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Top UK Cybersecurity Agency Takes Big Step For Blockchain

By **Mark Taylor**

Law360, London (January 20, 2017, 9:13 PM GMT) -- As financial firms continue to explore how blockchain technology will transform or even threaten their businesses, Europe's top information security agency on Wednesday took its first plunge into addressing the potential impact of the technology — a significant milestone, lawyers say, in the journey toward industry and regulatory acceptance.

The European Union Agency for Network and Information Security — which assists EU countries and the European Commission, the bloc's executive body, in meeting the requirements of network and information security in present and future legislation — issued a paper Wednesday that investigates some of the cybersecurity risks around distributed ledger technology, also known as blockchain.

A new report from Europe's top information security agency offers the "last piece of the puzzle truly missing" for banks and regulators to fully embrace blockchain, which is the technology behind cryptocurrencies like bitcoin, says DLA Piper's Nicolette Kost De Sevres. (AP)

"This is the last piece of the puzzle truly missing in order to embark on the road towards fully embracing distributed ledger technology," said Nicolette Kost De Sevres, Paris and Washington, D.C.-based senior policy adviser at DLA Piper.

"Everyone was asking these questions, and now an independent government agency has come out and stated in a neutral way the risks and positives," she added.

While traditionally information is held by a single entity such as a central bank, blockchain centers on a publicly distributed ledger tracking the validity, ownership and source of funds and recording all steps of a transaction.

Over the last two years, almost every major global bank has issued a report on blockchain or entered a partnership with rival firms to explore how blockchain can help the industry as a whole. The most prominent is coordinated by innovation group R3, bringing in more than 40 banks around the world,

including Barclays PLC, Credit Suisse Group AG, The Royal Bank of Scotland Group PLC, UBS AG, Bank of America Corp. and others.

Papers espousing the cost and efficiency savings from blockchain have become commonplace: Just last week, consultancy Accenture PLC and operations benchmarking company McLagan released an analysis saying blockchain could save leading investment banks up to $12 billion (£9.8 billion) a year in back office cost.

But ENISA's involvement marks the first time an influential information security agency has entered the debate.

In its paper, ENISA identifies a number of challenges banks face in looking to implement blockchain internally or as part of a wider consortium of members. It also addresses fraud, anti-money laundering requirements and legal provisions for implementing privacy.

"If you are a financial organization carrying out a blockchain project, the report provides a useful checklist of the security concerns that you need to ensure are being addressed by your internal team or any supplier that you're working with," said Susan McLean, of counsel attorney for Morrison & Foerster LLP and leader of the firm's fintech practice.

Several consortia are working together to create a fabric of blockchain. This base layer of mutually agreed code would allow value transfer between organizations in a similar way to that in which information is transferred around the world to computers via the internet.

It would mean instant transfer of funds, anywhere in the world at any time, and cutting time and processing costs associated with transactions. But the industry is still largely hesitant to see it as a solution.

"Although the appetite for blockchain remains, firms are aware of the potential risks and challenges with the technology which will need to be addressed before the technology is adopted," McLean said. "Particularly given the regulated nature of the sector and the potential size and scale of transactions that could be processed, security remains a key concern."

According to Adam Ryan, financial services and fintech attorney at Freshfields, a "key message" from the financial industry is that they will only move forward on blockchain if cybersecurity can be assured.

"Almost the very first thing clients mention is the cybersecurity aspect," he said. "That ENISA has come out with this is a reflection that large financial institutions are putting cybersecurity at the top of the agenda and only implementing it if they know they and their customers are protected."

He says banks are acutely aware of the stringent regulatory environment in which they operate, and that any innovation they introduce must stay within the rules.

The issue of interoperability, or ensuring a blockchain solution is compatible with existing systems or with those of other banks in the chain, is of central importance, lawyers say.

Modern banks increasingly have to weigh up critical technological issues such as coding, and attorneys say the technical detail offered by ENISA contains valuable insight into potential flaws with outsourcing a blockchain solution.

“In addition to a focus on anti-money laundering and fraud tools, the report raises the issues of interoperability of protocols and legal provisions and tools for implementing privacy compliance,” McLean said.

“In particular, it recommends the financial services industry, in cooperation with the regulators, define what is to be kept confidential in order to remain compliant with regulatory requirements,” she added.

In a public ledger, all counterparties would be able to gain access, and deletion of information would be difficult to implement, McLean says.

“Indeed, it’s these concerns over security and privacy that are two of the key drivers for the private blockchain solutions being created by financial services firms and consortia,” she said.

According to Kost De Sevres, harmonizing standards are “vitally important” to EU regulation, and ENISA’s paper touches on that.

“Industry and regulators will have to work together to set testing grounds and draw up security standards,” she said, “but also ensure technical tools that exist can be integrated too.”

This is in the interest of all players, from regulator to regulated, she says.

Micah Green, leader of the financial services practice at Steptoe & Johnson LLP, says he sees “real progress” in the industry’s path to embracing blockchain.

“The financial services community is working very hard to wrap its arms around this. It’s more than a technology; it’s a framework,” he said.

He points to one recent development in particular: The Depository Trust & Clearing Corp.’s announcement last week that one of its global data repositories **will be converted** to a blockchain technology.

DTCC, a major New York clearinghouse and post-trade service provider, selected IBM Corp., in partnership with Axoni and R3, to rebuild its trade information warehouse to handle post-trade processing of derivatives contracts over a distributed ledger framework.

The trade information warehouse service automates the record keeping, lifecycle events, and payment management for more than $11 trillion of cleared and bilateral credit derivatives.

DTCC said the initiative will reduce the cost of derivatives processing across the industry by eliminating the need for "disjointed, redundant processing capabilities and the associated reconciliation costs."

“I think it’s a major breakthrough,” Green said. “So much about technology developments can be about disrupting legacy structures and systems. But the question here is whether markets can apply [blockchain] in a manner that allows for cost-saving efficiency and the benefits that comes with it in a way that doesn’t disrupt capital markets.”

He says there is plenty of evidence in the regulatory interest, the partnerships and the investment capital still flowing freely that there remains a serious interest in how blockchain can revolutionize

finance.

“There is no question that if [blockchain] can be utilized by the financial services industry to save money by utilizing a technology that creates automation, efficiency, and if can help with compliance in a highly regulated industry, employing that technology will be attractive,” he said. “It’s more than kicking the tires and seeing if the technology works, it’s making sure it works in a way that is efficient and safe, and meets regulatory requirements.”

--Additional reporting by Tom Zanki. Editing by Ed Harris and Rebecca Flanagan.