the SEC staff to operate.

Faced with a growing number of ECNs, the SEC published a concept release on how to regulate ECNs and other ATSs. The concept release afforded the industry the opportunity to engage in a productive discussion with the SEC staff on how to regulate ECNs and other ATSs. In early 1998 the SEC adopted Regulation ATS which established how ECNs, ATSs, and exchanges would be regulated going forward and provided meaningful guidance to innovative firms that were launching ATSs.

FinTech and the regulation of digital assets presents the SEC with another opportunity to satisfy its statutory duties – protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation - by engaging in a constructive dialogue with the FinTech industry on how to regulate digital assets. The publication of a concept release on the regulation of FinTech and digital assets would be a meaningful step that would provide much needed guidance to the industry.

The FinTech Industry is in Need of Specific Rulemaking From the SEC Regarding When Digital Assets are Securities

While SEC enforcement actions have provided some guidance on when digital assets are securities, the enforcement actions have not addressed the needs of FinTech firms dealing with digital assets. Publication of a concept release on how the SEC will regulate digital assets would be a meaningful first step in

providing guidance to the industry. However, the guidance will only be helpful if it is followed by the SEC adopting a new rule on the regulation of digital assets – Regulation DA. The current guidance on the regulation of digital assets as securities requires a facts and circumstances based analysis by qualified counsel to determine if an asset is a security and if a firm’s activities require registration as a broker-dealer, an exchange, or an ATS. Such analysis is often cost prohibitive to the early stage companies that drive much of the innovation in FinTech. Rulemaking by the SEC will provide much needed guidance to the industry that will promote market integrity, capital formation, and protection of investors.

Regulatory Sandbox

As the SEC considers how to regulate FinTech, the Commissioners should consider the free market approach being employed in other jurisdictions that are actively supporting the development of FinTech, including Singapore and the United Kingdom. Both countries have adopted a regulatory sandbox.

Singapore

The Monetary Authority of Singapore (“MAS”) is currently developing a flexible framework for the regulation of FinTech companies. Rather than expanding existing regulatory systems to cover FinTech companies, the MAS has proposed a regulatory sandbox tailored to specific forms of FinTech innovation. In this system, FinTech companies will be able to experiment and grow without being subject to excessively burdensome regulation. The MAS will develop a supervisory framework as the technology progresses. Rather than have a single sandbox with a general set of relaxed rules, the MAS envisions a system in which the sandboxes have rules that are relaxed based on the specific technology in use. Actual regulation of FinTech companies under this system will only commence once they grow to a size that would pose risks to consumers and the wider financial system.

This framework recognizes that the existing regulatory frameworks may be ill-suited for new FinTech products and services. In developing this system, the MAS acknowledges



that FinTech companies may not fit neatly into a regulatory framework, and that some innovators may not want to approach the regulatory agency in order to avoid scrutiny and the potentially costly compliance actions where regulation is uncertain or oppressive. This is a significant recognition that uncertainty may stifle creation of new products and services in an industry that has been experiencing rapid growth. The sandbox model creates a platform for interaction between the regulator and FinTech innovators. This model also promotes the development of innovative regulatory solutions that will be critical in driving FinTech innovation.

United Kingdom

The United Kingdom's Financial Conduct Authority ("FCA") has taken a similarly progressive approach to the regulation of FinTech. The FCA has acknowledged the small, agile nature of many FinTech startups and seeks to limit barriers to innovation by providing direct support throughout the development of compliance procedures. Like the proposed system in Singapore, the FCA has developed a regulatory sandbox in order to provide a safe space for businesses to test new products and services with customers for a limited period without be subject all of the regulatory requirements. The goal of such a system is to reduce the overall cost and time of bringing these new technologies to market by enabling FinTech companies to refine their business models before being subjected to regulation.

Conclusion

Some regulators and members of the industry believe a centralized regulatory model for FinTech is necessary and should use existing, traditional supervisory structures. Such an approach risks stifling innovation. For many early stage companies, the regulatory and supervisory burdens of registering with the SEC as a broker-dealer, an ATS, or an exchange may outweigh the benefits. Fintech has been driven largely by the development of innovative technologies by small, agile start-up companies that have taken advantage of a lack of regulatory clarity. A lack of regulatory clarity has the potential to slow the development of these technologies.

The SEC should publish a concept release on the regulation of FinTech that will address when FinTech firms are offering securities and when a firm selling digital assets needs to register as a broker-dealer, an ATS, or an exchange. The concept release will promote a meaningful dialogue between the SEC and the industry. Such an approach will also reduce the risk of regulation stifling innovation. As part of the dialogue, the SEC should explore the adoption of a regulatory sandbox similar to those used in other jurisdictions because it will protect the public, and promote innovation and compliance with applicable laws.



For More Information

For questions regarding this alert or to learn more about how it may impact your business, please contact one of the authors, a member of our Financial Technology (FinTech) and Regulation practice, or your Polsinelli attorney.

To learn more about our Financial Technology (FinTech) and Regulation practice, or to contact a member of our Financial Technology (FinTech) and Regulation team, click [here](#) or visit our website at polsinelli.com.

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