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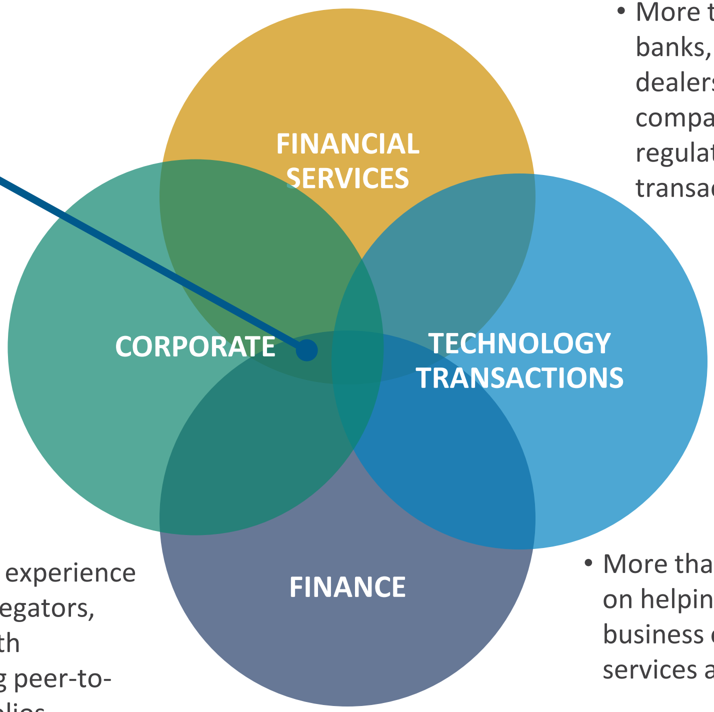
Fintech 2018 – Winds of Change – Where Are We Headed?

July 12, 2018

Mayer Brown Fintech Practice

Well-rounded capabilities from the deal management and technology perspectives within the context of financial institutions.



- More than 180 lawyers that represent banks, insurance companies, broker-dealers, asset managers and finance companies, in a range of litigation, regulatory, licensing, tax and other transactional matters

- More than 300 Corporate lawyers with extensive experience advising clients on a variety of high-profile strategic transactions, including M&A and VC investments

- More than 130 Finance lawyers with experience representing lending platforms, aggregators, lenders, issuers and underwriters with originating, financing and securitizing peer-to-peer, marketplace and fintech portfolios

- More than 50 lawyers focused on helping clients improve their business operations by sourcing services and technology

Agenda

- Introduction
- Regulatory Risks
- Data Risks
- Marketplace Lending
- Bank Charters

INTRODUCTION

Deals with Fintech Companies

- This presentation is about transactions where:
  - The “fintech company” is a non-bank focused on replacing a financial industry process with a digital tool.
  - The “FI” is a financial institution that brings equity funding, data, industry understanding, relationships and regulatory skill.
  - The fintech company brings digital tools, cloud-based delivery, robotics, AI and advanced analytics.
  - The deal involves financial regulatory risks, privacy and data security risks, other data risks, process automation risk or digital disruption risk.

Common Focus Areas for Fintech Companies

- Payments and remittances
- Banking and lending, including “marketplace lending”
- Blockchain/cryptocurrencies
- Insurance (InsurTech)
- Investment and wealth management
- Big data analytics

Types of Deals with Fintech Companies

PASSIVE INVESTMENT

- FI makes limited resource commitments and has no control
- FI may obtain board observation rights or seat
- FI may assist Fintech to grow its value

TECHNOLOGY LICENSE BY FINTECH

- FI obtains right to use Fintech's technology
- Minimal commitment by FI
- Fintech may learn from FIas part of implementation or maintenance
- FI has limited or no access to talent or the opportunity for future collaboration

SERVICES AGREEMENT

- Outsourcing, Software as a Service (SaaS), data analytics, etc. offer opportunities to collaborate, develop and commercialize new ideas
- FI benefits from technology funded by spend by Fintech's other customers

