Blockchain and Banking: Anticipating Federal Regulation in the United States

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Introduction

Blockchain technology, popularized by the virtual currency, Bitcoin, is being hailed by many as a ground-breaking innovation that will increase efficiencies in the global economy. Its applications could be far reaching, but presently its impact is most evident in the banking sector. Banks view blockchain as a tool to decrease transaction costs, processing times, and fraud. To illustrate the fervor behind blockchain, in September 2015, a consortium of nine banks established R3, a company focused on the research and development of blockchain. Within three months, the number of banks involved with R3 ballooned to 43.

Although, as discussed below, blockchain is praised for its self-regulatory mechanisms, issues with Bitcoin theft, market manipulation, and its use in illegal transactions have forced governments around the world to consider oversight. U.S. federal and state regulatory boards have expressed interest in policing the use of blockchains in financial transactions, and some have already taken action. Most of the current and proposed regulation deals with virtual currency, but these regulations provide insight into how governments will handle all types of blockchain activity.

This article will examine the future intersection of banking law and blockchain technology. First, it will provide a brief explanation of the technology and its potential uses by banks. Then, through an examination of the current regulatory
climate of virtual currency, it will discuss legal issues that banks should consider as they implement blockchains into their system. As this technology permeates financial markets, banks should prepare to adapt their practices, both to take advantages of opportunities and to conform to new laws.

**Blockchain and Its Use in Banking**

Although the inner workings of a blockchain system may be intimidating to tech novices, the concept is fairly straightforward. Basically, a blockchain is a ledger that is shared and verified by many different parties. An update to the ledger can only occur if a majority of users approve it. The approval process is technical, involving a cryptographic procedure, but ultimately users can theoretically share incorruptible information. Currently, parties typically rely on intermediaries, such as banks, to verify transactions, a blockchain could allow users to directly interact in a digital space without fear of fraud. Rather than creating anxiety in the banking world, this possible paradigm shift in financial transactions has inspired banks to develop new applications on the blockchain platform.

Banks foresee many uses for this technology. For example, by implementing "smart contracts" (i.e. a computer program that can automatically execute the terms of an agreement) on a blockchain, banks could establish syndicated loans in a fraction of the time and with fewer administrative hurdles. Banks could also utilize a blockchain to reduce inter-bank clearing requirements and provide for real time payments. Further, banks could reduce operational costs by using a blockchain to ensure compliance with anti-money laundering and know your customer laws. Experts theorize even more potential applications of blockchain in banking are on the horizon.

**Lessons from Virtual Currency Regulation**

Legal issues with virtual currencies and blockchain have sparked debate over proper regulation. Numerous federal regulators, including the Commodities Futures Trading Commission (CFTC), the Financial Crimes Enforcement Network (FinCEN), and the Securities and Exchange Commission (SEC) have released opinions on the topic. Likewise, six states have passed legislation or provided regulatory guidance. These materials have largely focused on virtual currency, rather than the blockchain technology that underpins it. However, by reviewing these materials, banks will be in a better position to anticipate and comply with future regulatory constraints on all types of blockchain systems.

One major focus of federal regulators has been ensuring that virtual currency exchanges comply with anti-money laundering (AML), know your customer (KYC), and consumer protection laws. Authorities are noticeably worried that money launderers and terrorist financiers could use virtual currencies to circumvent traditional banking institutions, because many virtual currency exchanges promise anonymity. For example, in May 2015, FinCEN assessed a $700,000 penalty
against Ripple Labs Inc., a virtual currency exchange, for failing to implement adequate AML programs.

Of course, AML, KYC, and consumer protection laws are not new to banks. However, banks should begin to consider how to integrate compliance programs into their blockchain systems. Blockchains could be used to verify customer identities in a fast, cost effective manner. Thus, blockchains, when appropriately programmed, can solve the problem of anonymity created by virtual currency exchanges.

A second issue regulators face is defining the information or instrument being transferred on the blockchain. For example, ambiguity exists as to the definition of virtual currency. Some agencies view it as a commodity or a security, while others view it as actual currency. The definition determines which agencies have authority to police virtual currency. Due to uncertainty, many agencies are preparing to regulate virtual currencies, which could lead to burdensome rules.

With this in mind, banks should proactively define the information and instruments that are transferred on their blockchains. Generally, the instruments will be easily definable (e.g. transfer of U.S. Dollars or stocks). However, where ambiguity exists, banks should work with the government to ensure that regulations are consistent and efficient.

Finally, the serious scrutiny that virtual currency faced shows banks that transparency and cooperation are crucial to prevent regulatory overreaction. The initial opinions and guidance on virtual currency were a response to multiple negative reports on Bitcoin. In 2011, Bitcoin became heavily linked to the black market because individuals were using the virtual currency to buy illegal materials online. Further, some have speculated that large Bitcoin holders have manipulated the Bitcoin market to make a quick profit. These stories portrayed virtual currency and blockchain as a seedy technology that needed stringent oversight.

To prevent other blockchain systems from reaching the same fate, banks must be transparent with government agencies. Banks should demonstrate that new blockchains are secure, protect consumers, and do not create unnecessary financial risk. Public relations will be an important part of blockchain implementation, as the technology tries to distance itself from the issues of Bitcoin.

**Takeaway**

Blockchain technology provides exciting opportunities to the financial services industry. If blockchain delivers the reduced transaction costs and processing times, banks on the forefront of research and development will gain a distinct competitive advantage. Banks should learn from the regulatory pushback against virtual
currency. Financial institutions that anticipate regulations and cooperate with government agencies will be more successful at seamlessly implementing their blockchain systems.

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