sifma

*Invested in America*

March 31, 2017

Ms. Marcia Asquith
Office of the Corporate Secretary
FINRA
1735 K Street NW
Washington DC 20006-1506

***Re: FINRA's Report "Distributed Ledger Technology: Implications of Blockchain for the Securities Industry"***

SIFMA[1] appreciates the Financial Industry Regulatory Authority's (FINRA) efforts to foster innovation, and FINRA's report "Distributed ledger Technology: Implications of Blockchain for the Securities Industry"[2] offers a thoughtful, detailed analysis of how the securities regulatory framework could potentially apply to distributed ledger technology (DLT) across many areas. We are encouraged to see this report, following comments by FINRA's President and CEO Robert Cook this January in his introduction to the 2017 FIRNA 2017 Regulatory and Examination Priorities letter on the importance of guidance to encourage innovative business models and the adoption of emerging technologies.[3]

The report comes at a very opportune time, as it become increasingly clear, as FINRA acknowledges, that DLT innovation is real and the industry is moving forward with a range of initiatives using this technology, both in the US and internationally. We appreciate the opportunity to begin a broad dialogue with FINRA through our response to the report. Given the broad range of potential applications of this technology, SIFMA's response will remain at a high level and focus on a number of key principles which we feel should guide regulators and supervisors as they integrate this technology and its applications into their oversight frameworks.

---

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] https://www.finra.org/sites/default/files/FINRA_Blockchain_Report.pdf

[3] www.finra.org/industry/2017-regulatory-and-examination-priorities-letter

**New York** | Washington

120 Broadway, 35th Floor | New York, NY 10271-0080 | P: 212.313.1200 | F: 212.313.1301

www.sifma.org

## *1. Principles for Effective Regulation of Distributed Ledger Technology*

**Regulators Should Promote and Support Continued Innovation**

Regulator approaches to DLT should first be based on the principle of not harming continued innovation whenever possible while still meeting regulatory oversight goals.

Regulator approaches to distributed ledger should remain focused on the behavior of market participants and the markets for assets they oversee, not on specific technologies. For example, application of DLT to move data management to a ledger should have a much narrower regulatory impact than a future market for token assets on a network. Similarly, firms should be free to experiment with DLT in non-production or limited pilot environment projects. We are encouraged by the degree to which we are seeing the mixture of collaboration and innovation between industry participants and technology firms. In addition, regulators should take into account the continued evolution of DLT from its current state before large production scale applications come into use. In addition, given the early state of applications of DLT, premature regulation could stifle future innovation.

**The existing regulatory framework will cover many applications of distributed ledger technology, with adjustments as needed on a case by case basis**

SIFMA recommends that the baseline assumption for regulators around DLT-based projects should be that they can operate within existing regulatory frameworks. Many applications of distributed ledger technology currently being explored by the industry are not fundamentally different from current market activity and firm operations, but are best understood as the addition of new technology to modify existing processes which are governed by an existing regulatory framework. This is highlighted by the role distributed ledger technology providers are playing to support technology transformation at existing market utilities such as exchanges and utilities.

We believe that this approach to understand the regulatory impact of DLT is consistent with the historical experience of the industry in recent decades, where existing regulations accommodated major transformations of industry technology and the automation of many industry processes.

**Regulation should be of specific use cases as needed, not the technology as a whole**

Given that applications of DLT will occur within an existing regulatory framework, the regulatory impacts of use of DLT will be driven by the specific products or processes where this technology is applied. The specific features of these markets and processes, as well as the details of regulatory requirements that currently govern them will determine the degree to which modification of existing regulations will be necessary. For example, there would likely be more regulatory impacts where all participants in a transaction on a ledger need to see and agree on it. In contrast, applications like managing golden copies of reference data housed on a distributed ledger would potentially have little to no regulatory impact.

Although it is difficult to make predictions given the rapidly evolving technology and the uncertainty around what use cases the industry will ultimately embrace, it is likely that the cases where the most significant rule changes may be needed will likely be around value transfer applications. However, these will need to be addressed on a case by case basis reflecting the role of the ledger vis a vis existing industry processes and the current regulations governing these markets– and even then, the bulk of the regulatory framework overseeing these transactions will likely remain the same. Similarly, regulation should remain focused on the public policy objectives that guide the regulatory rule set (such as systemic stability, investor/consumer protection, promotion of competition and consumer choice) as opposed to aiming to regulate the impacts of DLT itself.

