



BLOCKCHAIN IN FINANCIAL SERVICES

An Introduction for Lawyers

Blockchain technology has the potential to transform a wide range of industries and, as an increasing number of enterprise blockchain projects are announced and more and more legal and regulatory consultations and guidance are becoming available, firms have much to consider when exploring the potential to utilize blockchain and distributed ledger technology in their businesses.

With that in mind, Leonard Ng, co-head of Sidley's EU Financial Services Regulatory group, together with regulatory associate, Matt Feehily, hosted a client breakfast seminar in Sidley's London office with guests in the asset management, payments and banking sectors. In the seminar, they provided clients with a better understanding of the technology which underpins blockchain and cryptoassets and discussed a number of different possible use cases in a financial services context. Ng and Feehily also discussed the latest regulatory statements, particularly in light of the recent Facebook-led proposal to create a so-called stablecoin, Libra.

As Ng and Feehily discussed, blockchain-based projects are being launched in a wide range of different industries, from retail consumer goods to pharmaceuticals and electricity and power networks to global shipping. However, because of the potential to facilitate near-instant messaging, clearing and settlement, blockchain and cryptoassets have a particularly promising potential in a financial services context.

"For people unfamiliar with blockchain, a key thing to remember is that we are not just talking about Bitcoin," Ng said. "Although clearly Bitcoin and other cryptocurrencies are a big part of the landscape and represent an interesting new asset class in and of themselves, blockchain and distributed ledger technology offer exciting new ways for firms to offer financial services."

"The original use case for this technology was a decentralized payment mechanism" noted Feehily, "but, as Bitcoin has become a speculative asset, its utility as a payment instrument has become secondary. That's one of the reasons why we're seeing the development of a number of stablecoin proposals, including Libra in a retail payments context, but also in financial markets, such as the JPM Coin and the Utility Settlement Coin." This has caught the attention of many global regulatory bodies, including the Bank for International Settlements, whose head, Augustin Carstens, told the Financial Times in July 2019 that global central banks may have to issue their own digital currencies sooner than expected.

When used together with blockchain and distributed ledger technology, smart contracts also represent an interesting opportunity for firms to deliver more efficient financial services. There is a difference though between a "smart contract," which is a piece of automatically executing computer code, and a "smart legal contract," which is a legally binding contractual agreement between parties which allows for performance of

certain parts of the agreement to be facilitated through shared computer code, such as a payment event. Smart contracts operate like digital escrow agents. In the context of a broader legal agreement, a smart contract can perform functions throughout the contract's lifecycle. However, in order for this to work, the parties need to be very clear at the outset as to the intended effect of the computer code in various circumstances. ISDA is currently undertaking work towards the creation of a "computable contract" through the digital representation of its Common Domain Model, which establishes a common set of representations for derivatives events and processes.

Regulatory Guidance

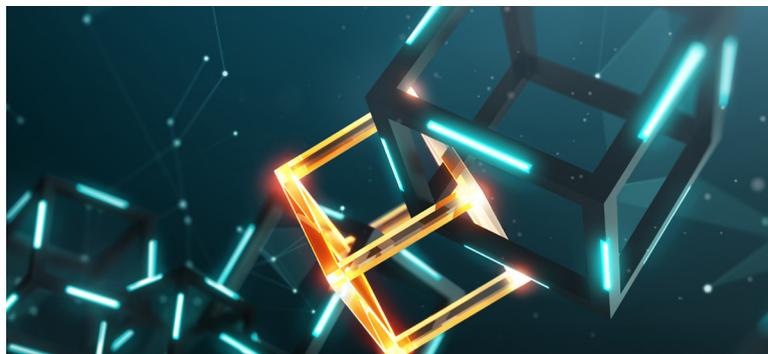
To date, there have already been a number of regulatory publications in relation to blockchain and cryptoassets both at a UK and an EU level.

In January 2019, the FCA published a Consultation Paper on proposed perimeter guidance following on from work done by the UK Cryptoassets Taskforce at the end of 2018. The UK regulatory bodies distinguish three classes of cryptoasset, namely: exchange tokens (i.e., tokens which are used as a means of exchange or for investment and are not issued or backed by a central body); security tokens (i.e., tokens which fall within one of the regulated 'specified investments' under the UK regulatory regime); and utility tokens (i.e., tokens which can be redeemed for access to a specific product or service). The key takeaway message was that firms should apply the existing regulatory regime to determine whether a cryptoasset fell within the regulatory perimeter.

More recently, HM Treasury published a consultation (which closed in June 2019) on the UK's implementation of the EU fifth Money Laundering Directive (MLD5). Taking account of recent FATF guidelines, HM Treasury is considering gold-plating MLD5 to extend the scope of the customer due diligence obligations to a broader variety of cryptoassets business.

From an English legal perspective, the "UK Jurisdiction Taskforce" which is part of the Law Society's "LawTech Delivery Panel" is currently preparing an authoritative legal statement on the status of cryptoassets under English private law. Amongst other things, it is hoped this statement will provide clarity as to questions such as whether cryptoassets can constitute property under English law and the circumstances in which a smart legal contract will be enforceable.

For firms considering investing in cryptoassets or embarking on a blockchain development project, there are a number of things to consider at the outset. "For regulated firms, the UK FCA will expect to see that senior management has been involved in the decision



to undertake a blockchain project or to invest in this new asset class," Ng noted. "Appropriate governance and systems and controls will also need to be put in place and a risk assessment framework should be signed off. An important part in being able to do that, will be for firms' legal and compliance staff to have a strong understanding of this emergent new field."

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