JOINT VENTURE OR STRATEGIC ALLIANCE

- FI brings data, regulatory skill, customers, industry depth, and possibly existing tech
- FIbrings technology and analytics skills
- Possible equity and control rights in Fintech or a JV entity
- Exit path is critical to value

MAJORITY INVESTMENT

- Monetary investment in an existing company (early or late stage) that results in a majority ownership interest in the company
- More resource commitments and control than a minority investment– investor would have board seats and corresponding responsibilities

INTERNAL ACCELERATOR AND INCUBATOR

- Captive programs that offer mentorship and early-stage investment to existing start-ups
- Similar format to external accelerators, but with more resource commitment

IN-HOUSE START-UP & ACQUISITION

- Monetary investment by FI in an existing or start-up Fintech that results in 100% ownership of the company
- Most resource commitment and control for the FI
- Least opportunity for Fintech's team to believe they have autonomy and upside

LOW — INVOLVEMENT → HIGH

Cultural Differences

Traditional Financial Institution	Fintechs
“We look to grow this historic institution.”	“We need a big win fast.”
“We bring vast amounts of data.”	“We can get new tech to market quickly.”
“We prize our sterling reputation.”	“We hope to be known someday.”
“Regulatory compliance is essential.”	“We aren’t regulated, as far as we know.”
“The legal requirements are uncertain so we need to proceed conservatively.”	“We are comfortable in grey areas.”
“You will be assimilated. Resistance is futile.”	“You will be disrupted. We are Netflix/Uber and you are Blockbuster/Yellow Cab.”

REGULATORY RISKS

Regulatory Interest is High

- OCC – June 2017 FAQs (OCC Bulletin 2017-21): fintech relationships and investments by federal savings associations and national banks must comply with OCC Bulletin 2013-29 (Risk Management of Third-Party Relationships).
  - Risks include reputation, credit concentrations, compliance, market liquidity and operational.
- Other OCC initiatives:
  - OCC Office of Innovation
  - Special Purpose National Bank (Fintech) Charter
- CFPB – October 2017 Consumer Protection Principles for data-sharing and aggregation involving fintech companies.
- Stakeholder responses vary on whether existing law needs to be changed and the degree that transparency is needed to protect vulnerable groups.

Regulatory Checklist for Investments in Fintech Companies

- ❑ FI investment versus holding company investment
- ❑ Controlling versus non-controlling interest
- ❑ Permissible activity restrictions
- ❑ Regulator approval or notice requirements
- ❑ Supervision of the fintech company

Permissible Activity Restrictions

- Does the fintech company have business activities that might not be permissible activities for the FI?
- Do the fintech company and its investors understand those restrictions?
- How will the FI monitor the fintech company's activities and strategic plans to ensure that they are permissible activities?
- What is the FI's exit strategy if a fintech company begins to engage in impermissible activities?
- Can the deal be structured to reduce the restrictions?
- Compliance with applicable activities restrictions, the FI's right to monitor that compliance and an economically viable "regulatory out" should all be considered early in the investment process.

Notice and Approval

- Investments may require notice or approval depending on a range of factors including identity of acquirer, investment authority being relied upon and control v. non-control. Examples:
  - **PRIOR NOTICE REQUIREMENTS:** Notice must be given to the relevant regulator a certain number of days before consummation; transaction may proceed unless the regulator actively objects.
  - **APPROVAL REQUIREMENTS:** Regulator's affirmative approval must be secured before the transaction can consummate.
  - **POST-TRANSACTION NOTICE REQUIREMENTS:** Notice must be given within a certain period of time (usually 10 days) after the transaction is consummated.
- An FI also shouldconsider any formal or informal supervisory or enforcement actions, which can also have an impact on notice and approval requirements.

Supervision of the Fintech company

- Certain investments by an FI in a fintech company might subject the fintech company to supervision by the FI's regulators.
- This is separate and independent of supervisory authority that the regulator might have with respect to the services that the fintech provides to the FI.
- An investment is most likely to give an FI's regulators the greatest degree of supervisory authority over the fintech company if the FI acquires control over the fintech company.

