Issues on the Hill and Beyond

A REPORT FROM THE INSTITUTE FOR FINANCIAL MARKETS

How Governments Are Reshaping Fintech

DC FINTECH WEEK 2019 was held over four days in October to touch on a wide variety of topics that influence the global fintech and financial services sector. The event, hosted in Washington D.C. by The Institute for Financial Markets, Georgetown University Law Center, Institute of International Economic Law and CQ Roll Call, featured more than 90 speakers across the fintech, regulation and governmental sectors. This report focuses on day two of the conference, titled "Issues on the Hill and Beyond" and continues the IFM's ongoing efforts to examine smart regulation and to discuss key aspects of financial technology.

You can see prior IFM publications:

- 2018 DC Fintech Week's *From the Sandbox to the Cloud: How FinTech Regulation is Evolving Globally*
- IFM's 2018 Smart Regulation Roundtable report *The Dawn of Cyrpto Regulation*
- 2017 DC Fintech Week's report, *New Rules of The Road*

The Fintech Week panels focused on: regulatory sandboxes, regulatory competition among jurisdictions, artificial intelligence, data and the role that the cloud plays in this space.

THE INSTITUTE FOR FINANCIAL MARKETS

An Introduction

It has been a decade since the creation of bitcoin, the open-sourced code that spawned the digital currency explosion of cryptocurrencies, crypto markets, initial coin offerings, blockchain and digital ledger technologies. Whether professionals agree or disagree about the impact of such technology, it has raised new questions about how to regulate new technologies, and integrate them into traditional financial services and financial markets.

The rise of digital assets also has coincided with other technology advances such as open banking, data mining, artificial intelligence (AI) and deep learning technologies. All of these developments are changing the way in which governments, regulators and market participants are viewing how best to cultivate and encourage innovation in these areas, yet do so with a regulatory framework that holds wrongdoing accountable and protects end-users across a multitude of products.

Today's financial technology sector has led to various approaches to deal with all of it—from fintech sandboxes in the UK and elsewhere, to collaboration across multiple nations and states, to bespoke regulations that differ across multiple jurisdictions. In short, the growth of these technologies has outpaced the way in which they are currently regulated and legislated. Some of that is simply due to the process required to create rules and regulations. Regulators do not want to be too hasty. Some of it is that various regulators have had to react to a host of new financial technologies that may not be proven or even successful in the broader marketplace. The "Issues on the Hill and Beyond" panels show various moves and initiatives by governments, but also highlight just how many questions still remain for these quickly evolving technologies.

The following sections contain a recap of the event on October 22, 2019 on the topics:

- Arbitrage or Adaptation? Domestic Rules, International Markets
- Diplomatic Roundtable: Cross-border Fintech Cooperation: UK-U.S. Financial Innovation Partnership
- Open Banking, Data and the API Economy

Arbitrage or Adaptation? Domestic Rules, International Markets

MODERATOR:

- **Michelle Bond**, Global Head of Government Relations, Ripple

PANELISTS:

- **Peter Kerstens**, Advisor for Financial Sector, Digitalization and Cyber Security, European Commission
- **Michael Liftik**, Partner, Quinn Emanuel Urquhart & Sullivan, LLP
- **Michael Mosier**, Chief Technical Counsel, Chainanalysis
- **Heng Wang**, Association Professor, University of New South Wales, Sydney

The growth of digital assets has created a conundrum for regulators. It's as if another G20 Summit, like the one in Pittsburgh in 2009, is required for financial technology to decide just what, who and how global technologies should be regulated. Experts in the area differ greatly on just how to accomplish a cohesive regulatory framework internationally.

For some, it starts with an effort to establish national standards that then serve as a framework for international cooperation. For others, finding common ground for international standards is key. This chicken-and-egg dilemma is one that may be difficult to solve, even on a national level where U.S. states and federal regulators are taking differing approaches to regulating cryptocurrency markets.

For Peter Kerstens, advisor for the Financial Sector, Digitalization and Cyber Security, European Commission, the process of establishing national guidelines first followed by international standards starts on a difficult path.

"Once national rules are set, then coordination (internationally) becomes very hard," Kerstens said. "We do see that quite a few jurisdictions are having difficulty with it because their starting point in international negotiations is to promote their national regulations."

Michael Mosier, chief technical counsel of Chainanalysis (a blockchain analysis company that supplies compliance and investigation software to global banks and governments) said the key here is to create an international baseline but not rigid standards which allow for product evolution. Traditionally, the U.S. has not taken strong positions on which standards should be adopted, but has let the market sort out preferences over time.