An additional complexity regulators will likely need to consider is that until distributed ledger applications have equivalence of cash on their networks, systems will need to have an "on ramp – off ramp" to move from activity conducted or tracked on a ledger to "real world" existing systems to make payments and value transfers. The regulatory impacts of these types of bifurcated applications will be different from ones where cash or assets are actually transferred on a digital ledger.

**Ongoing dialogue with regulators is important**

Dialogue between regulators and the industry will be valuable as both sides work to understand how DLT can be applied in the capital markets and how these applications will fit into existing regulatory frameworks. This dialogue should be ongoing as the industry explores distributed ledger applications, as opposed to a model where the firms' primary interaction with regulators is getting final approvals before a DLT-based project goes into production.

This ongoing dialogue allows the industry to start explaining potential applications of DLT to regulators and allows both sides to develop alignment around their understanding of DLT projects and their regulatory context. While this dialogue would not necessarily mean tight coordination during the development process, it would at least ensure mutual awareness. This awareness lets the industry move forward with development while reducing regulatory uncertainty and allows regulators to provide guidance as projects move forward, so the industry doesn't pursue initiatives that regulators are not comfortable with.

Given the many aspects of a regulator's rulebook which could be impacted by applications of distributed ledger technology, it would be very valuable for the regulatory dialogue process to include a "point person" at regulators to help firms work across their different branches and offices to review the regulatory impact of potential DLT projects.

Given the multiple regulators and supervisors who oversee markets and their participants, forums for dialogue with the industry around DLT initiatives should support simultaneous, coordinated engagement with multiple regulatory agencies that may have oversight over a potential emerging use case or project.

Openness for dialogue with regulators is different from regulatory sandbox initiatives seen internationally, which are primarily beneficial for allowing limited operation of new products or offerings

which are already in production. In contrast, development of distributed ledger technology would be better supported by more regulatory dialogue and engagement in pre-production stages.

**Regulators should be flexible regarding their own role, rules, and systems as technology evolves**

The transformative potential of DLT will likely also have implications for how regulators interact with market participants. As DLT projects are implemented, FINRA and other regulators should also consider how applications of DLT will result in new opportunities for more effective regulation and oversight. Regulators should be willing to adjust rules and systems to take advantage of new opportunities offered by DLT.

One potential opportunity for regulators in a DLT enabled environment would be to serve as a "node" on a network and configure that node as a channel to access information on market activity that they currently obtain through reports submitted by market participants. Moving towards giving regulators "self-service" access to data through a node on a network would offer a range of benefits to regulators, including much easier data mining, and would reduce the effort regulators spend on managing the "friction" of current reporting systems, such as handling reporting inaccuracies and managing compliance.

Although it is not a distributed ledger project, the development of the Consolidated Audit Trail (CAT) system provides a model for this type of change, as the CAT will provide a single a data source which regulators can tap into, allowing them to replace existing reporting requirements such as the Order Audit Trail System (OATS).

While ultimately the opportunities for new regulatory roles will depend on specific DLT projects and how they are configured, potential opportunities could include "regulator nodes" on a distributed ledger network giving FINRA access to information and allow the replacement of dealer driven reporting systems, such as TRACE, as FINRA would already have access to the data. Similarly, the usage of DLT platforms could obviate the need for confirm protocols such as 10b-10s.

**Substitutability**

Regulators are looking at DLT and its applications in markets at a time when the technology and the technology providers that support it are developing rapidly. Given the ongoing changes in the technology landscape, regulation needs to be designed to allow for substitutability of technology, so regulations do not lock in any one provider or technology configuration. Regulation should not result in the market being locked into vertically integrated technology monopolies

Given that DLT will continue to evolve and develop, any changes to rules to reflect the adoption of DLT today should be technology agnostic and "future proof." For example, amendments to CFTC Rule 1.31 removed the specific WORM requirements for data storage in favor of a technology agnostic approach.[4]

[4] http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2017-01148a.pdf

This approach to substitutability is consistent with the approaches to cybersecurity technology in the NIST standards.