Due Diligence Considerations

- Ownership/licensing rights to existing and future intellectual property
- Non-compete, confidentiality and work-for-hire agreements with key employees involved in developing intellectual property
- Use of open source software
- Whether the technology is protectable
- Reliance on third parties for key technology and critical services
- Out-licenses to third parties for the use of the intellectual property
- Operational capabilities and whether those will scale for the bank
- Material agreements

DATA RISKS

Data Legal Risks

Traditional Data Legal Risk	Fintech Game Changer
Privacy and transfer of Personal Data	Analytics allow people to be identified without disclosure of "personal data"
Data security, including prevention of unauthorized use, disclosure or change	Fintech may cut costs down by using insecure cloud platforms and may have limited data security skills
Cross-border data transfer in violation of EU GDPR and other regulations	Fintech may leverage a global platform involving cross-border access
Information governance, including being ready for discovery demands and destroying data when no longer needed	Fintech analytics result in data being combined, changed or derived, making it harder to produce or destroy

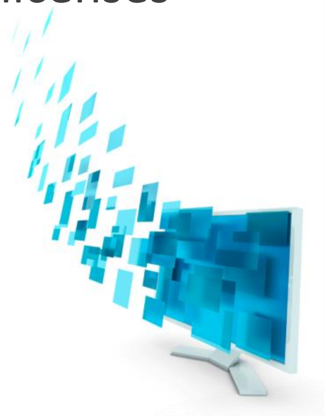
Data Rights Risks

- Data has little protection under intellectual property laws.
- FIs may inadvertently leak data rights to the fintech company:
  - "we may use data that you provide to improve our services and for other business purposes"
  - "you agree to provide us copies of any data that you possess regarding …"
  - "We may aggregate and utilize your data in combination with other similar data in an aggregated manner"

- Thus, strong contract rights are critical to allow the FI to preserve competitive advantage.

Risks Increase Using Licensed Data

- Data provenance is easy to lose.
- Data is hard to trace in systems.
- Derived data and metadata are grey zones.
- Data scientists are trained to find data and use it, not to find data licenses and comply with them.
- Fintech entrepreneurs want to win customers, not read contracts.



Key Data License Contract Terms

1. Scope
2. Users
3. Purposes
4. Term / Termination
5. Retention / Destruction
6. Location Restrictions
7. Security
8. Quality
9. Rights
10. Liability

Risks to Address in Due Diligence Before Licensing Data

- Do any laws limit or prohibit the intended license?
- Would licensing this data subject the licensor to laws governing certain other data providers, such as the Fair Credit Reporting Act?
- Does the licensor have the rights that it needs from data sources to obtain the data and grant the license?
- Is the licensor obligated by its own data licenses to pass some terms through?
- Does the licensor or licensee need the right to be able to destroy the data?
- Are both parties prepared to manage compliance?

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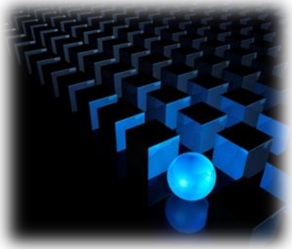
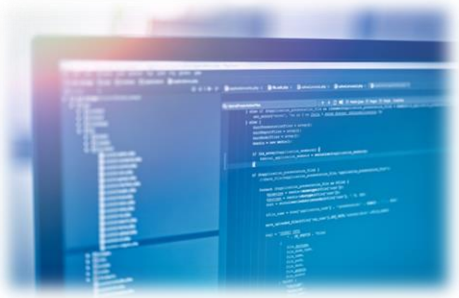
Risks in Licensing FI Data

- Data or results of analysis being provided to others.
- Liability for deficiencies in licensed data.
- Liability for confidentiality, privacy or data security breaches by your licensees.
- Liability for misuse of licensed data by the fintech company or a joint venture (e.g., use that is inconsistent with the FI's regulatory or contractual obligations).
- Inability to enforce the license terms.
- Assignments, sales, bankruptcies or other changes in licensee.



