Morgan Lewis

LOOKING BEYOND THE TECH IN FINTECH

Fintech Regulatory Pitfalls and Best Practices

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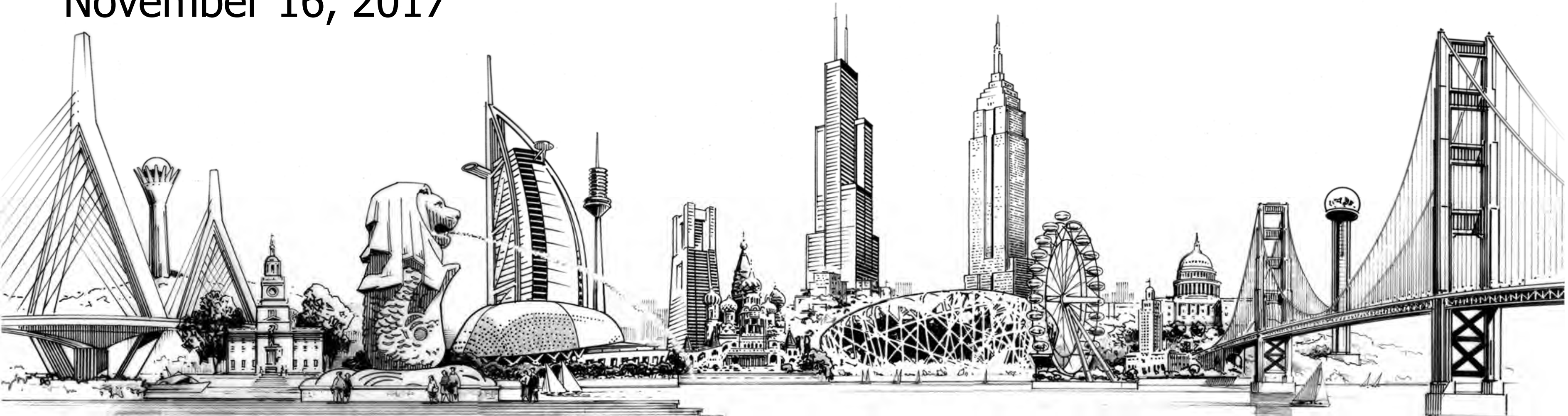


FINTECH:
CURRENT STATE OF PLAY

What is Fintech Anyway?
Fintech Market Landscape

SECURITIES
- Back-Middle Office Tech
- Trading Technology
- Wealth Management
- Liquidity Pools
- Robo Advisors
- Online Brokers / Trading / Custodians
- Data / Analytics / Research

BANKING
- Enterprise Banking Tech
- Peer-to-Peer Lending
- Consumer-Oriented Financial Services
- Real Estate Tech
- Bank Payment Solutions
- Alternative Lending
    - Consumer, SME, Real Estate

BLOCKCHAIN / CRYPTOCURRENCY
- Bitcoin wallets
- Security providers
- Sidechains
- ICOs

Sources
Financial Technology Partners
CB Insights

PAYMENTS
- Merchant Services
- Networks / Associations
- Telcos: Carrier Billing and NFC Infrastructure
- Transactions Security
- Card-Based Payment Products
- Online / Mobile Payments
- E-Rewards / Loyalty
- International Money Transfer
- Financial Institutions

INSURANCE
- Core Software (e.g. Claims Management)
- Data and Analytics
- Sales and Distribution

FINANCIAL MANAGEMENT SOLUTIONS
- Enterprise Resource Planning
- Financial Planning
- Accounting Support

HEALTHCARE
- Patient Care Administration (e.g. RCM)
- Benefits Management
- Health Insurance Sales & Distribution

Fintech Trends

Rising customer expectations for more personalized and digital experiences

Accelerated advancements and adoption of technology

Increased access to VC funding globally

Unmet customer needs driving the demand for alternatives

Reduced barriers to entry providing a more competitive landscape

Sources
Capgemini World FinTech Report 2017
PWC Global FinTech Report 2017

Fast Growing Addressable Market

Banking

Only about **1%** of North American consumer banking revenue has migrated to new digital business models but that this will increase to about **10%** by 2020 and **17%** by 2023.

