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SEC Holds Forum to Discuss Fintech in the Financial Services Industry

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On November 14, 2016, the Securities and Exchange Commission (SEC) held its first public forum to discuss financial technology ("Fintech") innovation in the financial services industry. The Fintech Forum was divided into four panels and addressed issues relating to automated investment advice, or robo-advisors; distributed ledger technology, or blockchain; online marketplace lending and crowdfunding; and investor protection. Panel participants included current and former state and federal regulators, policy experts, advisors and industry stakeholders. The SEC's forum follows other work agencies have done to better understand Fintech, including the Consumer Financial Protection Bureau's Project Catalyst and October 2016 report; the Office of the Comptroller of the Currency's March 2016 paper, June 2016 forum and October 2016 framework regarding responsible innovation; and the Federal Trade Commission's June 2016 marketplace lending forum. Earlier in the year, SEC Chair Mary Jo White directed the creation of a Fintech working group within the SEC to evaluate emerging technologies and assess SEC policy and regulatory requirements applicable to Fintech firms. In her opening remarks, Chair White noted that this forum was a component of the working group's efforts to solicit input from Fintech stakeholders.

Panel 1: Impact of Recent Innovation in Investment Advisory Services

The first panel included representatives from three firms that offer digital financial advisory platforms and a representative from a global association of investment professionals. The panel discussion focused on the rapid rise of robo-advisors, or automated investment advisory services, provided by both traditional asset managers and standalone online platforms, and related business and regulatory issues. The SEC moderator noted in her opening remarks that the digital advice model is currently projected to grow to over $2 trillion in assets under management by the year 2020.

The panel discussion began by focusing on the factors that are driving growth in this sector. The panelists noted that digital advisory platforms attract retail clients that do not currently utilize traditional investment services due to a lack of investable assets. Such platforms also address a growing "retirement crisis" and attract retail clients that will not have access to the same retirement benefits of past generations. Digital advice is data driven, testable and transparent, and allows financial advisors to scale their existing financial models while providing high-level investment services to a greater segment of the population.

Digital advice represents a wide spectrum of delivery models. Some platforms offer an exclusive digital relationship, while other platforms may offer an exclusive human relationship that is supported by digital technology. Digital advisory platforms can be used to meet the financial objectives of investors across a wide financial spectrum. While digital advisory platforms are often associated with millennials, the panelists emphasized that such services can benefit everyone, not just younger investors. The panelists acknowledged, however, that a certain level of comfort with technology is necessary in order to manage wealth through a digital platform. The panelists also noted that older investors are gravitating to digital advisory platforms because of the transparency and convenience they offer.

To conclude the panel discussion, the panelists addressed some of the regulatory challenges and issues that arise in the digital advice space. One of the issues raised by the panelists was fiduciary duty and compliance with the Investment Advisers Act of 1940. While digital advice services offer a new technology-based platform for client advisement, the technology is managed by human financial advisors who are legally obligated to act in the best interest of the client. Another issue discussed by the panelists was algorithm design and oversight. Digital advisory platforms are designed to aggregate and analyze financial information and make investment recommendations that are personal to the specific goals of an investor. One panelist noted that industry participants need to collaborate on the standards for evaluating and applying such algorithms.

The panelists agreed that in five to 10 years, the term "robo-advisor" will no longer exist because digital advice services will be fully integrated into every aspect of the financial services industry. With that in mind, regulators need to ensure that oversight and examinations of financial advisors continue to evolve with the rapid changes in the industry.

Panel 2: Impact of Recent Innovation on Trading, Settlement, and Clearance Activities

The second Fintech panel focused on distributed ledger technology, commonly referred to as "blockchain," and its impact on the financial industry's trading, settlement and clearance activities. The discussion was moderated by the SEC's assistant director of the Division of Enforcement and head of the SEC's Distributed Ledger Technology Working Group. Distributed ledger technology enables recordkeeping without a centralized authority, instead relying on a decentralized electronic ledger of all transactions and activities that occur on the network, which all participants on the network may view. Blocks of transactions are recorded, including timestamps and a reference to the preceding block, and the ledger is updated when network participants reach a consensus.

The wide-ranging panel discussion addressed business factors driving the financial industry's interest in distributed ledger technology, including the potential for financial institutions to reduce costs and operate more efficiently. The discussion described several current cases involving distributed ledger technology, both within the financial industry, such as for clearing and settlement systems, and more broadly, including in the energy and health care industries.