"Let's set some basic principles and then allow for that evolution, allow for the product to shake out and see where the risks are," Mosier said. "It should be risk based but we're still determining what the risks are. That differs for different jurisdictions."

How this all plays out is still unknown on the international stage, but regulators are watching to see how countries like the United States deal with these sectors, as states and federal regulators try to set their own regulations.

There is no question regulators at the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) have taken cautious approaches to digital asset markets. The CFTC and SEC claimed their turf with cryptocurrencies falling under the CFTC's definition of a commodity and the SEC claiming oversight of digital tokens and initial coin offerings. Beyond that, it has been a difficult process to follow for some.

Michael Liftik, a partner at the global white-shoe law firm of Quinn Emanuel Urquhart & Sullivan, LLP, said the SEC's approach has been "behind the ball and disjointed." A former SEC deputy chief of staff, Liftik said there has been a number of problems with the SEC's handling of digital assets regulation. He cited articles published by the SEC, speeches and statements by the SEC chairman Jay Clayton or commissioners and the adaptation of existing SEC rules to new markets as having created even more questions from market participants.

Liftik pointed to the Howley Test that has been applied to initial coin offerings. The Howley Test, first established in 1946, essentially sets the definition for a security. In short, a security must: include an investment of money, have an expectation of profits, be invested in a common enterprise and come from the efforts of others.

"With the Howley Test from the 1940s, I think everyone is in agreement that it doesn't really work in this context," Liftik said. "And so you see the regulator struggling to make sense of this."

He also said the SEC and CFTC came out at different times with their fintech hubs and "no action letters" to fintech firms that are meeting regulatory guidelines. The process is cumbersome and slow, putting such services at odds with the pace of development in these markets.

Going Global

One example of the challenge facing regulators, treasuries and central banks, is the fast evolution of international digital currencies based on fiat currencies. Just who is responsible to oversee such innovations? Take Libra, the cryptocurrency created by Facebook is backed by a basket of fiat currencies and U.S. Treasury securities and managed by the Libra Association, a group of entities based in Geneva, Switzerland. While Libra has faced heavy criticism from regulators in the U.S., Europe, India and elsewhere, it also has spurred the discussion among participants on how to regulate such markets.

"They moved the debate about crypto assets into the mainstream," Kerstens said. "If successful, they would be the first global mainstream blockchain application. They could have a large existing network that can implement a new payment solution in the world. That will really freak out regulators all over the world."

The possibilities of a mainstream digital currency has pushed central banks to consider their own central bank digital currency (CBDC). China's central bank, for one, is looking to launch a digital version of the yuan, although the timing of its release is uncertain. Tunisia's central bank was the first to launch a digital sovereign currency in test form on November 8, 2019.

Heng Wang, associate professor at the University of New South Wales, Sydney, said the move by the Chinese Central Bank is a "game changer." A sovereign digital currency could be integrated into the massive social media app WeChat, which is used for a variety of purposes including purchases and money transfers. The concept of data use by governments is a concern, however.

"I don't want to underestimate some of the difficulties with it, starting with data sharing," Wang said. "I hope that it will not be a race to the bottom."

From a regulatory point of view, central bank digital currencies could provide better regulatory controls. Mosier said tracking wrongdoing may be easier or more efficient with a digital payment system. In his view, digital payment systems could provide a balance of privacy and enforcement powers. A digital asset payment system could be monitored for various money and payment flows in almost any sector. He brought up an example of bitcoin being used in child sexual exploitation investigations. Tracing such bitcoin movements helped break a case that stretched over 38 countries.

"Even with privacy enhancements, you were at least able to show connections, see where things were going to all these different countries and...doing things (as investigators) in a year that you could not have done in traditional fiat states."

Diplomatic Roundtable — Cross-border Fintech Cooperation: UK-U.S. Financial Innovation Partnership

MODERATOR:

- **Sharon Yang**, Deputy Assistant Secretary for International Markets, U.S. Department of the Treasury

PANELISTS:

- **Haytham Agabani**, Senior Financial Policy Advisor, British Consulate-General New York
- **Daniel Greenland**, Deputy Director of International Financial Markets, U.S. Department of the Treasury
- **Sameer Gulati**, FinTech Specialist, UK Department for International Trade
- **Paul Thanos**, Director, Office of Finance and Insurance Industries, U.S. Department of Commerce

A look at the fintech sector shows that in many ways, we're still just getting started.

The investment trend across many sectors of financial technology is nothing new, nor are government initiatives that are helping firms with everything from legal and regulatory support to assisting firms with access to markets internationally. What is clear though, is that governments and regulators are rolling out new partnerships and cooperative agreements in fintech, which coupled with the investments, could propel new innovations across multiple borders.

