WHITE & CASE

Financial Regulatory Observer

The financial services industry is undergoing a radical transformation. Companies that can navigate this uncertain terrain will retain a competitive edge

May 2017

Financial services sector continues to navigate uncertain regulatory terrain

Welcome to the first issue of the Financial Regulatory Observer, our digest of regulatory change and technological disruption facing the financial services industry.

In more ways than one, 2017 is shaping up to be the year of the financial services regulator. The financial services industry is undergoing a transformation in response to changes wrought technological disruption and regulatory reform.

To keep track of the regulatory framework, we have put together our Financial Regulatory Observer to serve as a guide to selected topics driving these fundamental changes.

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EMEA Bank Regulatory Capital

Essential features of bank capital regulation across Europe in one handy wall chart.

By James Greig, Stuart Willey, Dr. Andreas Wieland, Richard Pogrel, Dr. Dennis Heuer and Cenzi Gargaro

Regulatory capital requirements for prudentially supervised financial services companies across Europe are complex and changing rapidly. To keep track of the regulatory framework in the region, we have brought together the essential features of bank regulation in our EMEA Regulatory Capital wall chart.

The chart provides a list of regulatory capital acronyms, the most important definitions and key ratios of the current regulatory framework, as well as an overview of the loss absorption waterfall deriving from rules on the hierarchies of creditors' entitlements in bank insolvency and resolution scenarios. The chart is being maintained online and will be the keystone feature of our Financial Regulatory Observer.

The wall chart highlights the interplay between regulations on total loss-absorbing capacity (TLAC) and the minimum requirement for own funds and eligible liabilities (MREL), which is a requirement under the EU Bank Recovery and Resolution Directive.

Certain key issues, such as creditor hierarchy, some conditions around bank bail-in and detailed provisions around MREL eligibility and the interrelationship between buffers, as well as maximum distributable amount (MDA) triggers within MREL, are yet to be clarified by the regulators, so we will be updating the wall chart as material changes occur

On the chart there are five columns, which set out the basics of Bank Regulatory Capital in the European Economic Area (EEA). The key features are:

- The "Paradigm business model" contains the European Banking Authority (EBA)'s standardised description of bank business models, showing where exposures and liabilities can arise.
- The "Asset Stack" which refers to the basic capital requirements of the Capital Requirements Regulation (CRR) which defines, within the framework created by the Capital Requirements Directive (CRD IV), the requirements imposed on banks and certain investment firms to hold specific levels of regulatory capital, dependent on the institutions' specific exposures and liabilities. The CRR requires regulated institutions to issue identified categories of equity and debt instruments to build a regulatory capital base (referred to as own funds) to an amount, that when a bank looks at the ratio of its exposures to its liabilities, (with assets being determined on a risk-weighted basis) risk-weighted figure for assets (referred to as Total Risk Exposure Amount), the ratio will not fall below certain specified percentages for the different categories of regulatory capital being issued. Broadly speaking, the risk-weighted asset total is calculated by adding together all of the institution's assets and some off-balance sheet items. Both assets and off-balance sheet items are determined in accordance with the specific valuation and risk-weighting multipliers set out in CRR. Figure 2 indicates the provisions setting out the relevant risk-weight figure for each CRR-identified category of exposure.
- The "EU Stack" sketches out the hierarchy of bank capital, showing which categories of bank capital will be available to meet creditor claims and the sequence in which losses incurred by the regulated institution will be allocated among the bank creditors. The investors in the financial instruments indicated at the very bottom will be the first among the creditors to bear losses.
- The "Creditor Hierarchy" and various national stacks, which indicate the current national creditor hierarchies of some of the member states of the European Union, derived from their jurisdictions' specific insolvency regimes. As the national insolvency regimes are not fully harmonised, creditor hierarchies differ from country to country, although, for the purposes of BRRD, there are proposals that hierarchies be harmonised in order that banks may structure their capital on a level playing field.

Click here to view EMEA Regulatory Capital chart.

Please click here to order your complimentary copy of EMEA Regulatory Capital chart.