Payments

The number of card payments worldwide is projected to rise by **55%** between 2015 and 2021 to reach **417B**.

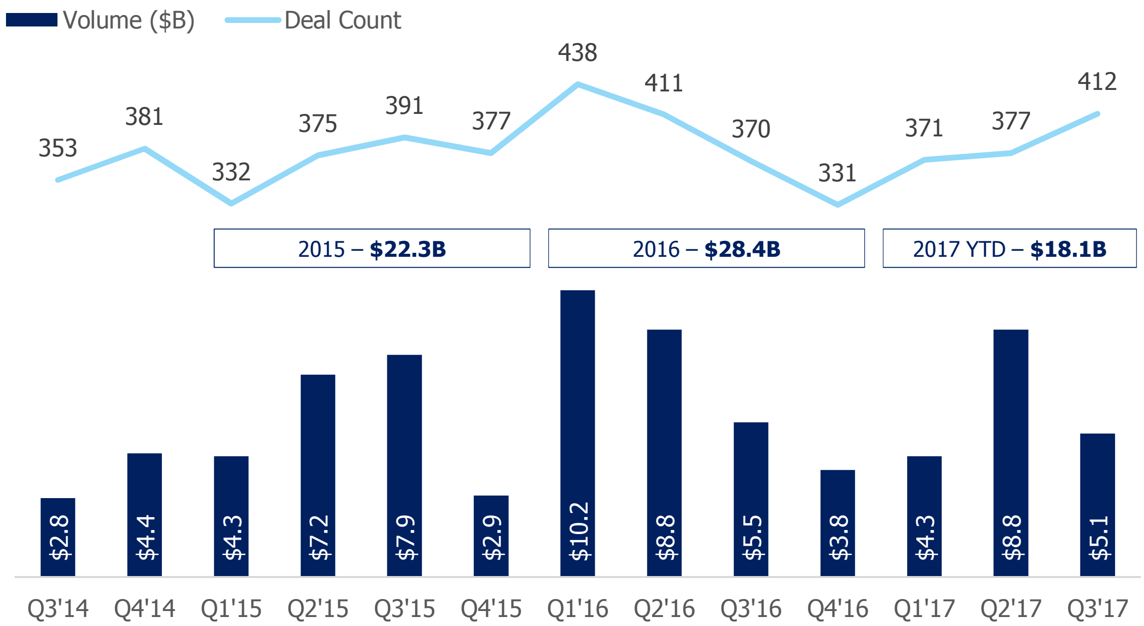
Cryptocurrency

The value of cryptocurrency transactions will surpass the **$1T** milestone before the end of 2017.

Sources
CITI "Digital Disruption: How Fintech is Forcing Banking to Tipping Point" March 2016
RBR "Global Payment Cards Data and Forecasts" 2016
Juniper Research "Cryptocurrency Transactions Expected to Break $1 Trillion Barrier This Year" 4 September 2017

Global Fintech Financing by Volume and Deal Count

Quarterly Trend



Global Fintech financing volume activity in 2017 is on pace for second best year after a record year in 2016

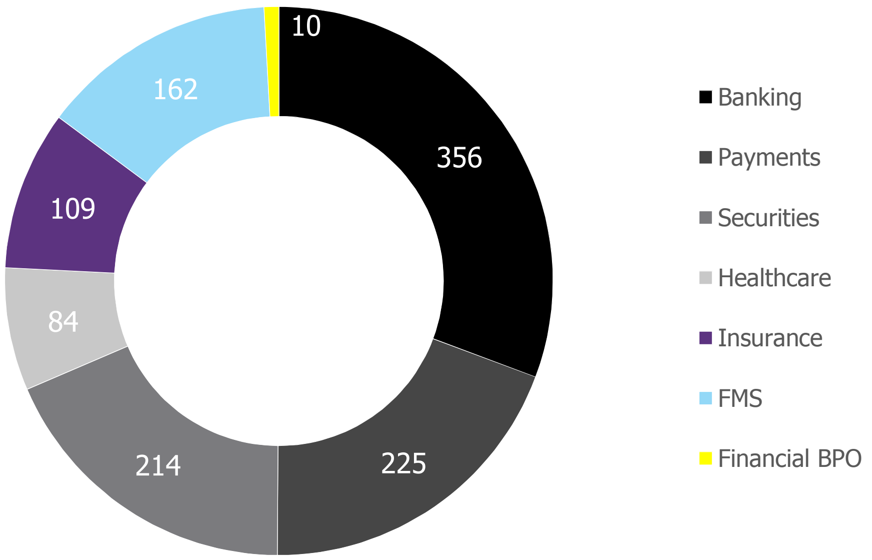
Q3 2017 financing exceeded $5.1 Billion across 412 deals. This quarter was the second largest in terms of deal count

