

Fintech regulation to watch in 2020

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Fintech regulation accelerated in 2019, with federal agencies focusing on the digital-asset enforcement front while also accepting a handful of digital token offerings. Countries also worked together to address many of the growing concerns around illicit activity in fintech.

Myriad questions remain, however, for attorneys grappling with the regulatory framework governing the sector. Here, Law360 looks forward to what might be afoot for fintech regulation in 2020.

A Lumbering Giant in D.C.

Fintech took Washington, D.C., by storm in 2019.

While the Facebook-backed Libra cryptocurrency spurred high-profile hearings in the U.S. House of Representatives and Senate, the House Financial Services Committee launched new task forces focused on fintech and artificial intelligence that held in-depth hearings with experts in the field.

Attorneys say stakeholders are likely to see increased awareness of fintech issues in the national capital in 2020, but given the looming general election and lingering uncertainty, it remains unclear if any big legislation directly addressing fintech will gather steam.

"All of a sudden, folks who didn't think they really had to understand virtual assets at the beginning of this year now feel they need to get an expertise because there's this thing that might destroy monetary policy as we know it globally," Gary DeWaal, special counsel at Katten Muchin Rosenman LLP, told Law360.

Some attorneys in the space are bullish on the likelihood for congressional action.

Ridgway Barker, a partner at Withers LLP, predicted some movement by lawmakers "because it's not just the members of Congress, it's the regulators, particularly those on the Treasury side, who want to have some clarity."

Like Barker, DeWaal sees fintech as a largely bipartisan topic in Congress. Nevertheless, "there is still a lot of controversy out there," DeWaal said. "So I would be surprised if there's a material law adopted next year one way or the other."

Further propelling fintech into the fray within the Beltway is the first U.S. senator arriving directly from the fintech digital asset space: Former Bakkt CEO Kelly Loeffler of Georgia was appointed to fill retiring Sen. Johnny Isakson's seat.

CFTC Reauthorization Act of 2019

Attorneys who spoke with Law360 point to one promising bipartisan piece of legislation specifically addressing fintech, if briefly, that has a decent chance of enjoying majority support in Congress in 2020.

The bipartisan CFTC Reauthorization Act of 2019, which includes a section on digital commodities, might very well have the best chance of any bill even tangentially addressing fintech next year. Commodity Futures Trading Commission Chairman Heath Tarbert called the section a "great step," although a "very modest" one, at an event in mid-November. The act made its way through a House committee at the end of October.

Tarbert said he found the inclusion of digital assets “an important signal.”

The bill includes a section titled “Digital Commodity” that would require the CFTC to promulgate rules pertaining to the “heightened review” of derivatives contracts based on digital commodities like Bitcoin and Ethereum.

When bitcoin futures products began trading in 2017, the bill text says, the CFTC said in guidance that it wanted designated contract markets to engage in a deeper review of those contracts with “extensive visibility and monitoring of markets for those virtual currency derivatives and underlying settlement reference rates.”

“I think this makes it a little more clear that there’s a heightened level of responsibility with respect to digital commodities, that you have to have some insight into the transactions on which you’re basing your contract,” Jeffrey Steiner, co-head of Gibson Dunn & Crutcher LLP’s derivatives practice and of the firm’s digital currencies and blockchain technology team, told Law360, referring to the reauthorization act.

There are other bills addressing digital assets that have been introduced, but none are likely to make any serious waves, Steiner said. But he noted that the Senate is still likely to come up with its own version of the reauthorization act.

The Custody Question

In July, the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority released a joint statement saying that existing consumer protection safeguards may not be effective or available when applied to digital asset securities, raising questions about how broker-dealers can adhere to custodial requirements when they touch digital assets.

The regulators noted they are in discussions with registered and unregistered broker-dealers that want to move into the digital asset securities space, saying proposals for appropriate compliance structures “remain under discussion.”

While attorneys who spoke with Law360 note the CFTC has been more open to accepting custody solutions for digital assets, the SEC has been particularly circumspect.

Crypto custody proposals approved by the CFTC are a function of the agency employing a principles-based approach, DeWaal said.

“They basically have ticked the boxes and have demonstrated to the CFTC that they have systems and controls, the finances, and bells and whistles and governance and all the right things that give them comfort,” he said. “The SEC is a far more prescriptive regulator.”

Various companies that have yet to register with the SEC as broker-dealers are seeking approval from the commission to engage in digital asset-related activities and have submitted new membership applications to FINRA. Likewise, a number of broker-dealers with existing registrations need further approval to begin dealing in digital asset securities.

There are varying opinions about how the custody question might play out in 2020.

“I actually think they’ll get that done next year,” said Barker of Withers. “That is the biggest focus from a true regulatory point of view. The basic custody framework, customer protection rules framework, is all set. But I think the mechanics of how you do it is what they’re going to focus on.”

