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ICYMI: Fintech Regulation Needs More Principles, Not More Rules

Op-ed by Chairman Tarbert Featured in Fortune

These are exciting times for our derivatives markets. From blockchain to digital assets, innovative financial technologies are changing the way derivatives markets work.

The Commodity Futures Trading Commission (CFTC) has an important role to play in determining how these new products and technologies evolve. Our mission is to promote the integrity, resilience, and vibrancy of derivatives markets through sound regulation. The trick with digital assets is to foster the development of exciting new products while mitigating potential risks.

We must remember that how we regulate is just as important as what we regulate. That's why a principles-based approach is the best way to govern this emerging market.

Principles-based regulation involves moving away from detailed, prescriptive rules and relying more on high-level, broadly-stated principles to set standards for regulated firms and products. Companies will then be responsible for finding the most efficient way of satisfying those standards. Such an approach affords greater flexibility to the tech sector. It will also enable the CFTC to stay ahead of the curve by reacting more quickly to changes in technology and the marketplace.

A more principles-based approach can help reduce the need for volumes of regulations that seek to dictate every aspect of a firm's behavior. As Winston Churchill put it, "If you make 10,000 regulations, you destroy all respect for the law." Yet Titles 12 and 17 of the U.S. Code of Federal Regulations—which together cover banking, securities, and derivatives regulation—now total over 13,000 pages.

It is important to recognize that principles-based regulation is not a euphemism for "deregulation" or a "light-touch" approach—far from it. Principles-based regulation is a different way of achieving the same regulatory outcomes as rules-based regulation. But it simply does so in what is, in many cases, a more efficient and flexible manner. That flexibility also prevents subversion of those outcomes through the kind of loopholes that revealed the inherent vulnerability of rules-based regulation in the run up to the financial crisis.

Of course, in practice, it is rare for to have either a purely principles-based or a purely rules-based regulation. Rather, they represent two ends of the regulatory spectrum. Every principles-based regulatory regime has some rules, and every rules-based regime has some element of principle. For this reason, we frequently see hybrid regulatory systems of principles and rules. The appropriate mix of each will depend on a number of factors, such as the regulatory objective, maturity of the market, the characteristics of market participants, and quality of the regulator.

Applying this analytic framework to digital assets and other fintech products leads me to conclude that we should take a predominantly principles-based approach in this area. Some issues that touch customer protection—the treatment of assets held by financial firms on behalf of customers, such as cash and securities held as margin, for instance—are generally more suited to a rules-based approach. But overall, CFTC staff is currently considering how the core principles applicable to exchanges (venues where derivatives trades are executed) and clearinghouses (entities that take on and manage the post-trade counterparty credit risk) can be better tailored for fintech.

For instance, core principles have been central to our evaluation of clearinghouses that would clear derivatives resulting in delivery of Bitcoin. Digital assets face the unique operational risk of a systems hack that could result in loss or theft. Our core principles include a requirement that clearinghouses have systems to identify and minimize operational risk. The CFTC does not have formulaic, prescriptive rules laying out what systems are required. The agency also does not spell out how operational risk must be allocated between clearinghouses and its members and customers. Yet derivatives clearinghouses are anything but lightly regulated.

Because we took a principles-based approach, each of our three clearinghouses currently handling digital assets was able to adopt a different method of facilitating Bitcoin transfers and addressing the risk of loss. Each worked with our front-line staff to comply with the CTFC's core principles governing operational risk and the allocation of losses. This approach is allowing the market to develop under sound regulation but with market participants, not the regulator, determining which specific arrangements are commercially viable.

Given the rapid pace of innovation and the markets supporting it, taking a principles-based approach to regulating digital assets and other fintech products would permit a period of development and observation. After we fully understand the outcomes and potential risks of digital assets, it may be appropriate to adopt more tailored and targeted rules, or a more balanced combination of principles and rules. What we don't want to do is take a heavy hand and snuff out innovation altogether.

Of course, our willingness to allow innovation to develop should not be confused with a tolerance of fraudulent behavior or a so-called light-touch approach. The CFTC has been actively policing the digital asset markets, having brought more than a dozen enforcement actions in this area against scammers and entities offering unauthorized derivatives. We have also recently brought actions for violations of our core principle obligations, demonstrating the high standards the CFTC has set even if we allow reasonable discretion in how those standards are met by regulated firms.

In many circumstances, principles-based regulation can provide a more effective regulatory approach for overseeing financial services in this global technological age than a highly prescriptive rules-based approach can. Ensuring that America remains a global fintech leader will be essential to our future prosperity. Principles can ensure sound regulation without unsound consequences for innovation.

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