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# US RegTech: the dawn of the digital era for federal financial regulation?

In June 2017, Hogan Lovells and Innovate Finance co-published a white paper called 'The Future of RegTech for Regulators,' which studies the FinTech and RegTech initiatives across the globe and provides insight into what the US can learn from them. Richard Schaberg, Laura Biddle, and Loyal Horsley of Hogan Lovells, who were involved in the creation of the white paper, explore the report's 'holistic approach' to integrating RegTech for regulators, which involves a framework with three approaches.

FinTech has been a hot topic for years - what changes can mobile banking bring to the unbanked and underbanked communities around the world? What credit options can open for the traditionally subprime market with online marketplace lenders? The potential for FinTech to change the financial system, and the world, still seems incredible. More recently, the financial services sector has considered another side of FinTech: integrating technological solutions into the industry's regulatory compliance obligations in order to streamline compliance requirements.

RegTech for regulators, or 'SupTech' (as it is sometimes called), could potentially allow US financial regulators to once again lead the international conversation on financial services and innovation. As discussed in our recent white paper, *The Future of RegTech for Regulators: Adopting a Holistic Approach to a Digital Era Regulator*, which we co-authored

with Innovate Finance, a UK-based trade association representing the UK's 'global fintech community,' the US financial regulatory system is lagging behind many of its international counterparts. Our discussion of the 'holistic approach' to integrating RegTech for regulators hinges on a framework with three approaches, which can be taken in sequential order or be used separately: (i) the Ecosystem approach; (ii) the Digital Financial Infrastructure ('DFI') approach; and (iii) the Rule and Process Change approach. We outlined each of these approaches and provided domestic and international examples of their utility and potential.

## Step one: Ecosystem

The Ecosystem approach calls for the creation of a technology friendly environment. In the UK, for example, the Government and regulators have worked to be at the forefront of the FinTech conversation. This includes encouraging innovation and creating the Bank of

England's FinTech Accelerator, which allows the government and industry to work together and better understand the new innovative solutions and how these solutions could work with the existing infrastructure. Singapore is perhaps the best illustration of a government creating a fertile ecosystem, which is possible due to its centralised government. The Monetary Authority of Singapore has stated its vision for a 'Smart Financial Centre' and worked to realise that vision by creating: an innovation lab; a FinTech and Innovation Group (which works with industry to foster innovation in the financial services sector), the Financial Sector Technology & Innovation Scheme (which provides grants and investments in FinTech), and a FinTech Office to provide a single point of contact/access for all FinTech-related matters.

Some US players have recently begun to recognise the importance of creating an inviting ecosystem for FinTech and

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RegTech. The Consumer Financial Protection Bureau (‘CFPB’) was really the first mover among federal financial regulators, launching Project Catalyst in 2012. Project Catalyst works to engage the FinTech industry so that innovators consider consumer protection and compliance early in the development of new financial products and services. The Office of the Comptroller of the Currency (‘OCC’) has created an Office of Innovation, the purpose of which is to serve as the point of contact for all FinTech related questions with regard to national banks (or relationships with national banks). The Commodity Futures Trading Commission (‘CFTC’) recently announced the launch of LabCFTC, the purpose of which is to facilitate communication with the industry in order to ensure responsible innovative solutions in the derivatives and commodities markets. Finally, the Financial Industry Regulatory Authority (‘FINRA’), which is a self-regulatory organisation rather than a federal financial regulator, established an Innovation Outreach Initiative with the goal to better engage the FinTech community. State financial regulators have been more proactive and welcoming of the FinTech industry and FinTech solutions, as most FinTech products and services require state licensure (e.g., money transmitters, non-bank lenders, loan servicers, and debt collectors, among others).

To date, these efforts have had varying success and the only long term outreach program is the CFPB’s Project Catalyst, which may be slightly hampered by the relative pall hanging over the agency since it was established. Success notwithstanding, these efforts represent the acceptance by federal regulators of FinTech as an important addition to the financial services industry, which will encourage more players to enter the market. Regulator interaction with the industry will foster innovation, both for consumer facing products and services and for the tools the regulators use to supervise entities and to monitor and enforce compliance.

### Step two: Digital financial infrastructure

While FinTech products and services are revolutionising the financial services industry, the products or services themselves are not new but rather traditional consumer financial products

repackaged and delivered in new ways. Similarly, RegTech solutions are not rethinking compliance obligations, such solutions are potential aids to meet current compliance requirements in a more efficient and effective manner. This means that these new tools are running through the same systems as the old products and services. New technology cannot safely and efficiently run on old tracks. The financial infrastructure must change in order to continue to effectively provide financial products and services to the populace. However, unlike the creation of a friendly ecosystem or revising rules and processes, changing and updating infrastructure is an incredibly expensive process.

The UK and Austria are in the midst of updating their financial infrastructure. In the UK, the Payment Systems Regulator (the world’s first dedicated payment systems regulator) has established a Payment Strategies Forum and has released its plan to update the UK’s payment system, which includes dramatically simplifying the current system, which will immediately speed up payments and settlement. Austria’s central bank has worked with the financial sector to create a common software platform, to allow for the implementation of a new, streamlined regulatory reporting model.

It is India, though, that has completely overhauled its infrastructure to address the new digital world. India has created the ‘India Stack,’ which aims to create a digital identity for every person in India. This system provides the opportunity for a previously unbanked population to gain access to financial services. Further, the provision of identification numbers for every citizen enables better tracking, better monitoring for fraud, and simply more opportunities due to its uniform system for delivering government services to a population of 1.3 billion.