Deal count has been growing for the third straight quarter while deal volume dipped from $8.8 Billion in Q2 2017

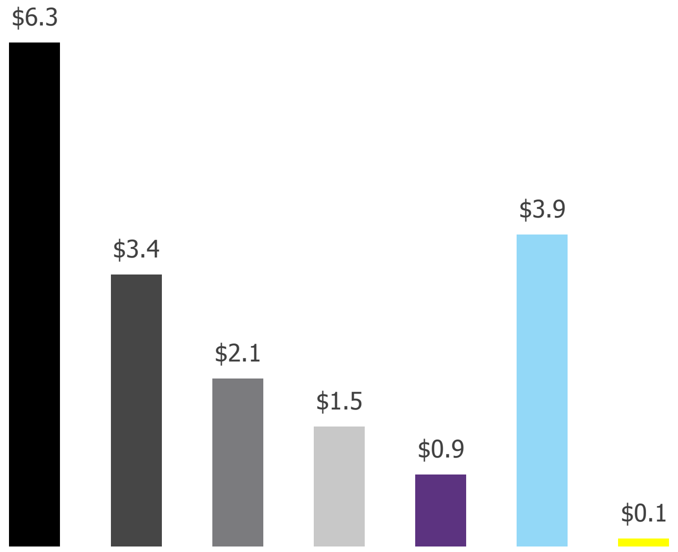
Sources
FT Partners Q3 2017 Fintech Insights

Global Fintech Financing by Segment
2017 YTD Q3

Global Fintech Financing by Segment (Deal Count)



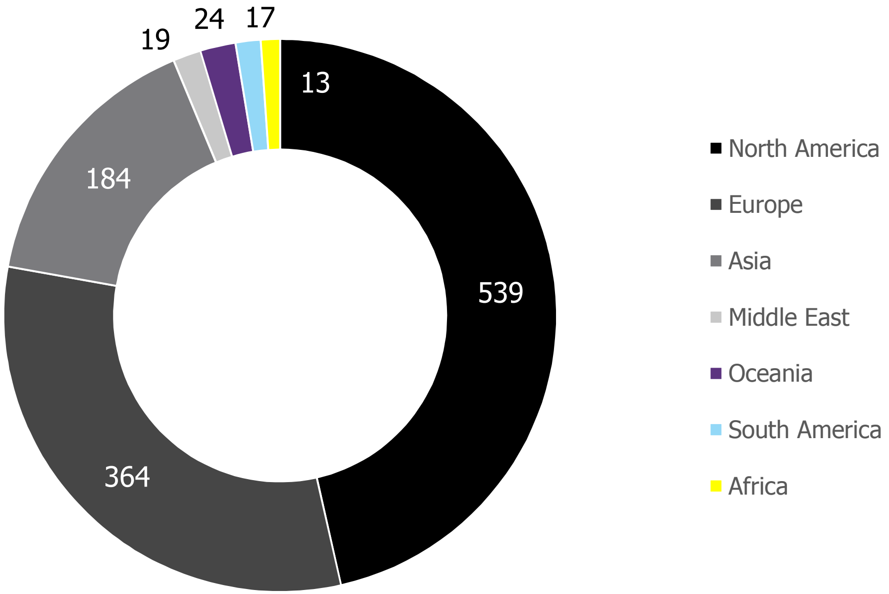
Global Fintech Financing by Segment (Volume in $B)