The wall chart will be updated as material changes are announced and as proposals are finalised. ■

> "Regulatory capital requirements across Europe are complex and changing rapidly

Asset management: Coming out of the shadows

Financial Stability Board addresses structural vulnerabilities from asset management activities.

By Stuart Willey

On 12 January 2017, the Financial Stability Board (FSB) published its Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities.

Over the last decade, global assets under management have risen from US$53.6 trillion in 2005 to US$76.7 trillion in 2015, equating to 40 per cent of the global finance system. The growth of the asset management sector has provided a welcome alternative source of liquidity to traditional bank funding, but with the increasing importance of the co-called 'shadow banking' system comes a need for regulators to gain a clearer understanding of how asset management funds function and in cases of stress, the problems they could present to the health of the wider financial system.

FSB set out 14 policy recommendations to address four main areas that could present a risk to financial stability: liquidity mismatch in open-ended funds; leverage within investment funds; operational risk and challenges at asset managers in stressed conditions; and securities lending activities of asset managers and funds.

Liquidity mismatch in open ended funds

'Liquidity mismatch' refers to open-ended funds that allow for immediate redemption by investors, but these funds often hold investments in relatively illiquid assets. If market prices dropped sharply and liquidity deteriorated, investors could withdraw, forcing funds to convert illiquid assets into redemption cash at short notice.

Although many funds have access to short-term financing to bridge this gap, the FSB considers that if there were to be an unanticipated large loss causing several investors to withdraw at once, that financing may not be sufficient.

The FSB worries that significant redemptions from funds, combined with significant consequential asset sales, may lead to material price declines, or increases in price volatility in the secondary markets, that would be serious enough to impair market access by borrowers and trigger market contagion.

Some jurisdictions already have measures in place to combat these risks. The FSB cites jurisdictions which limit investments in illiquid assets to between 10 per cent and 15 per cent of total assets. There are also post-event measures, such as redemption gates, or withdrawal limits or suspension of withdrawals. However, these measures are aimed at protecting investors, are not uniformly applied and do not take into account the wider impact on the financial system.

The FSB suggests three areas for improvement in relation to liquidity mismatch: information and transparency; liquidity management systems; and liquidity management tools.

US$76.6 trillion

Global assets under management

> **"The growth of the asset management sector has provided a welcome alternative source of liquidity to traditional bank funding**

Information and transparency: The FSB recommends that national authorities should collect information on the liquidity profile of different funds (Recommendation 1). This might include funds' liquidity risk management, portfolio liquidity and liquidity of individual portfolio holdings, and contingent sources of funding.

Recommendation 2 suggests greater transparency and frequency of investor disclosure requirements, with the goal being to reduce the perception that daily redemption of fund units equates to liquidity of fund assets. Additional disclosure could include, for instance, the availability of liquidity management tools and their potential impact on investors.

Liquidity management systems: The FSB's principal recommendation is that authorities require, or suggest guidance on, the alignment of a fund's investment strategy with its terms of redemption (Recommendation 3); the more liquid a fund's asset pool the sooner redemption can be achieved. It is suggested that a fund's redemption terms could be dynamic and capable of adapting to the makeup of a fund's asset pool.

The FSB also suggests an increase in the availability of risk management tools (Recommendation 4), especially those that would help reduce "first-mover advantage", which otherwise rewards investors that pull out of funds by imposing lower charges (Recommendation 5).

Authorities that require or provide guidance on stress testing should inform both the funds and authorities of potential management system issues (Recommendation 6).

A build-up of leverage can create and/or amplify risks to the global financial system

Liquidity management tools: As a corollary to its suggestion that funds should have liquidity risk management tools in place, the FSB also suggests that there be clear decision-making processes which dictate when the management tools can be used (Recommendation 7). The suggestion is that the process itself be made transparent to both investors and the relevant authorities.

Transparency on this issue aims to remove any potential stigmas attached to the use of risk management tools. Recommendation 8 follows on from this, suggesting that authorities should also provide guidance on the use of liquidity risk management tools in stressed conditions.

Leverage within investment funds

Leverage within investment funds, in addition to synthetic leverage resulting from the use of financial derivatives, is seen as problematic. The FSB notes that a build-up of leverage can create and/or amplify risks to the global financial system through direct and indirect channels.