**Competition & Collaboration**

Regulators should understand the importance that both competition and collaboration play in support the adoption of DLT in the markets, and balance the importance of ensuring robust competition while preserving opportunities for market participants, technology firms, and market infrastructure providers to collaborate. Regulation should support competition between market participants and between DLT providers, while avoid creating opportunities for regulatory arbitrage, given the high standard the securities industry holds itself to under the existing regulatory framework.

However, the development of DLT solutions will require collaboration within the industry - both between securities firms as well as with infrastructure providers, exchanges and technology firms, and regulators should ensure this collaboration can continue. Much of the work currently underway to understand and implement DLT today is occurring through various collaborative structures, and continued collaboration to is essential to solve technology challenges and understand how to apply this technology across multiple firms at production scale to support market activity. As DLT platforms mature, regulators should also be aware of the importance of common technical standards/protocols to enable interoperability between different existing DLT platforms.

### *2. Specific Topics Related to Distributed Ledger Technology*

In addition to the principles above, FINRA's report raised a number of important issues which SIFMA would like to take the opportunity to comment on.

**Private vs. Public Networks & Implications of Private Networks**

FINRA's report discussed the differences between public and private distributed ledger networks. Given the importance of the difference between these two technology configurations, regulators should fully understand the differences between use of private versus public networks, and understand that private networks are more likely the initial starting point for applications of the technology.

In addition, there are a range of other issues around private network configurations which may have regulatory implications. For example, as private networks develop, they may include entities who are not currently regulated by the regulators and supervisors who oversee the market in question. These could include technology providers or market or reference data services. In addition, there may be differences in the status and risk profile of entities represented on a private network, depending on how it is configured. Development of private networks may also create situations where assets under the oversight of a regulator are handled on a private network operated by entities outside the jurisdiction of that regulator. Ultimately these questions around network privacy and membership will depend on the specific markets and processes a ledger handles and how it is configured.

**Smart Contracts**

Smart contracts—commonly defined as agreements that are both automatable and enforceable — present transformational opportunities in the financial services industry. Much work remains to be done, however, before the smart contracts technology matures. In most use cases, the smart contract code will not become a complete substitute for legal prose. One potential challenge for the industry is to identify, for each use case, the portion of a customary contract that is susceptible to automation. Another challenge is to agree on a common set of terms, a consistent taxonomy. Other challenges have also been identified, ranging from anticipating impact of extraordinary events on automated contracts to dealing with issues that are specific to long-term agreements.

Work is underway among the industry groups, consortia and individual financial firms to tackle the various challenges of bringing smart contract technology into the mainstream. This work largely entails incremental developments that would not require new regulation, such as greater standardization of legal contracts and greater automation of business logic. Regulators are encouraged to participate in the formative discussions around smart contracts in order to stay close to this developing area and to express their views at critical junctures of development. As the technology matures, there may be opportunities for regulators to serve an enabling role in acceptance of smart contracts in financial services, similar to the legislative and regulatory enablement of the use of electronic signatures in modern commerce.

**Anti-Money Laundering (AML) and Customer ID Verification**

The identify management and authentication features of distributed ledgers may also present opportunities around third party outsourcing for Customer Identification Program (CIP) purposes. Distributed ledger systems may provide for a centralized identity management function, which could be used for CIP purposes, such as in accordance with Section 326 of the USA PATRIOT Act. As the technology develops, regulation around AML and customer identification should be modified to reflect any new functionality available through distributed ledgers.

**Conclusion**

SIFMA appreciates FINRA's publication of this report, and their invitation to the industry to begin dialogue around the regulatory and market implications of distributed ledger technology. Given the potentially transformative potential of this technology, we appreciate FINRA's forward leaning approach to understand how it will impact existing industry processes and the regulatory frameworks that oversee them. SIFMA and its members strongly believe in the value of ongoing dialogue between the industry and regulators as distributed ledger technology is implemented, and we hope this letter is the first step in this process.

We appreciate the opportunity to respond to the report, and would be pleased to further discuss any issues raised in this letter or other questions FINRA may have around DLT. Please feel free to contact me or 212-313-1260 or tprice@sifma.org or Charles De Simone at 212-313-1262 or cdesimone@sifma.org.

Sincerely,

Thomas Price

Managing Director, Operations, Technology & BCP

SIFMA