Client Update
The Future of Blockchain: FINRA Has Some Thoughts

NEW YORK
Lee A. Schneider
lschneider@debevoise.com

Michael Coburn
jmcoburn@debevoise.com

Samuel E. Proctor
seproctor@debevoise.com

WASHINGTON, D.C.
Luke Dembosky
ldembosky@debevoise.com

Jeffrey P. Cunard
jpcunard@debevoise.com

Satish M. Kini
smkini@debevoise.com

Naeha Prakash
nprakash@debevoise.com

Given the broad scope of possibilities inherent in distributed ledger ("Blockchain") technology, many firms in the securities industry have been eager to explore how to adopt and apply the technology to their businesses. The industry's attention to Blockchain has led the Financial Industry Regulatory Authority ("FINRA") to release a report examining the potential impacts of the technology on the business and regulation of the securities industry (the "Report").[1] In conjunction with the release of the Report, FINRA has requested that interested parties send comments concerning any aspect of the paper by March 31, 2017.

The Report provides a good overview of Blockchain technology, how it might be applied in various aspects of the securities industry and some of FINRA's thoughts on regulation of this new technology. FINRA adopts a cautiously optimistic tone towards the use of Blockchain. The use of Blockchain by firms may also be a means for regulators to further their own mission of protecting investors, although this point is not addressed by the Report.

BACKGROUND

Blockchain allows transactions to be recorded on a decentralized database maintained through a peer-to-peer network (the so-called distributed ledger). A transaction is initiated by any member of that network and is then verified by the other members. Once verified, the transaction is "cryptographically hashed" and permanently recorded on the distributed ledger. The recording is then secured with a private key and, in general, once set it cannot be altered.

[1] FINRA, Distributed Ledger Technology: Implications of Blockchain for the Securities Industry (Jan. 2017), *available at* http://www.finra.org/sites/default/files/FINRA_Blockchain_Report.pdf.

Blockchain technology has many potential applications for the securities industry, including for broker-dealers. For example, FINRA notes that firms currently are examining the use of the technology to execute, clear and settle securities trades, syndicated loans and credit default swaps. In addition, firms are exploring the use of Blockchain to standardize reference data for certain securities products, create a centralized client identity management function, and to streamline certain procedures related to industry-wide utilities. The Report briefly discusses various other possibilities but does not mention any applications directly associated with the Consolidated Audit Trail.

REGULATORY CONCERNS

In the Report, FINRA identifies a number of areas in which Blockchain may introduce additional regulatory uncertainty into the securities industry. FINRA appears to view Blockchain as having the potential to create a "paradigm shift" for broker-dealers, and thus it believes that many areas may require additional attention from both the industry and regulators. For example, the Report indicates that firms will need to ensure that the uses of Blockchain comport with the relevant supervision requirements. Furthermore, and of paramount importance, the Report asks firms to appropriately consider how to implement network security features, particularly where customer data is implicated.

In addition, the Report notes that firms also will need to take into consideration anti-money laundering, customer identification and "know-your-customer" requirements. The Report indicates that firms can take these steps by, among other means, determining how to verify the identities of parties with whom it transacts on the Blockchain network and by considering how to engage in transaction monitoring in accordance with the firm's existing anti-money laundering processes.

In considering the various applications for Blockchain, the Report notes its possible uses for tracking transfers of private company shares and facilitating faster clearing and settlement of transactions in securities, syndicated loans and other asset classes, as well as other "industry utility" functions to streamline repetitive processes. On this basis, FINRA indicates that broker-dealers using Blockchain technologies should consider the implications under the financial responsibility rules (SEC Rule 15c3-1 and 15c3-3), FINRA Rule 4311 relating to carrying agreements and transaction monitoring/surveillance requirements such as the market access rule (SEC Rule 15c3-5). Finally, FINRA states that broker-dealers must ensure that the information recorded on the Blockchain complies with recordkeeping rules under SEC Rules 17a-3 and 17a-4 and FINRA Rule 4511.

BENEFITS AND RISKS

According to the Report, Blockchain technologies have two primary potential benefits: (1) transparency by making available the complete history of all securities transaction on one network, and (2) improved market efficiency through eliminating many post-transaction processes.

The Report, however, raises a number of security, operational and governance concerns regarding the implementation of Blockchains. Unlike Bitcoin, Blockchains used by financial firms will most likely run on a private network with a central governing body. Market participants will need to determine how such a network will be governed and managed. They also must establish eligibility criteria for inviting and removing members from the network. Thus, participants will have to ensure the network is adequately secure.

CONCLUSION

By issuing this Report, FINRA has sought to further the discussion around Blockchain and the regulatory issues associated with its implementation. We are aware of several interesting Blockchain initiatives in other, less-regulated industries, as well as fundraising efforts for such projects using Blockchain tokens. It remains unclear how readily the securities industry will adopt Blockchain solutions.

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Please do not hesitate to contact us with any questions.