Last year was a record year for fintech investment globally with venture capital invested in 2,300 deals globally at 2 ½ times the investment levels in 2017. The U.S. garnered about $10.6 billion, China $18.9 billion and $1.7 billion in the UK in venture capital and private equity capital, according to Sameer Gulati, FinTech specialist with the UK Department for International Trade.

"Looking globally, now every country wants a fintech strategy and a fintech sandbox," Gulati said. "We're seeing a maturing of these markets globally."The value of global fintech deals according to Accenture Analysis was $55.3 billion in 2018. Investments hit $22 billion in the first half of 2019, down from $31.2 billion a year earlier. Much of that drop was attributed to the massive 2018 fundraising for Ant Financial, which totaled $14 billion in May 2018 alone. While estimates on fintech investment vary, they generally show a continued strong appetite for new ideas and products that could be used beyond domestic markets.

Fintech Agreement

Such numbers have spurred governments to cooperate in the space to help foster more cross-border access for financial technology firms.

One example of how governments are working together is the Financial Innovation Partnership (FIP) between the U.S. and UK. The agreement, announced in May 2019 between the U.S. Department of the Treasury and the UK's HM Treasury, is focused on collaboration among the private sector, sharing information and expertise on regulatory approaches and promoting growth and innovation in fintech.

Sharon Yang, deputy assistant secretary for international markets, U.S. Department of the Treasury, said the FIP was timely because "it is a very interesting time for financial regulators." On the one hand, there are regulatory benefits to information sharing. On the other, Yang said agencies are trying to encourage development in key areas such as artificial intelligence and data.

From a commercial standpoint, there is great opportunity forged by cross-border deals. With UK firms, for example, 70% said that the US was their market of choice.

"What we're trying to say is, how can we reduce those market access barriers or perceived access barriers?" Gulati said, adding that not many UK firms know about various innovations happening on the ground in the U.S., or that firms can go visit the LabCFTC and OCC innovation lab and talk to U.S. federal regulators over issues and concerns.

Regulatory Benefits

The concept of cross-border cooperation in the fintech space can be broad in scope. By setting similar or common compliance standards, firms can more easily extend their technologies into different markets. Knowing those details is important for companies as they scale up their firms and products.

Haytham Agabani, senior financial policy advisor at the British Consulate-General New York, said India was a good example of how a country set up selected APIs for tech firms to use, which linked to a unified payment system now used by 1 billion registered users. Established guidelines can help firms dramatically expand "as long as you have the right standards, implementation model and right governance mechanisms," Agabani said.

One of the key issues going forward, will be how regulators work together in terms of regulation and broader regulatory guidance and economic help. The Global Financial Innovation Network (GFIN) was proposed in 2018 by the UK's Financial Conduct Authority to provide just that – cooperation among regulators and fintech firms to share information and interact with regulators in different countries. GFIN was launched in January 2019 and accepted its first set of eight firms in April 2019. The sandbox now has 35 financial regulators and supervisors from 21 jurisdictions with a goal toward streamlining cross-border testing of technologies.

In the meantime, national regulators are working with others on various initiatives that may help pave the way for the next innovations. Indeed, it is a critical time for financial technology.

"A lot of this is the realization that fintech does not have boundaries," Gulati said. "Ultimately, what we are looking for are shared insights that lead to principles-led regulation. And how can we reduce those perceived market access barriers."

Open Banking, Data and The API Economy

MODERATOR:

- **Steve Boms**, President, Allon Advocacy LLC

PANELISTS:

- **John Pitts**, Policy Lead, Plaid*
- **Matthew Swinehart,** Director, Office of International Financial Markets, U.S. Department of the Treasury
- **Sam Taussig**, Head of Global Policy, Kabbage Inc.
- **Andres Wolberg-Stok**, Global Head of Digital Policy, Citi Consumer Banking

The digital world we live in is all about data – consumer data, financial data, alternative data and so on. Data sets in the financial services area are a critical component of today's financial system and yet, there are very different regulatory approaches to data from country to country.

The question then is: how can we best regulate the data space in a way that protects consumers yet promotes innovation? The answers and solutions are far more complex than it appears as fintech firms struggle to find the ways to make the technology work smoothly, integrate with traditional bank and financial systems and still meet regulations that may or may not be up to date.

A simple poll of the audience at DC Fintech Week about who knows which data aggregator handles and has access to their data associated with their banking, credit card and payment services revealed a simple truth. Less than 1% of the audience knows who those firms are. Indeed, few understand how the system works.

