

Blockchain Technology & Buy Side Adoption

Part II: Legal and Regulatory Challenges



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Introduction

[Part I of this series](#) delineated some of the opportunities for blockchain and digital assets in the buy side industry. Despite the potential for new technologies to improve operational efficiencies, lower costs, and better serve clients - which has increased interest among asset managers - the majority of blockchain applications used by asset managers remain in their infancy. In this report, Part II, we consider some of the legal and regulatory questions that buy side managers, particularly asset managers, might face when considering implementing blockchain.

Fiduciary Duty

In most jurisdictions, the key legal duty of an asset manager is a fiduciary one: to act in the best interests of their client. Asset managers generally execute their roles without much involvement from clients and occupy a position of real trust. Distributed ledger technology (DLT) promises decentralization, security, and trust, making traditional asset management seem almost anachronistic. However, we do not yet live in a world where we can fully remove the human touch from these processes. Given the continued demand for their services, asset managers will have to consider how to discharge their fiduciary duties in a world where DLT and blockchain technologies both exist and produce new asset classes.

Use of DLT/Blockchain Technology

How can a technology act in the client's best interests? How do we build paradigms that ensure asset managers make, manage, and dispose of investments in a safe, efficient manner without creating unnecessary risk? These are not legal questions, though they highlight part of a legal duty. Furthermore, regulators tend to be technology agnostic, so long as the technology used does not preclude regulatory compliance. Relevant considerations might include the extent to which the use of DLT changes who is making investment decisions, the level of transparency and oversight of a technology that effectively runs itself, reporting of information to clients, and the efficacy and thoroughness of record keeping. In fact, most of these questions are analogous to those posed to contemporary asset managers, who often rely on algorithms to determine investment strategies and execute transactions.

Asset managers do not operate in isolation; they use the wider market infrastructure as well as services of third parties. Asset managers should consider the extent to which these third



parties rely on DLT, especially if that takes the form of a regulated outsourcing arrangement requiring regulatory approval or notification.

As noted in Part I of this report, there are a number of reasons asset managers believe they can differentiate themselves using DLT: reduced costs, improved speed of settlement, and more efficient compliance, all of which are relevant to the fiduciary question. Over time, it is possible the question may become whether it is possible to act in a client's best interests *without* the support of DLT or blockchain technology.

Investing in Cryptoassets

On the question of investments, buy side firms will have to consider to what extent they can satisfy their fiduciary duties by investing in cryptoassets; if investment in cryptoassets is permitted by applicable regulations, they must consider how to appropriately diversify risk. Again, this raises many non-legal questions such as whether such assets have sufficiently clear and measurable value, and how volatile and liquid they are. However, these issues are relevant to that legal duty, as well as to regulatory requirements. It also raises some practical questions for an asset manager, such as how to buy and sell these assets, hold them, and exercise any rights and discharge any obligations that attach to them. The buy side will need to understand the evolving market infrastructure and what service providers can offer in order to properly discharge their duties and comply with regulatory requirements, such as best execution.

Regulation

Another key legal issue is whether, in order to invest in these types of assets, a manager needs a regulatory licence, which will vary according to jurisdiction. In many jurisdictions, this may depend on the type of buy side activity, with the regulation of discretionary investment management often limited to financial instruments and other types of regulated investment, while operating collective investment schemes or managing funds may be regulated regardless of the regulatory status of the asset, as is the case in harmonized European legislation.

Discretionary management

Where regulation of buy side activity depends on the underlying asset being regulated, the law in many jurisdictions is still developing. At present, many countries attempt to determine



whether a cryptoasset fits one of the existing categories of regulated investment by comparing characteristics with traditional instruments, such as securities. This tends to mean decentralized cryptocurrencies and so-called utility tokens are not treated as investments. However, this is not always a straightforward distinction as these laws were not designed with cryptoassets in mind. Some new types of assets will fall outside the existing scope of regulation, creating what regulators may feel is a regulatory gap.

The European Securities and Markets Authority (ESMA) noted in January 2019 that security tokens are, in principle, covered by the EU legal framework on asset management in so far as such security tokens fall within the scope of “financial instrument” under MiFID II.ⁱ It also stated that examples of the regulatory use cases of DLT in the asset management domain were incidental.

Several jurisdictions are working to determine how best to fill regulatory gaps. However, at least in Europe, it may take some time to reach conclusions, as the Commission indicated that “a gradual regulatory approach might be considered, trying to provide first legal clarity to market participants as regards permissioned networks and centralised platforms before considering changes in the regulatory framework to accommodate permissionless networks and decentralised platforms.”ⁱⁱ In the meantime, some jurisdictions are taking their own steps, with Malta including a financial instruments test for cryptoassets in its Virtual Financial Assets Act and Germany introducing a new category of cryptoassets within its definition of financial instruments.

Fund management

On the other hand, operating collective investment schemes or managing funds tend to be regulated activities even if the underlying assets are not regulated; raising capital from investors with a view to pooling and investing it in accordance with some form of strategy for the collective benefit of those investors triggers a requirement for authorization. In January 2019, ESMA noted that three national competent authorities in the EU had examples of cryptoassets that could form units in collective investment undertakings, two of which were effectively offering cryptoassets that served to pool investments into other cryptoassets and another which was pooling funds to then be invested in real estate assets. Another national competent authority noted several examples of alternative investment funds that it had approved.