The panel discussed potential benefits for consumers and investors, including reduced costs for products and services. The discussion also addressed how the growth of distributed ledger technology might affect regulated entities, with some panelists suggesting that distributed ledger technology is not likely to make existing services obsolete, but rather prompt the roles of certain institutions to change. The moderator noted that, while the SEC's mission is to protect investors and the financial markets, the SEC does not want to obstruct the growth of new technology that has the potential to benefit investors. The panel discussed how distributed ledger technology could affect the role of regulators and auditors, with one panelist suggesting that the continued growth of distributed ledger technology may enable regulators and auditors to become more proactive in oversight and help facilitate the supervision of markets and market participants.

The SEC has been considering the implications of distributed ledger technology for securities settlement and other areas of SEC supervision for some time. For example, in 2015 the SEC released an advance notice of proposed rulemaking (ANPR) regarding the transfer agent rules that apply to securities settlement, requesting public comment for consideration of potential future SEC rulemakings. Included among the SEC's questions was the following question regarding distributed ledger technology:

> A new technology, the blockchain or distributed ledger system, is being tested in a variety of settings, to determine whether it has utility in the securities industry. What utility, if any, would a distributed public ledger system have for transfer agents, and how would it be used? What regulatory actions, if any, would facilitate that utility? How would transfer agents ensure their use of or interaction with such a system would comply and be consistent with federal securities laws and regulations, including the transfer agent rules? Please explain.

In a March 31, 2016, speech, Chair White commented that distributed ledger technology "has the potential to modernize, simplify, or even potentially replace, current trading and clearing and settlement operations," and stated that comments to the transfer agent ANPR will help the SEC determine "how to best regulate these new innovations." These recent developments and the SEC's Fintech Forum panel discussion suggest that distributed ledger technology will continue to be a focus for the SEC.

Panel 3: Impact on Recent Innovation in Capital Formation

The third panel focused on the impact of recent innovations in capital formation, mainly with crowdfunding and online marketplace lending. Panelists included representatives from a small business lending platform, a venture capital firm, a data and analytics firm and a due diligence and compliance services firm. The panel also included a state financial services regulator and a former administrator from the U.S. Small Business Administration (SBA).

The moderator started the conversation broadly by asking panelists to share their perspectives on the impact of financial innovations on capital formation. The former head of the SBA talked specifically about capital formation in the small business sector. She described how such innovations in the small business lending market have sought to fill in the gaps left by traditional financing sources, particularly when the capital markets froze during the recent financial crisis. The panelist further noted that gaps still exist in the small business lending market in "small dollar" loans (loans under $250,000) and in equity capital. The state regulator noted that to date, the small business lending market is the least automated and most paper-intensive segment of the lending market. Online marketplace lending, however, has significantly streamlined the lending process and allows small businesses to access credit within a shorter timeframe. Several panelists agreed that marketplace lending has evolved past its first phase, which they referred to as the Wild West. The former head of the SBA commented that the marketplace lending landscape is evolving from a phase of competition between banks and online marketplace lenders to partnerships. Online marketplace lenders offer what most banks have lacked—customer-facing technology with the ability to attract business. Banks, on the other hand, can tap into their existing customer base. Banks are increasingly partnering with online marketplace lenders in a number of ways, including licensing online applications or entering into white label arrangements.

The panel also examined how the recent development of marketplace lending securitizations has enabled small businesses to effectively access the capital markets. One panelist also referenced a recent *Wall Street Journal* article citing that more than half of mortgages are now funded by nonbanks. Nonbanks do not have access to cheap deposit financing, and so such entities look to the securitization markets that offer permanent capital at a lower cost and at scale.

The moderator shifted the conversation to discuss the types of information investors need in order to make an informed investment decision in the marketplace lending space. The panelists focused on the importance of standardized loan-level disclosure and the need for adequate disclosure around bankruptcy-related events and business continuity. One panelist noted that while investors want more standardized data, the higher relative costs of issuing asset-backed securities in the public securitization market, which is subject to more stringent SEC disclosure standards, including Regulation AB, has caused marketplace issuers to issue asset-backed securities in the private, Rule 144A market.