But DeWaal was less certain.

“I just think that certainly all evidence suggests that if the SEC can punt the issue, they will,” he said.

The SEC Sometimes Plays Nice

Attorneys who spoke with Law360 largely agree that the SEC will continue on its path of engaging with the fintech industry in earnest, with more no-action letters and Regulation A+ offerings expected in 2020. The Reg A+ framework allows small issuers to take on nonaccredited investors without enduring the rigors of a full initial public offering, as long as they limit the offering to \$50 million in a 12-month period.

But more enforcement is likely, too.

“I think that you will continue to see from the SEC consideration of no-action letters as well as enforcement actions for digital assets, and the continued issuance of those types of actions and letters will add to this regulatory framework that is being created,” Michael Nonaka, a partner at Covington & Burling LLP, told Law360.

This process reflects the way many frameworks in the financial services space have developed over the years, he said.

“It’s incremental progress. It’s slow progress. But it’s still progress and provides better understanding,” Nonaka said.

In July, the SEC issued its second no-action letter for a digital token to the gaming company Pocketful of Quarters, saying the issuance of the platform’s blockchain-based token did not trip registration requirements with the commission. The letter, together with the first SEC-approved digital token offering under Regulation A+ obtained by Blockstack earlier that month, started to fill in some of the blanks around the regulation of digital tokens, attorneys said at the time.

The SEC has taken “a more conciliatory tone in terms of the no-action letters. I think it’s signaled a willingness to want to work with the industry to move things forward,” Leslie Spencer, a partner at Ropes & Gray LLP, told Law360.

The sector may not see a resolution on some particular issues, like when a digital token changes from a payment tool to an investment tool, Spencer said, so staying in close touch with SEC staff will be crucial for fintech companies.

When asked in public forums the best way to stay on the right side of regulations in the fintech space, financial regulators, including the SEC and CFTC, agree that speaking with them early and often is the best bet.

FinCEN and the Travel Rule

In light of over \$4.26 billion in cryptocurrency holdings lost globally in the first half of 2019, according to cryptocurrency anti-money laundering intelligence firm CipherTrace, Group of 20 countries have sought to apply rigorous new anti-money laundering requirements that aim to limit the potential for laundering funds through cryptocurrency exchanges.

Of significance on this front is a new Financial Action Task Force regulation known as the travel rule, which requires extensive identifying information about individuals involved in cryptocurrency transactions made between “virtual asset service providers,” including cryptocurrency exchanges.

The travel rule developed by FATF “is a big step forward in coordinating the process” between various countries that have disparate approaches to anti-money laundering, know your customer and other disclosure requirements, Shearman & Sterling LLP attorney and sanctions expert Danforth Newcomb told Law360.

Newcomb added that the first steps toward implementation have started, and as each country has to promulgate its own regulations, industry groups are working to encourage consistency across the global regulations to come.

“There is a growing effort, in particular driven by the private sector but also by the regulators, to precook the relevant regulations so that [the travel rule] can be implemented relatively painlessly and relatively inexpensively,” he added.

As digital currencies seek to become mainstream, it will be critical for the industry that money laundering and illicit money transfer labels be addressed. The FATF travel rule is a good start, said John Jefferies, chief financial analyst at CipherTrace.

“In some ways, it’s a bit of a bitter pill for some of the exchanges to swallow, but on the other hand, I think that such regulation is making cryptocurrencies safer. It helps grow the whole ecosystem and helps it become an institutional client asset,” he said.

Adherence to the travel rule will help illustrate the maturity of the industry, Jefferies said, and once cryptocurrency exchanges are recognized merely as financial institutions, then it makes sense that they would be regulated in similar ways and would have the same types of regulatory boundaries as other financial institutions.

There is little doubt that in 2020 the Financial Crimes Enforcement Network, which oversees Bank Secrecy Act and anti-money laundering regulations will play an important role in the fintech world as travel rule requirements hit the books, Jefferies said.

Guidance was provided by FinCEN in spring that aggregated existing regulations and explained how they apply to the cryptocurrency industry.

For the industry, the guidance released May 9 was among the most significant to come out of FinCEN since the agency issued 2013 guidance clarifying that it considered certain broad categories of cryptocurrency industry participants to be “money transmitters,” which are subject to a range of registration, reporting and compliance requirements under the Bank Secrecy Act.

In the end, as American legislators and regulators grapple with the fintech world and what is to come, they will inevitably keep an eye on what is going on around the globe, DeWaal’s colleague at Katten and fellow special counsel Cathy Yoon said.

“I think that if we are pushed by developments in other countries that we see as a competitor, and if they actually turn out to be valid developments, I think that will push at least certain factors,” she said.

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