Additional Key Legal Risks if the Fintech Company Uses AI, Bots, and Analytics

- Disappointments in performance, all-in cost or capability.
- Surprise charges from application software companies for data use.
- Inability to extract derived data, metadata and “learning” from the tool.
- Fintech company may stop maintaining a tool that bank depends on.
- Regulatory complexities (e.g., identifying the reason for an adverse action, inadvertent disparities)
- Fintech company exceeding bank’s rights in the data.
- Inability to explain basis of pricing and coverage recommendations by AI systems to regulators.
- Fintech company “learning” from bank’s data.
- Bank’s data that is on fintech’s system being sold, auctioned in bankruptcy, etc. of fintech company.



Digital Disruption Risks to Avoid Through Contract Terms

- Losing the “race to learn” in the pilot phase.
- Giving up domain knowledge beyond data.
- Handing “the keys to the kingdom” to data-savvy fintech company:
  - FI personnel may undervalue data.
  - Absent a strong contract, the law provides little protection for data or learnings.
- Limiting your agility through exclusivity clauses.
- Becoming entangled:
  - Inability to disengage on data flows to fintech.
  - Inability to stop using fintech tools.

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Steps to Take Before a Deal is Pending with a Fintech Company

- **OBTAIN OR DEVELOP** descriptions of existing and likely future uses of data.
  - Interview digital marketers, data scientists, data strategists, etc.
- **RESEARCH** your legal and contractual obligations regarding data.
- **OBTAIN** consents and licenses for existing and likely uses of data by fintech companies.
- **REVIEW** and update privacy, records retention and other relevant policies.
- **ASSIGN** responsibility for monitoring regulatory changes relevant to fintech companies.
- **BOLSTER** compliance measures.
- **INVESTIGATE** any possible problems in a legally-privileged process.
- **TREAT** fintech deals as high-risk and strategic even if they are low-dollar.

MARKET PLACE LENDING

Lending Framework – Overview

- There are two potential ways in which to lend
  - The non-bank partners with a bank or state-licensed lender (bank partnership model)
  - The non-bank serves as the lender
- Each potential option may require a license
  - Lending license to originate loans
  - Debt collection or servicing license to collect payments on the loans
  - Loan brokering license to assist in the procurement of loans

Lending Structure – Bank Partnership Model

- The non-bank enters into an arrangement with a bank (e.g., national bank, state-chartered bank) or a state-licensed lender in which the bank or the licensed lender originates the loans for the individuals, and the non-bank purchases the loan receivables from the bank/licensed lender
- Under this arrangement, the non-bank would perform certain functions for the bank/licensed lender, such as marketing, servicing and facilitating the platform
  - For example, the non-bank may assist in collecting application information, perform underwriting using the bank/licensed lender's credit criteria, etc.
  - This arrangement would be formalized into an agreement with the bank or state-licensed lender
- The bank or state-licensed lender would enter into an agreement with the individuals, and be able to charge interest on the loans

Lending Structure – Bank Partnership Model *(cont'd)*

Advantages	Disadvantages
• Generally, avoids lending licenses for non-bank	• Depending on structure, could trigger loan broker, debt collection and/or servicing license obligations for non-bank
• Federal preemption when partnering with a bank (benefit that state usury laws would not apply to bank)	• Depending on the structure, "true lender" and *Madden* risk – regulatory scrutiny of partnership model (e.g., some states have moved or are moving toward requiring a license for such arrangements)
• Ease to market	• As service provider to bank/licensed lender, non-bank will be subject to regulatory supervision and examination by bank and regulators
	• Less control over the program