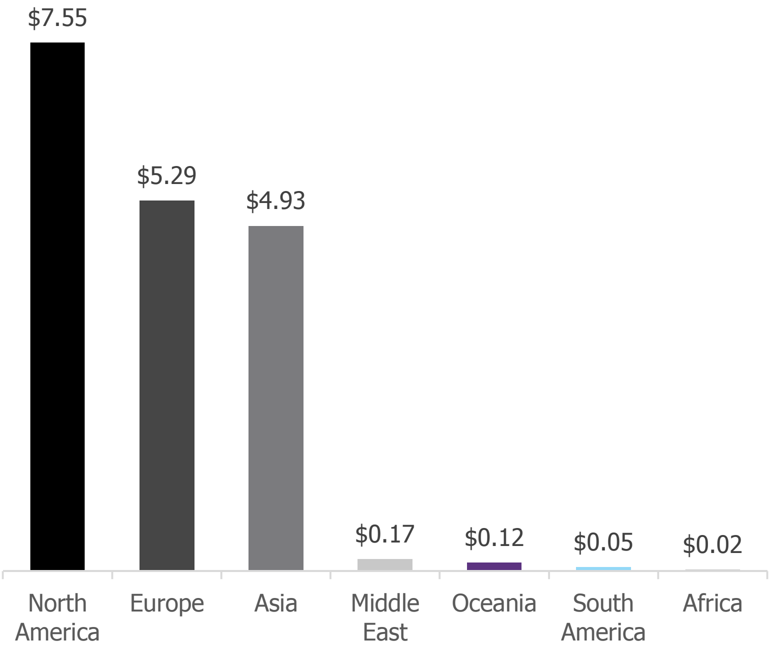
Sources
FT Partners Q3 2017 Fintech Insights

Global Fintech Financing by Region
2017 YTD Q3

Global Fintech Financing by Region (Deal Count)



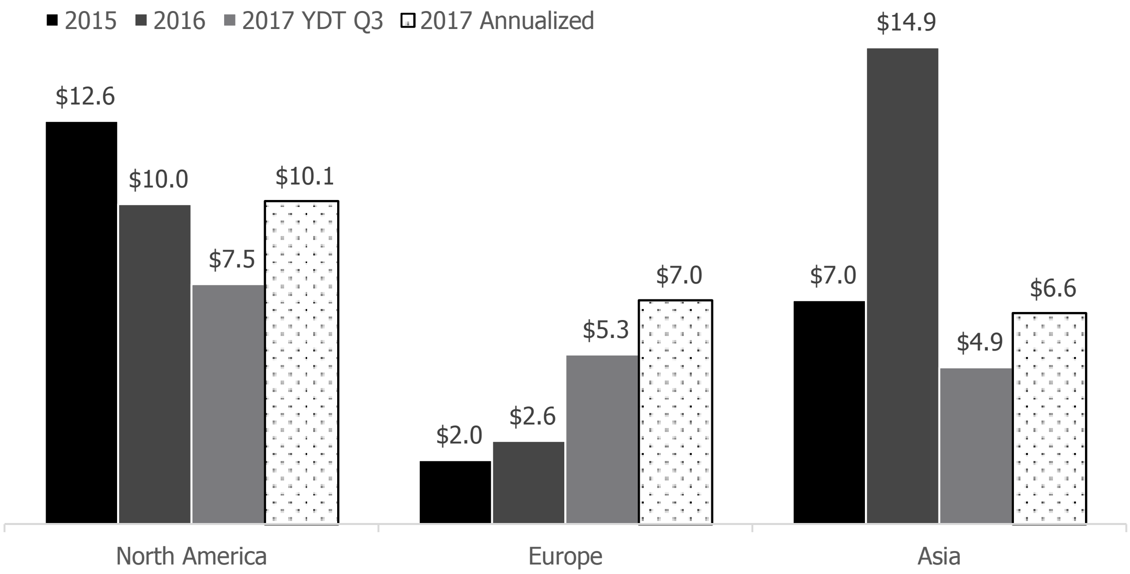
Global Fintech Financing by Region (Volume in $B)