Here is How Your Bank Access Works Online

Given that most people have no knowledge of how transactions are facilitated from your bank to a merchant or service, it is helpful to know the difference between two central online payment aggregation systems—screen scraping and APIs. Screen scraping is used by a service to access a user's bank account using your personal username and password. For example, you go to a website to buy an item and are asked for your banking or payment credentials. So you enter them. What most people do not know is that information is being handed to a third-party service that then uses your name and password to access your bank or payment account as if it were you. Such services then can access your accounts for any variety of reasons, viewing salary data to personal buying preferences.

There is a technology shift toward an Application Programming Interface (API) that is your bank's own dedicated gateway or interface which allows an individual to share data without having to share your bank information. Users can control what data is shared and for how long.

While the simple answer to the issue is to push all banks over to the API methodology, there are challenges associated with it. For starters, not all banks, especially smaller community banks and service providers have the money to spend on developing an API system. In the U.S., there are roughly 14,000 banks, community banks, credit unions and financial services companies. Many simply won't spend money to make the switch to the API.

Last year, the Financial Industry Regulatory Authority (FINRA) issued a warning to investment firms and investors about the risks of sharing account data with aggregators, and allowing access to bank accounts as well as trading, wealth management, retirement accounts and others.

John Pitts, policy lead at Plaid said his firm, which builds a technology platform that enables applications to connect with users' bank accounts, would like to take credentials out of the access process but there are a number of hurdles to overcome. For starters, he said there is a gap between "old regulation and new technology." Regulation (REG E) provides a basic framework that establishes the rights, liabilities, and responsibilities of participants in electronic fund transfer systems. While REG-E is the most relevant regulation, it has holes, especially in terms of liability in the case of someone stealing funds from an account. REG E holds the bank accountable if consumers are harmed.

The question is: if a consumer's credentials are shared with an aggregator and they are used to make an unauthorized transfer, is the bank liable? Banks have argued that they didn't give the aggregator permission to access the account—the customer did. So it is not liable to pay for any theft. Aggregators, however, are not covered by the current regulations and so they are exempt from liability.

Andres Wolberg-Stok, global head of digital policy at Citi Consumer Banking, called it a vicious cycle. The move to APIs is a solution, but getting that set up can be cumbersome and difficult for banks to do with aggregators.

Finding Regulatory Clarity

How then to deal with this is an evolving conundrum for participants in the market? In the absence of a clear mandate by legislators or regulators, the market looks likely to continue on with the screen scrape system in place today with some adoption of the API model.

Sam Taussig, head of global policy at Kabbage said a move to end screen scraping altogether would be "ending a fundamental tool of the internet." And a shift to an API standard would require industry coordination and acceptance.

"We need to think about this in an iterative and transformational way in the United States that will continue to serve my end customers, bank customers and merchant customers," Taussig said. "What that involves is evolving the liability framework, evolving the traceability technology and evolving the API standard."

The EU has tackled the issue with a policy called the revised Payment Services Directive (PSD2), which was launched in January 2016, but allowed EU states until January 2018 to make it law. The directive set a common set of rules across the EU and aims to allow customers more choice in how they manage payments and bank accounts. Using APIs is a key component of the policy. Yet, even with its set guidelines, the EU plan has not been a perfect fit, said Pitts. The top-down governmental approach hasn't worked in his opinion.

"The top down approach was, "You, the banks, open up your systems and start sharing data with other people," Pitts said. "What is missing is, "What if the consumer wants more of their data to show up in their bank? And what if banks want to take advantage of data sources that are not banks and start making their own credit decisions?"

These multi-streams of information have made it difficult for banks and consumers to determine just what types of data are most relevant and valuable. Pitts advocates for a "bi-directional, or consumer directional system" that allow customers to direct the content to the entities they choose.

Wolberg-Stok agreed with that view and expanded the potential universe of customer data to areas such as health care, telecom, energy and other data sectors that are of value to the consumer and larger entities as well.

Taussig said that the data issue and consumer rights to own that data is creating a broader ecosystem of payments. He pointed to Australia, where customers have universally owned their data which is spawning growth in the "banking as a service" area.

"We need a system where data can flow omni-directional, to create an environment where you have a greater productive landscape that has banks, fintechs and fintechs are servicing banks and everything else in between," Taussig said.

The world may have to wait.

** In January 2020, Visa announced it would buy Plaid, a privately held fintech startup.*

This report was written and produced by Jim Kharouf for the IFM.

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THE INSTITUTE FOR FINANCIAL MARKETS

THE INSTITUTE FOR FINANCIAL MARKETS

2001 Pennsylvania Ave. NW, Suite 600 | Washington DC 20006-1807

Tel: 202-223-1528 **Fax:** 202-296-3184 **Web:** theifm.org