The US Government is unlikely to even attempt such a far-reaching and transformative infrastructure change; however, the US is planning some important changes. First and foremost, President Trump reiterated his commitment to revitalising American infrastructure throughout the campaign, stating that the US would spend \$1 trillion to update our

“crumbling infrastructure.” Once in office, by Executive Order, he created the Office of American Innovation, which is headed by Jared Kushner. While nothing has come from this new office as of now, it has the potential to be a point of contact for proposed technological infrastructure innovations.

As discussed above, the CFTC recently announced its LabCFTC initiative. One of the main goals of the initiative is to achieve ‘CFTC 2.0,’ which represents the agency’s willingness and desire to adopt and adapt to the new technologies available to create a more technology and innovation friendly regulator. The Board of Governors of the Federal Reserve System (‘Federal Reserve’) has not created an outreach program or similar initiative, but it has drafted task forces and held forums to better understand and address the opportunities and issues presented by FinTech and RegTech. The Federal Reserve has issued a report on the use and integration of distributed ledger technology (‘DLT’; for purposes of clarity all such systems are referred to as DLT in this article) into the payments, clearing, and settlement systems. The report concluded that DLT is potentially transformative, but is still relatively untested. The Federal Reserve has convened a task force and issued a report regarding the creation of faster payment systems, acknowledging the need to update the payment systems infrastructure. These reports are important and indicate the Federal Reserve is engaged in the conversation and with the industry. Any large infrastructure projects, however, will require funding from Congress, which is unlikely to happen in the near future.

Once again, at the state level there are some very encouraging signs. The National Mortgage Licensing System (‘NMLS’), mandated by the federal SAFE Act, has been an incredible success. It began as a central repository for states’ mortgage licensing requirements (including applications and ongoing reporting obligations) and now has expanded to include many other licences, including money transmission and virtual currency. Each state decides its level of participation, but the majority has chosen to offer more licenses through NMLS, providing a more streamlined and efficient process for industry.



## In the UK, regulators have been careful to be forward-thinking in their rule revisions, including defining new regulations in machine readable format and mandating an open API framework for the nine largest account providers in the UK.

### Step three: Rule and process change

As discussed above, many FinTech products and services are new versions of old products and services, usually with a different delivery system. RegTech solutions, on the other hand, are often completely new tools that can be used to meet existing compliance obligations. DLT is such a tool. The complete digitisation of applications and regulatory reporting are perhaps less exciting, but would be similarly innovative. However, many of the statutes and regulations regarding financial regulatory compliance are prescriptive as to the delivery/system of meeting compliance requirements. Thus, statutes and rules would have to be amended to address RegTech innovation.

In the UK, regulators have been careful to be forward-thinking in their rule revisions, including defining new regulations in machine readable format and mandating an open API framework for the nine largest account providers in the UK. This technology neutral, forward-thinking approach is essential because technology is evolving at an incredibly rapid pace. If a new rule is too prescriptive, it will be rendered obsolete very quickly. New rules obviously must be drafted to ensure compliance with relevant obligations, but also with the rapid pace of innovation in mind.

The US Securities and Exchange Commission ("SEC") and the European Union offer potential cautionary tales about the adoption of new rules and processes. The SEC has worked to make its online repository of public disclosures, EDGAR, more tech friendly. In order to achieve that goal, in 2009 the SEC mandated the use of interactive data reporting. That system, XBRL, while now

fully implemented, required a great deal of time, training, and funding, by both the industry and the SEC. With the ever-growing use cases for DLT, as well as the introduction of a bipartisan bill, the Financial Transparency Act (H.R. 1530), which would mandate fully searchable, standardised, machine readable data across the federal financial regulators, it appears XBRL may be rendered obsolete rather quickly. However, the SEC and reporting companies may be reticent to 'waste' sunk costs and could be incentivised to argue against potentially better solutions. Similarly, the EU's General Data Protection Regulation was designed to be technologically neutral, but did not take into account the potential of DLT. Even with its technology neutral stance, the use of DLT may not fit into the structures of data protection and presentation.

Besides the SEC's EDGAR update and the introduction of the Financial Transparency Act, the US has not yet focused on rule and process change. Recently, FINRA released its report on DLT and requested comment from industry and interested parties. While FINRA's questions regarding the use of DLT in US capital markets are unlikely to have a dramatic impact, it was the best opportunity to 'speak' to the SEC on the issue of integrating DLT into capital markets, as the SEC will certainly take an interest in both FINRA's report and the comments thereto. At the state level, there have been more widespread efforts to pursue statutory and regulatory changes to address innovative solutions. Cook County, Illinois has created an initiative to replace the property title transfer system with one using DLT. The Cook County Recorder of Deeds

is the second biggest in the nation, so its success could represent an amazing opportunity for the use of DLT in state and local governments. Similarly, the State of Delaware has announced an initiative to move its corporate chartering, reporting, and transactions onto a DLT system. As Delaware is the most popular state for corporate chartering, the introduction and ongoing use of DLT could set a national trend.

### Next steps

The US financial regulatory system is more complex than that of almost any of its international counterparts: there are many federal regulators, some with overlapping jurisdictions, there are 50 states, plus the District of Columbia, Puerto Rico, Guam, and the Virgin Islands each with its own regulatory scheme. This complexity means that the sweeping adoption of RegTech is unlikely. However, in this arena, states are fulfilling their role as laboratories, perhaps acting as 'sandboxes' for FinTech and RegTech innovation and integration in financial services. The states are pushing new initiatives that may lead to piecemeal adoption of RegTech solutions in order to foster increased competition with federal regulators and other state regulators for FinTech business. At the federal level, a disinterested, hostile Congress and an incredibly partisan environment mean the chances of passing new laws focused on innovative regulatory solutions or providing increased funding or freedom for the regulators, is next to zero. However, a competitive spirit is one of the United States' defining characteristics, so allowing the rest of the world to pull ahead in financial technology and innovation is unlikely to sit well and may spur change and new solutions.