Sources
FT Partners Q3 2017 Fintech Insights

Global Fintech Financing by Region
Deal Volume Yearly Trend

Global Fintech Financing by Region (Volume in $B)



Sources
FT Partners Q3 2017 Fintech Insights

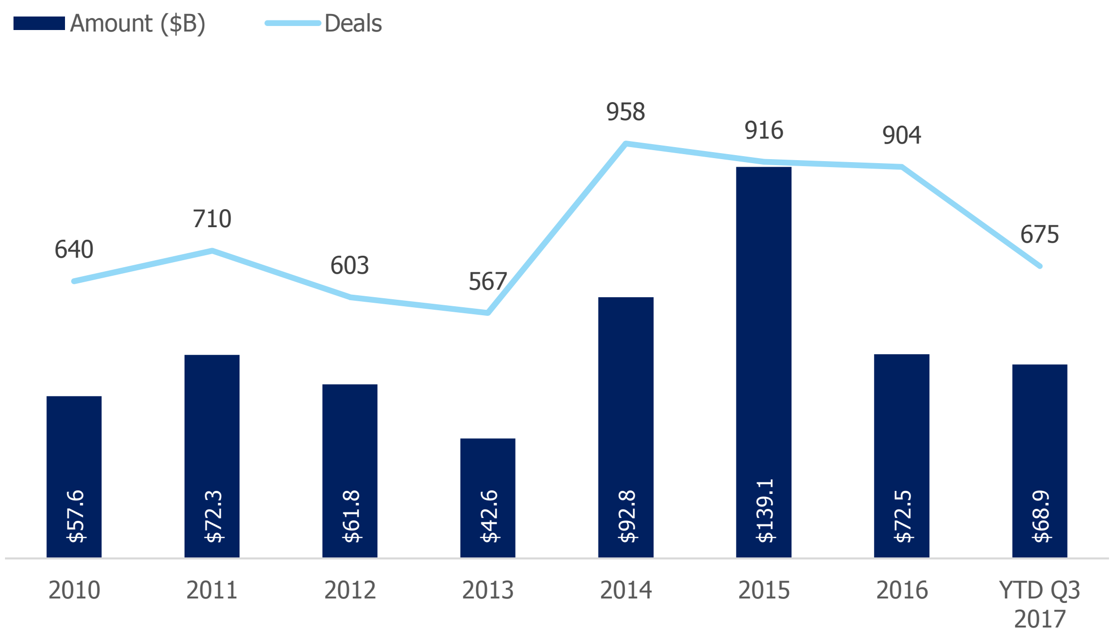
Europe has already exceeded last year's financing volume and is on pace to pass Asia based on annualized volume

North America is on pace to meet the 2016 financing volume

Asia is trending down and on pace to meet the 2015 financing volume after a monster $14.9B year in 2016 which included:

- $4.5B Ant Financial financing
- $3.3B Meituan-Dianping financing

Global Fintech M&A
Yearly Trend



Global Fintech M&A deal activity in 2017 is on pace with 2015 and 2016 levels

YTD Q3 2017, Fintech M&A accounted for **$69 Billion,** almost exceeding the full 2016 volume activity

On annualized basis, 2017 deal amount exceeds 2016 by **27%**

Sources
Financial Technology Partners Fintech Insights Report Q3 2017

FINTECH:
KEY REGULATORY CONSIDERATIONS

Consumer Financial Services is Highly Regulated

- Products can be regulated at both the federal and state level
- Applicable laws and regulations are not always consistent
- Regulations can impact product design and features or even states where the product is offered
- Need to gain an understanding of what is and is not regulated
- What laws do or do not apply will be activities-based ("facts and circumstances")

Case Study:
Marketplace Lending/Online Direct Lending

- Some marketplace lenders/providers allow third-party investment in loans
- Can use both traditional and nontraditional underwriting criteria
- Marketplace lending typically uses the bank partnership/marketing model
- Direct lenders obtain state lending licenses and lend under those licenses
- Mostly consumer; an increasing number of small business lenders