This is in part because leveraged funds are more sensitive to changes in asset prices, and investors may be more inclined to redeem from leveraged funds that experience stress because these funds may be perceived to be riskier.

Although the FSB notes that there are certain measures in place to counteract leveraging risks—derivatives exposures are controlled through netting agreements and collateralisation requirements for instance—these are not seen as sufficient protection for the health of the wider financial system. A lack of leverage limits and consistent accessible data on leverage remain serious issues.

To tackle this, the FSB put forward three recommendations: development of consistent leverage measures; national collection of data on leveraged funds; and collection of aggregated data across jurisdictions.

The development of consistent leverage measures: Under Recommendation 10, the International Organisation of Securities Commissions (IOSCO) would identify and develop consistent measures of leverage. This would assist with the assessment of leverage in the financial system generally, and would be particularly valuable when seeking to identify whether a fund's use of leverage should be subject to additional assessment using risk-based measures.

National collection of data on leveraged funds: Recommendation 11 is that authorities should establish a monitoring framework that allows them to collect data on leverage in funds under their oversight. This would potentially require authorities to create systems to analyse and aggregate that data.

Collection of aggregated data across jurisdictions: Finally, Recommendation 12 is that IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions, allowing authorities to monitor leverage at a global level.

POLICY

14

Policy recommendations by FSB to address main areas of risk

Operational risk and challenges at asset managers

Although operational difficulties and business transition issues at asset managers have not typically caused problems for the wider financial system, the FSB considers that they could still be a risk if they were to occur during a period of stressed market conditions.

There is a risk, for instance, that if investors could lose confidence in a fund, this could lead to redemptions. If the asset manager is big enough, this could in turn affect market prices of investment assets.

One scenario in particular is highlighted by the FSB, namely where an asset manager, itself under stress, needs to transfer client accounts. In this situation, difficulties are foreseen with the termination of derivatives contracts, where contracts need to be closed out or re-established in difficult market conditions. Issues are also envisaged with the replacement of ancillary services, such as IT, securities lending agents and custodial services. There would in addition be legal and regulatory issues associated with the transfer of client accounts.

The FSB notes that methods of managing this risk are employed

Three recommendations put forward by the FSB

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Regulation often addresses causes of the previous crisis while creating unintended circumstances that could trigger the next one

widely but not uniformly across all jurisdictions. These include requirements for the establishment of appropriate operational risk management processes; a requirement for business continuity plans; requirements as to the establishment of external custodians; and regulatory reform to promote the central clearing of standardised OTC derivatives.

Recommendation 13 is therefore that authorities should have requirements or guidance for asset managers to have comprehensive and robust risk management frameworks, especially with regard to business continuity plans. It is also hoped that authorities would share their experiences and approaches used to identify and address operational challenges and difficulties.

Securities lending activities of asset managers and funds

The FSB also looked at the securities lending activities of asset managers, noting an issue arising where large asset managers are acting as agent members, especially those that offer borrower or counterparty indemnifications.

Here the FSB notes two potential regulatory gaps. The first concerns potential losses linked to indemnification-related exposures. Unlike agent lender banks, agent lender asset managers do not face capital requirements related to their indemnification exposures in any jurisdiction. Under stressed conditions, an asset manager may find itself unable to meet its indemnity obligations.

Second, the FSB considers that there is an opacity risk in relation to indemnifications. Again, this is due to a mismatch between the regime applied to the banks and the regime applied to asset managers.

For bank-affiliated asset managers, the FSB recommended that the Enhanced Disclosure Task Force improve public disclosure for banks on any indemnifications provided as agent to securities lending clients. Such a recommendation does not exist for asset managers offering securities lending indemnities.

Taken together, the FSB worries that this could lead to a situation in which an asset manager, unable to meet its indemnity commitments, precipitates a contraction of securities lending activities more generally.

The FSB's Recommendation 14 is that relevant data be collected on the agent lender activities of asset managers in order to better assess risks to financial stability associated with any indemnification provided. This could then lead to requirements that asset managers providing indemnification adequately cover potential credit losses from their indemnifications.