Some types of funds are also regulated such that there are restrictions regarding the types of assets in which they can invest, at least up to certain limits or proportions. For example, in Europe, Undertaking for Collective Investment in Transferable Securities (UCITS) schemes cannot invest directly in unregulated cryptoassets or derivatives and exchange traded notes that reference them, although this could change if the cryptoasset market evolves such that eligibility standards can be met. If the index meets certain criteria, UCITS schemes can invest in derivatives referencing an index, though at present it is unlikely that an index referencing cryptoassets could do so.

Supporting services

The legal and regulatory categorization of cryptoassets is also relevant to the services that may be needed to support their management and the type of service providers that an asset manager may need to use.

Crypto custody

A good example of this may be crypto custody, where traditionally the law has required authorization of persons holding regulated investments. A number of companies are set up to hold such assets for investors or their agents, though in some countries they cannot or do not need to be authorized. Indeed, if they were authorized as custodians, it is unclear whether they would be able to comply with the existing custody rules: although some of their fundamental principles such as segregation between proprietary and client assets are also important for the protection of cryptoassets, it may not be possible to comply with many of the detailed rules which assume certain registration mechanics. In addition, existing custody rules may not address other key risks in holding cryptoassets, such as their susceptibility to cyber fraud and theft. In particular, the Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) commented, in relation to the SEC's Customer Protection Rule, that merely maintaining a private key to a crypto wallet for digital securities may not be sufficient because it does not provide enough control for one to reverse or cancel an unauthorized or mistaken transaction and it is difficult to prove that other parties do not have access to the key, which could allow them to make transfers.

Some jurisdictions have taken steps to design bespoke regulation for this service. For example, Germany has introduced a new regulated financial service which covers the custody, administration, and safeguarding of cryptoassets, or of private cryptographic keys used to hold,



store, or transfer cryptoassets as a service for others. As a result, service providers such as custodian wallet providers will now require a licence for crypto custody business.

Settlement

Some of the early use cases of DLT explored its use for quicker and more efficient settlement of assets, including digital assets representing other assets; in Part I of this series this was identified as being a particular benefit for the buy side. Settlement also raises a number of issues which need to be considered given the need for financial market infrastructures, such as securities depositories and settlement systems, to have a clear and enforceable legal basis for their activities. The legal nature of assets must be clearly defined to ensure that DLT is effective for transfers and to clarify the point at which a transfer is final and irrevocable in the event of the failure of one of the parties. Most systems are also designed to minimize settlement risk by achieving delivery of the asset versus payment, which may require some form of link between the two legs of the transaction.

In many jurisdictions, the relevant legal framework of property, insolvency, and contract law for these issues is supported by legislation to help address these questions, though these do not generally address cryptoassets specifically. The European Commission has recently consulted on whether the relevant pieces of European legislation can be interpreted in such a way that would permit the use of DLT for settlement or whether it is necessary to design a bespoke framework. The responses indicate a range of views, so it remains to be seen how this will progress.

In the U.S., the Commodity Futures Trading Commission (CFTC) recently issued final guidance on “actual delivery” for digital assets, which relies on two factors: “(1) a customer securing: (i) possession and control of the entire quantity of the commodity... and (ii) the ability to use the entire quantity of the commodity freely in commerce (away from any particular execution venue) no later than 28 days from the date of the transaction and at all times thereafter; and (2) the offeror and counterparty seller... do not retain any interest in, legal right, or control over any of the commodity purchased on margin, leverage, or other financing arrangement at the expiration of 28 days from the date of the transaction.”ⁱⁱⁱ Large, influential jurisdictions clearly defining the regulatory treatment of digital assets will help provide legal clarity for the technology moving forward.



Other legal and regulatory challenges

There are of course many other legal and regulatory challenges for buy side firms seeking to deploy DLT or invest in cryptoassets. There are important legal issues - for example, in a public blockchain system, it is not clear who should be held accountable for any breach of law (since no central party exists) or even which law applies (in the event that nodes span multiple jurisdictions). While some of these issues can be agreed upon between the participants in a permissioned blockchain, any asset manager using them would need to be comfortable with the arrangements for governance and disputes, as well as the risk that other laws may be relevant, regardless of what is agreed.

Complying with requirements to protect personal data may also be a challenge given that one of the most important and revolutionary features of blockchain is its ability to store immutable information, which does not sit comfortably with some of the fundamental principles of data protection and privacy.

On the other hand, blockchain technology has the potential to significantly improve some aspects of regulatory compliance, especially anti-money laundering and counter financing of terrorism (AML/CFT) measures.

Looking forward

Around the world, lawmakers, regulators, and those crafting relevant policy are working to upskill on DLT, engaging industry to develop appropriate legislative and regulatory frameworks to ensure benefits outweigh risks. It is essential that the buy side continues to actively develop new use cases and mechanisms to mitigate risk, while engaging regulators and other stakeholders to demonstrate the technology's benefits. Many jurisdictions have implemented fintech initiatives, including regulatory sandboxes, which allow innovative ideas to be tested in a real but controlled environment; fintech accelerators and innovation hubs such as the UK Investment Association's Velocity are excellent examples of this.

ⁱ https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf

ⁱⁱ https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2019-crypto-assets-consultation-document_en.pdf

ⁱⁱⁱ <https://www.cftc.gov/PressRoom/PressReleases/8139-20>