Typical Bank Partnership Model

- Marketplace provider partners with a bank to develop underwriting criteria
- Marketplace provider is the customer-facing entity (branded website, etc.)
- Bank originates the loan
- Bank sells the loan to the marketplace provider, typically after a few days
- Marketplace provider engages in servicing and collections
- Marketplace provider considers itself a bank service provider and not a “lender”

Bank Partnership Model Regulatory Issues

- "True Lender"
  - Can the contract designate the lender at origination (i.e., the bank) or will the party with the "predominant economic interest" be the "true lender"?
- "Valid when made"
  - National banks and state banks can "export" the interest rate of their home state to loans originated to borrowers in other states
  - If a loan was valid at origination with respect to state usury laws due to federal preemption, the general rule is that the loan remains valid if purchased by a subsequent buyer
  - *Madden v. Midland Funding* may (or may not) call this rule into question
- The marketing platform may be treated as a service provider to the bank and subject to supervision and oversight by federal or state regulatory agencies (banking agencies, Consumer Financial Protection Bureau (CFPB), etc.)

True Lender and Valid When Made

The scope and applicability of both doctrines are developing through the courts, often with seemingly inconsistent outcomes

BillMeLater

CashCall cases

Madden v. Midland

Think Finance

Colorado v. Marlette Funding

Alternative Underwriting Criteria

- Some marketplace lender and direct lender models focus on "alternative" underwriting criteria as an alternative to credit scores and other traditional criteria
- Goal is to provide credit to underserved population, recent graduates, people with future earning potential, people with little credit history
  - College attended
  - Grades and GPA
  - Work history
  - Potential future income
  - Social media profile
  - Savings, bill payment, and spending habits
  - Bank account and retirement account balances

Fair Lending Risk

- Equal Credit Opportunity Act and Regulation B make it unlawful for:

  any creditor to discriminate against any applicant with respect to any aspect of a credit transaction (1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract); (2) because all or part of the applicant's income derives from any public assistance program; or (3) because the applicant has in good faith exercised any right under the Consumer Credit Protection Act.

- Applies to both intentional discrimination (disparate treatment) and facially neutral conduct that results in discrimination (disparate impact)
- Applies to both consumer and commercial lending

Mitigating Fair Lending Risk

- Consider whether criteria used in application and underwriting could favor one group over another
- Test the models before implementation for pricing differentials that appear to vary based on protected status of applicants
- Ongoing testing of use of discretion (which should be minimized), models, and results (disparate impact testing)
- Disparate impact occurs when a creditor employs facially neutral policies or practices that have an adverse effect or impact on a member of a protected class <u>unless it meets a legitimate business need that cannot reasonably be achieved by means that are less disparate in their impact</u>
- Testing and careful design of models can help support a defense to disparate impact

Other Consumer Regulatory Risk

- Other federal consumer laws
  - Truth in Lending Act and Regulation Z
  - Fair Credit Reporting Act
  - Fair Debt Collection Practices Act
  - Electronic Funds Transfer Act and Regulation E
- Mortgage lending requirements
  - Real Estate Settlement Practices Act (RESPA)
  - Dodd-Frank Act mortgage originator rules (Regulation Z)
  - Areas where caution may be advised in the virtual environment may include (i) referral fees to intermediaries (RESPA anti kickback restrictions) and (ii) services that could fall under mortgage brokering or origination requirements (CFPB mortgage originator rules under Regulation Z)

Intermediation and Support Platforms

- Financial technology providers and services that support online lender programs, but do not actually engage in lending activities
  - Lender referral programs
  - Loan technology support services (application facilitation, document review and processing, etc.)
- Most intermediaries offering these services structure them to avoid or minimize federal and state licensing and other regulatory requirements
- If these providers are doing business with banks or other consumer financial lending firms, they still may be treated as service providers that are subject to federal or state regulatory and supervisory oversight