A desire for greater transparency runs through the FSB's report. Indeed, it seems to be seen as the cure-all for most of the perceived structural risks associated with asset management funds.

However, the FSB's recommendations occasionally stray into the unworkable. For instance, requirements that redemption delays be fixed according to the nature of the underlying asset class are likely to be seen as going too far into the relationship between fund manager and investor. Moreover, the additional regulatory burden may be met with opposition from all sides: funds will voice opposition to the increasing cost of compliance, while regulators themselves may have a diminished appetite for more expensive and time-consuming market surveillance during a period in which they are already grappling with the implementation of a raft of new measures governing the global financial system. Stability is the right goal to aim for but regulation often address the causes of the previous crisis, while creating unintended consequences that could trigger the next one. ■

Countdown to PSD2: Towards a level playing field?

When the second Payment Services Directive (PSD2) is transposed into national law among European member states in 2018, it will reflect a revolution in the payments industry.

By Dr. Carsten Lösing

PSD2 builds on the original payment services directive which was introduced in 2007 and led to a new relationship between consumers, retailers and banks. Customers now pay for goods and services through non-banking devices, and that trend will only accelerate and expand with the introduction of PSD2. The new directive aims to account for the pace of technological change in the payments industry since the introduction of the original directive by extending the scope of regulation, both in terms of geography and types of service providers. An ever-broader array of companies will fall under the scope of regulation as fintech companies and telecoms providers compete with established banks in this new financial world order.

Under the original directive, different interpretations and local implementation of certain matters of scope and exemption led to regulatory arbitrage, legal uncertainties and potential market distortions in practice, and it is hoped these can be tackled under the PSD2.

The recasted directive expands the geographic scope set out in the first directive beyond the European Economic Area (EEA), and covers any payment that has an EEA leg to it, irrespective of the currency it is transacted in. PSD2 will take effect from 13 January 2018, and its scope is set out in the Regulatory Technical Standards (RTS) created by the European Banking Authority. The RTS cover passporting, while enhancing protection of consumer rights and payment data protection in response to increasing levels of cybercrime and online fraud.

The introduction of PSD2 gives regulatory recognition to two new types of payment services—Payment Initiation Service Providers (PISPs) and Account Information Service Providers (AISPs). Both can be either bank or non-bank institutions.

> “An ever-broader array of companies will fall under the scope of regulation

PISPs will be able to initiate a payment order at the request of the payment service user with respect to a payment account held at another payment service provider. PISPs will do this by establishing a software ‘bridge’ between the website of the merchant and the online banking platform of the payer to execute a credit transfer. Under PSD2, PISPs must apply for a license from a national regulator and fulfill various regulatory requirements covering levels of initial capital, permanent funds as well as safeguarding client money, and sound and prudent management. They must also demonstrate robust governance, a well-defined organisational structure, risk management and sound administrative and accounting procedures.

AISPs offer online services to provide consolidated information on one or more payment accounts held by the payment service user with either another payment service provider or with more than one payment service provider.

Given that this does not involve payment, the rules governing AISPs are less onerous than PISPs, and as such they only need to register with their national competent authority to provide insurance cover. Both types of market participants will be able to benefit from the European Passport and provide their service throughout the EEA.

Under PSD2, financial institutions managing payments accounts which are active in the field of online banking must provide third-party providers with access to their customers’ accounts, provided their customers grant their permission. This provides new business opportunities to traditional banks as well as fintech companies and other non-bank service providers which must comply with new regulations in order to access account information and handle payments.

Elements of the RTS covering passporting, notification and supervision will come into force on 13 January 2018. But the RTS covering strong customer authentication and secure communication will not be applicable by then and are likely to postpone final implementation of the PSD2 regime until late 2018 or early 2019.

- European Union Member States must implement PSD2 into national law by the January 2018 deadline, but there are local differences in terms of timing and transposition that need to be addressed.
- On 19 December 2016, the German Federal Ministry of Finance published the first proposal regarding the partial transposition of PSD2 into national law. This piece of legislation includes the supervisory provisions of PSD2 and amends the German Payment Services Supervisory Act.
- Meanwhile, the Federal Ministry of Justice and Consumer Protection has amended the German Civil Code which allocates responsibilities and liability among the parties and other provisions only governing the relationship between payee and the payment service provider, such as the rights of consumers. There are indications that during the process of enacting, the draft laws will be combined into one single act.