The panel moved on to address current challenges facing investors, issuers and intermediaries in crowdfunding. In light of recent innovation and diversification in the types of instruments that are being offered to investors (e.g., a Simple Agreement for Future Equity (SAFE) and a Keep It Simple Security (KISS)), one panelist expressed concern that due to a lack of standardization in documentation and structure, some investors may not have the tools to make a well-informed investment decision. The panelist predicted, however, that the market would eventually achieve some level of standardization. Panelists discussed some of the regulatory disclosure hurdles that small businesses and startups face as first-time issuers. In this regard, one panelist stressed the importance of issuer education around preparing offering disclosure. This panelist noted, however, that some discipline is being imposed by marketplace intermediaries and emphasized the importance of the role such marketplace intermediaries must play in navigating a new issuer through the disclosure and due diligence process. The state regulator shared his perspective on the success that state-level crowdfunding has achieved. More than 30 states have implemented, or are in the process of implementing, state-based crowdfunding. He also forecast that the SEC's recently adopted final rules amending Rule 147 and adding Rule 147A will have a positive impact on intrastate offerings. The panelist noted, however, that there still exists a "knowledge gap" with crowdfunding mechanics, and he highlighted the importance of issuer and investor education both with federal and state crowdfunding offerings.

At the conclusion of the discussion, a panelist acknowledged the SEC's work thus far in proactively engaging online market participants and monitoring industry developments. The panelist noted, however, that regulators need to come to the table on both federal and state levels, and coordinate and clarify existing regulatory guidance in order for the industry to experience continued growth.

Panel 4: Investor Protection in the Fintech Era

The final panel was moderated by the SEC's director of the Office of Compliance Inspections and Examinations. The panelists included a CEO of a Fintech software advisory firm, a former SEC regulator and an SEC investor advocate. The discussion focused on Fintech's impact on investor protection and some of the inherent challenges faced by both market participants and regulators in light of Fintech innovation. The panelists acknowledged that investors have benefited from Fintech innovations by gaining access to more detailed information. In addition, one panelist noted that financial firms and banks on the sale side have adopted, or are in the process of adopting, new technologies in order to enhance risk and compliance platforms. The adoption of such technologies by participants in the capital markets seeks to improve market transparency and ultimately benefit the investor as the end-user.

The panelist agreed that the biggest challenge financial firms face when using or adopting technology-based innovations is maintaining investor trust. The panelist noted that new Fintech innovations provide market participants with the capabilities to improve on investor trust. For example, automated systems allow market participants to better manage the quality, dissemination and security of data. One panelist stressed, however, that regulators need to generate trust in the system and not in any particular player or platform. The panelists noted that while a strong regulatory framework may help improve investor confidence in new technologies, complex bright-line rules and regulations may create barriers to entry for both large financial institutions and startups. Large financial institutions must balance the need to innovate against regulatory compliance. Startups often do not have the internal resources to determine how and what regulation applies to the technologies they use or develop. As a result, startups tend to adopt such technologies and later work with regulators to address regulatory compliance issues, rather than ensuring that new technologies fit precisely within the related regulatory framework before implementation. One panelist observed that startups, however, have adopted a number of innovative ways to address the issue of investor trust, including hiring experienced, top talent from seasoned financial institutions for their C-suite positions and boards of directors.

The panel discussed how regulators, including the SEC, should address technology innovations in the financial services industry. The panelists agreed that regulators need to actively review their current rulebooks and determine what changes are necessary. The panelists also noted that regulators need to stay abreast of the technology that is being used in the industry. One panelist recommended that the SEC react to such changes by hiring technology experts and investing in training programs for its staff. Another panelist suggested that the SEC use technology innovations to make application programming interfaces (APIs) or industry data more accessible to market participants as a utility and to further spur innovation. A number of panelists agreed that in assessing its current regulatory framework, the SEC should consider adopting flexible standards over bright-line rules. Flexible standards are less likely to chill the adoption of Fintech innovation by regulated entities and take into account the net effect Fintech innovation has on the financial services industry.

Conclusion

The SEC's Fintech Forum made clear that a number of Fintech innovations have the potential to transform the U.S. financial markets and the way such markets are regulated. However, in order to maximize the benefits of Fintech innovations, innovators and other market participants must continue to engage in active dialogue with both state and federal regulators. The SEC's Fintech Forum is likely to be one of many avenues through which the SEC will receive input from industry stakeholders as it continues to evaluate how its current regulatory framework can effectively address ongoing innovations in financial technology.

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