FINTECH:
THE CFPB AND UDAAP

What is UDAAP

- UDAAP risk – Unfair, Deceptive, or Abusive Acts or Practices
  - CFPB has federal UDAAP enforcement authority
  - FTC and state AGs also have UDAP enforcement authority (doesn't include "abusive")
- CFPB continues to be aggressive in its UDAAP enforcement cases
  - Attempting to collect loans for which the lenders should have had a state license (true lender issue) is "deceptive, unfair and abusive" (*Golden Valley Lending, Inc.*)
  - Claiming "state of the art" technology or security when the technology is not "state of the art" is "deceptive" (*Dwolla, Inc.*)
  - Technology breakdowns impacting financial consumers can be "unfair acts or practices" (*UniRush LLC*)
- Marketing materials and websites need to accurately describe the products and services, function as advertised, and be properly maintained

State Regulation

- Consumer lending requires state licenses
  - Licensing requirements vary according to loan type and nature of loan-related activity
  - In particular, real estate-secured loans are subject to more extensive licensing and regulation
- Commercial lending also requires licenses, but in only a handful of states
  - CA (California Finance Lenders Law) is a prime example of one of these states
- There may also be state licensing requirements for, or restrictions on, brokering, servicing, collections, or purchasing of loans

Cybersecurity

- Major focus of state and federal regulators
  - Safety and soundness issue for banks
- Implicates a number of risk factors
  - UDAAP/UDAP
  - Federal and state consumer privacy safeguarding requirements
  - Consumer class actions
  - State data breach law violations
  - Reputational damage

Cybersecurity

- NYDFS Cybersecurity Rule (March 2017)
  - Applies to entities regulated by the NYDFS
- Federal banking agency (OCC, FRB, FDIC) joint advance notice of proposed rulemaking (ANPR) on enhanced cyber risk management standards (October 2016)
  - Would be primarily applicable to large banks and their service providers
  - Agencies proposed a tiered, risk-based approach
  - Rules or guidance? Not yet decided. Does it matter?
- As bank service providers, nonbank FinTech companies are already subject to supervision and examination, as well as the bank's own cybersecurity standards
- FinTech providers must conduct due diligence of their own technology providers and testing of systems to ensure adequate cybersecurity

FINTECH CHARTER AND INDUSTRIAL BANK CHARTER

Why a Fintech Charter or Industrial Bank Charter?

- Parent company is not a “bank holding company”
  - Bank holding companies are subject to own set of regulations and capital requirements, and are supervised by the Federal Reserve Board
  - Also, bank holding companies cannot conduct non-financial activities
- Preemption of state usury rates by exporting interest rate of the bank’s home state
- Preemption of state consumer laws in limited circumstances
  - Dodd-Frank Act significantly limited federal preemption of consumer laws

OCC Fintech Charter

- OCC authority to charter "special purpose national banks" already exists
- OCC has proposed to start accepting applications from technology companies for a special purpose national bank charter (Fintech charter)
- OCC released a proposal for the Fintech charter application, but has not finalized the process
- Recipients of Fintech charter would be regulated as special purpose banks, similar to credit card banks
  - Most significantly, holders of a Fintech charter would not be subject to state lending license requirements or state usury limits (other than their home state's limits) by reason of federal preemption

OCC Fintech Charter

- State financial regulators have objected to the charter as exceeding the OCC's chartering authority and avoiding state regulation
- Conference of State Bank Supervisors filed a lawsuit against the OCC in US District Court for the District of Columbia to enjoin the OCC from granting Fintech charters
- The New York Department of Financial Services has separately sued in US District Court for the Southern District of New York in Manhattan to block the Fintech charter

OCC Fintech Charter

- Acting Comptroller of the Currency Keith Noreika has expressed strong support for the Fintech charter

- Future of the Fintech charter, and the charter’s utility for Fintech companies, is uncertain

- Acting Comptroller Noreika is starting (reopening?) the conversation about the separation of banking and commerce

Industrial Bank Charter

- State-chartered bank and FDIC insured
- Popular way for non-financial companies to enter into financial services
- Parent company is not a “bank holding company”
  - Parent company is still subject to supervision
- Most industrial banks tend to be specialized (auto finance, taxi medallion finance) but some are more general purpose.