France is expected to follow suit by reforming the relevant articles (L521-1 to L526-40 in Title II) of the Code Monétaire et Financier. Article 70 of the Act, known as 'Sapin 2,' authorises the French government to implement PSD2 within 18 months.

Given that the UK government is likely to trigger the two-year 'Article 50' withdrawal process from the European Union in the coming months, it seems likely that the UK's EU withdrawal negotiations will still be 'in-progress' when the January 2018 deadline for implementation of the PSD2 arrives. All affected UK firms should therefore continue to progress with, and invest resources into, their own internal analysis and any change planning for PSD2 as guided or directed by the relevant national competent authorities, either the Prudential Regulatory Authority or the Financial Conduct Authority.

The UK will likely want to retain an arrangement that will be closely aligned with the EU to secure easy and seamless payments throughout the EEA in general and the Single Euro Payments Area (SEPA) in particular.

As well as the legal framework, there are administrative guidelines, recommendations or explanatory notes published by the national competent regulatory authorities which also have to be updated and adapted to the new PSD2 regime. The current documents can be found on the websites of the French Authority for prudential supervision and resolution (Autorité de contrôle prudentiel et de resolutionACPR), the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin) and the UK Financial Conduct Authority (FCA).

Harmonisation of national laws

The new directive seeks to clarify exemptions that national supervisory authorities have interpreted differently within the different Member States.

Among them is the limited network exemption which is used by retail chains for low-value payments. Under PSD1, diverging administrative practices throughout Europe created a competitive advantage for firms operating in certain Member States. For example, shopping centres in the UK could benefit from the limited network exemption while those in Germany could not. In France, the ACPR originally took a narrow view on the limited network exemption, but was in one case ("Printtemps") overruled by a decision of the Conseil d'état which held that the exemption is not limited to a single company but might also apply to several companies belonging to the same group.

Against this backdrop, the EU Commission considers it necessary to restrict the limited network exemption, and as a consequence, some firms currently not requiring a license as e-money institution or payment institution will become regulated under PSD2. However, uncertainty remains in the wording of the limited network exemption. There are no clear-cut thresholds which local authorities can look at, and it will be interesting to see how administrative practice develops. PSD2 introduces a new obligation to notify the national regulator if the value of payment transactions within a limited network exceeds €1 million over the preceding 12 months. The regulator will then decide if the activities qualify for exemption.

PSD2 also limits exemptions for telecom companies. There will be an upper limit which, in the case it is exceeded, will lead to a license requirement and the supervision of those companies by national regulators. Below-the-threshold payment services of telecom companies remain unregulated.

Improvement of the security of payments

PISPs shall comply with so-called strong customer authentication which is defined as authentication via at least two components categorised as knowledge (something only the user knows, such as a static password, code or personal identification number); possession (something only the user possesses, such as a token, smart card or mobile phone); and inherence (user's biometric data, such as a fingerprint). These components will act independently of each other, so that the breach of one does not compromise the reliability of the others.

This strong customer authentication is required if customers access their payment accounts via the internet, initiate an electronic payment or take any action via remote access that poses a risk of fraud in the payments area or any other abuse.

2018

EU Member States must implement PSD2 into national Law by January 2018

The EBA was due to submit the draft RTS on strong customer authentication to the European Commission by 13 January 2017. The EU Commission will then carry out a legal review before adopting it with the EU Council and EU Parliament having scrutiny rights in the process. It is expected that the EBA will publish the final version of its regulatory standards in February or March 2017 with an enactment by the EU Commission as a Delegated Act shortly thereafter.

Once the EU Commission has adopted the RTS, they will come into force 20 days after its publication in the Official Journal of the EU. Member States must then ensure the application of the RTS 18 months after the date of their entry into force. Given these timelines, the RTS will not be applicable before October 2018. An application in 2019 seems more realistic.