Industrial Bank Charter

- In 2006, the FDIC enacted a moratorium on approving deposit insurance for new industrial banks
  - Motivated in part by concerns over Walmart and Home Depot industrial bank charter applications
- Moratorium was extended and then incorporated into the Dodd-Frank Act to allow time for the FDIC to study the issue
- Moratorium expired in July 2013 but no applications until recently
- No approvals yet

QUESTIONS?

Biography

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Melissa R. H. Hall represents US and overseas banks, nonbank financial services companies, investors in financial services, and technology companies in regulatory and corporate matters. She advises them on a wide range of state and federal financial regulatory laws and regulations. She provides counsel on financial regulatory compliance and enforcement, including state and federal licensing requirements, consumer financial products and compliance, payment systems, corporate and transactional matters, financial institution investment and acquisition, and the development of new financial services products.

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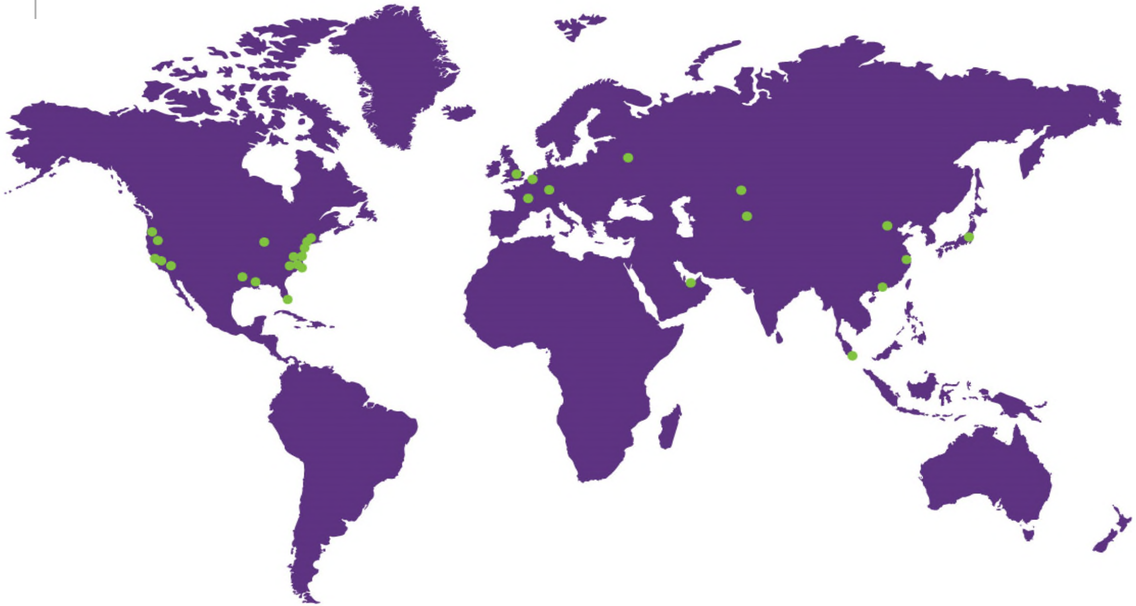
Andrew Ray is the leader of the firm's interdisciplinary corporate practice in Washington, DC, where he represents public and private companies, financial sponsors, and management teams in a broad range of industries, including technology, financial services, life sciences, real estate, and the not-for-profit sector. Various industry publications recognize Andy as a leader in both M&A and in communications law, among other fields. He recently led the team representing Oculus VR in its $2 billion sale to Facebook, which was named the M&A Advisor M&A Deal of the Year.

Our Global Reach

- Africa
- Asia Pacific
- Europe
- Latin America
- Middle East
- North America

Our Locations

Almaty	Chicago	Houston	Orange County	Shanghai*
Astana	Dallas	London	Paris	Silicon Valley
Beijing*	Dubai	Los Angeles	Philadelphia	Singapore
Boston	Frankfurt	Miami	Pittsburgh	Tokyo
Brussels	Hartford	Moscow	Princeton	Washington, DC
Century City	Hong Kong*	New York	San Francisco	Wilmington



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