The preliminary discussion paper for RTS received a critical response from members of the EU Parliament as well as from some of the 147 market participants including banking associations, credit card organisations and consumer protection groups which took part in the consultation.

The main criticism referred to a lack of exemptions that would make payments above a threshold of €50 overly burdensome in terms of booking, payment and settlement of transactions. Furthermore, market participants fear that the requirement of strong customer authentication in Europe and not in other jurisdictions such as North America could cause friction. For example, credit card companies expressed concerns that European business travelers could not use their credit cards in the US and vice-versa—US business travelers would not be able to process their credit card transactions in Europe.

PSD2 will act as a catalyst for the payments services sector. PSD2 aims to address inconsistences that have arisen from the original directive and keep pace with current and future developments. But whether it will bring about the much-heralded revolution in Europe's financial services sector is yet to be seen. ■

Blockchain and the financial markets: Will 2017 be the year of the regulators?

New rules covering blockchain and distributed ledger technology could be on the horizon following a flurry of consultation papers by leading financial regulators.

By Willem Van de Wiele

In 2016, policy makers and regulators started to take an active interest in blockchain and distributed ledger technology (DLT). However, many adopted a "wait and see" approach rather than producing binding regulations. 2017 is shaping up to be the year of the regulators. The focus on DLT has intensified with a slew of reviews, such as a new report by the European Securities and Markets Authority (ESMA), a consultation started by the Financial Industry Regulatory Agency (FINRA) in the US and the report by the International Organisations of Securities Commissions (IOSCO). This increasing scrutiny places an onus on market participants when assessing the technologies they intend to use. This requires them to monitor the legal and regulatory developments that may affect them at a national and international level and to proactively engage with the regulators to help develop clear and balanced regulation.

> **Many policy makers adopted a "wait and see" approach to DLT rather than producing binding regulations**

Global trends

The Financial Stability Board (FSB) discussed DLT in March 2016, indicating that it wants to better understand the implications of the new technology. IOSCO also made a commitment to analyse the impact of DLT. The Financial Action Task Force on Money Laundering (FATAF) and IMF also published reports on virtual currencies and DLT. The Bank of International Settlements (BIS) indicated its interest in investigating the impact of DLT and virtual currencies on the role of central banks.

Pan-European trends

The European Parliament has recognised the importance of the technology, indicating that existing regulation will continue to apply, but also called for "smart regulation fostering innovation and safeguarding integrity, while taking seriously the regulatory challenges that the widespread use of virtual currencies and distributed technology might pose".

The Parliament identified risks related to money laundering and terrorist financing and created a task-force to study the technology, but so far it has not adopted a hands-on approach.

- In June 2016, ESMA launched a public consultation on the use of distributed ledger technology applied to securities markets.
- In July 2016, the European Commission published proposals to bring virtual currency exchange platforms and custodian wallet providers within the scope of the 4th Anti-Money Laundering Directive (these proposals have been adopted in the Parliament in 2017) and also set up an internal task force on financial technology.
- Other EU bodies, such as the European Central Bank (ECB), also started investigating the impact of DLT and its regulatory implications.

US trends

While no form of "binding" federal regulation was adopted in the US, various policy makers such as the OCC, CFTC, SEC, Federal Reserve and US Congress indicated their interest in further investigating the opportunities, risks and implications of DLT. In addition, at the state level, various states, such as Vermont and Delaware started investigating state laws, with the aim of facilitating the adoption of DLT.

Result of the ESMA Consultation

ESMA recognised the benefits DLT could bring to the securities markets, notably more efficient post-trade processes, enhanced data reporting and data management. The consultation paper also highlighted a number of risks and challenges such as interoperability and the use of common standards, governance, privacy issues and scalability. ESMA stressed that the

Seven observations regarding DLT and the developing regulatory framework:

- **Early days** – It is still "early days", as the technology is still in evolution and regulators are still familiarising themselves with the technology. While regulators are clearly taking a more active interest in the technology, this does not mean that they immediately plan to issue "DLT-specific" regulations. However, given the speed of technological developments, this may change more rapidly than expected. Regulators signal that they are open to dialogue on the topic, and it is important to engage with them.
- **All about the model** – The type of model adopted may influence the application of the existing legal and regulatory framework. A 'permissioned blockchain', which is privately owned and operated by vetted participants, may give rise to fewer questions than the use of DLT in the context of a 'permissionless' or public network. However, permissioned blockchains may take away some of the potential benefits the technology may have.
- **Watch the status quo** – Even though there may be no "DLT-specific regulations" for specific applications of the technology, the impact of the existing regulations cannot be underestimated. This may make the implementation of the technology in certain highly regulated areas, such as post-trade settlement for securities, more complex. Developments in these areas may be slower.
- **Niche developments** – We are likely to see faster developments in specific areas such, as trading of securities that are not listed on a regulated market, trade finance or commodities trading.
- **Enabling legislation** – The importance of "enabling legislation" is not to be underestimated, i.e., where legislators actively create a legal framework enabling the use of technology. Examples of this are the French Sapin II legislation that will allow the issuance of certain securities on the blockchain, as well as initiatives in Vermont and Delaware.
- **Beyond financial regulation** – The impact of data protection regulations, e.g., the application of the "right to be forgotten" under GDPR, require specific attention and further clarifications. Also, the importance of intellectual property protection should not be underestimated. Some have mentioned that there are signs that a "patent race" is underway. The use of "smart contracts" enabled by DLT will raise new questions regarding liability at the intersection of code and law.
- **Beyond legal aspects** – Beyond the purely legal aspects, issues around governance and standard setting will be of key importance for the further application of DLT in the financial sector.

presence of DLT does not liberate users from complying with the existing regulatory framework.

In terms of applying the existing legal framework, it will be particularly important to assess whether a DLT-enabled platform would fall within the scope of EU rules on post-trading activities, such as the European Markets and Infrastructure Regulation (EMIR), the Settlement Finality Directive (SFD) and the Central Securities Depositories Regulation (CSDR).

While ESMA indicated that DLT may create or exacerbate some risks, it is premature to assess the exact nature and level of these risks. ESMA anticipates that legal questions will arise as the technology develops and its applications become more visible. It believes that it is too early to gain a complete understanding of the changes that the technology may introduce and that any regulatory action would be premature.

> "It is too early to gain a complete understanding of the scope of changes that DLT may introduce

FINRA consultation

Published in January 2017, the FINRA report "Distributed ledger technology: implications of Blockchain for the Securities Industry", also recognises the potential benefits of DLT for financial market infrastructures, such as additional efficiencies and increased transparency. FINRA also refers to novel risks, such as data security and privacy. Moreover, FINRA refers to the continuing relevance of the existing legal framework, e.g., a DLT application that seeks to alter clearing arrangements or serve as a source of recordkeeping by broker-dealers, may fall under its existing rules related to carrying agreements and books and records requirements.

DLT may also have implications for FINRA rules such as those related to financial condition, verification of assets, anti-money laundering, know-your-customer (KYC), supervision and surveillance. Fees and commissions, payment to unregistered persons, customer confirmations, materiality impact on business operations, and business continuity plans also may be impacted depending on the nature of the DLT applications. FINRA has invited market participants to take part in an open dialogue.

IOSCO report on fintech

The IOSCO report on financial technologies (fintech), including its intersection with securities markets regulation, which was published in February 2017, recognises the benefits of the use of DLT in financial services, such as cost reduction in settlement, faster speed of settlement, reliability and traceability of records, as well as the possibility to facilitate automatic and real-time filings to regulators, efficiency enhancement and enhancement in security.

IOSCO identifies various technological challenges such as scalability, interoperability, cyber resilience, as well as operational challenges such as issues regarding governance and risks associated with the use of smart contracts (the coding error). IOSCO refers to legal challenges regarding KYC and AML. IOSCO has not yet proposed any specific regulation to address technological challenges such as scalability, interoperability, cyber resilience, or operational challenges such as issues regarding governance and risks associated with the use of smart contracts (the coding error). IOSCO refers to legal challenges regarding KYC and AML. IOSCO has not yet proposed any specific regulation. ■

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