Madden v. Midland Funding LLC

- In May 2015, the U.S. Court of Appeals for the Second Circuit issued a decision in *Madden* that created uncertainty for the bank-origination model used in connection with marketplace lending platforms
- Issue: whether interest charged by a non-bank assignee of debt originated by a national bank is protected by the National Bank Act from state usury laws
  - The plaintiff in *Madden* defaulted on her bank-issued credit card account, and the bank sold the debt to Midland Funding
  - The interest rate on the credit card account was higher than the maximum rate permissible under the usury law of Madden's state, New York
- Under the NBA, the bank could rely on federal preemption of the state usury law because it is a national bank that could charge the interest permitted under the laws where the bank is located, i.e., exportation
  - Nonetheless, Madden sued non-bank debt collector Midland Funding for charging a rate in excess of the New York usury limit after the bank sold the debt to Midland
- In 2013, the U.S. District Court for the Southern District of New York found for Midland Funding, but the Second Circuit overturned that decision

Midland Funding LLC v. Madden (cont'd)

- In November 2015, Midland Funding petitioned for *certiorari*
- On June 27, 2016, the U.S. Supreme Court denied *certiorari* in *Midland Funding*
- The case could have significant implications for the secondary loan market, which relies on the long-standing 'valid when made' principle of contracts
  - And in particular for marketplace lenders, which routinely purchase and sell bank-originated loans
- At present, the *Madden* holding applies only in the Second Circuit, which is comprised of Connecticut, New York and Vermont
- The federal Financial CHOICE Act, H.R. 10, includes a "fix" for the Second Circuit decision
- On February 27, 2017, the U.S. District Court for the Southern District of New York ruled that Madden may proceed with a class lawsuit against Midland Funding

Bank Partnership Model – True Lender

- Some cases have held that the bank partner rather than the bank is the "true lender"
  - Results in violation of state licensing laws
  - Usury issues
- No clear test
  - Predominant economic interest
  - Substance over form
- Factors
  - Bank partner funds the loan
  - Bank partner sets underwriting criteria
  - Bank partner indemnifies bank
  - Bank return on interest in the loan
  - Type of loan

Lending Structure – Non-Bank as Lender

- The non-bank would act as the lender to the individuals
- The non-bank would enter into a loan agreement with each individual in which the individual agrees to repay the non-bank as the lender
- The non-bank may be required to file applications to obtain state lending licenses
  - License application requirements include net worth, experience, bond and approval by state regulators
- The non-bank would need to obtain funding or have funds to originate the loans

Lending Structure – Non-Bank as Lender *(cont'd)*

Advantages

- Less regulatory uncertainty from a "true lender" and *Madden* standpoint
- Non-bank may be allowed to charge certain fees and interest on the loans in excess of the state usury limitations (in some instances)
- Non-bank would have control over the lending program

Disadvantages

- Significant up-front costs related to application and approval of licenses
- Administrative and regulatory burden of being a lender (e.g., disclosure requirements and restrictions on loan terms and conditions)
- Compliance with federal and state consumer protection laws for lenders
- Subject to regulatory examination and supervision

BANK CHARTERS

OCC Special Purpose National Bank Charter

- In December of 2016 the Comptroller of the Currency solicited comment a white paper, “Exploring Special Purpose National Bank Charters for Fintech Companies”
  - The white paper addressed issues associated with, and conditions for, extending national bank charters to Fintech companies
- The White Paper said the OCC could grant a special purpose national bank charter to companies that either engage in fiduciary activities or engage in at least one of the three core banking functions: (1) receiving deposits, (2) paying checks, or (3) lending money
  - The OCC said that issuing debit cards or engaging in other means of facilitating payments electronically is the “modern equivalent of paying checks”
  - This should include money transmission
- In March of 2017 the OCC released a draft supplement to its licensing manual for Fintech Charters and a Summary of Comments and Explanatory statement responding to the comments received on the white paper

OCC Special Purpose National Bank Charter *(cont'd)*

- The OCC stated that three principles would guide national bank Fintech charters:
  - The OCC would not allow inappropriate comingling of banking and commerce
  - The OCC would not allow products with predatory features or unfair or deceptive acts or practices
  - Fintech charters would not receive a light touch in the supervisory process
- A Fintech charter would be limited banks that do not take deposits thereby opening them up to companies where the parent company does not want to become bank holding companies subject to the Bank Holding Company Act
- The OCC's also noted capital and liquidity requirements would be tailored to the particular activities of the Fintech company
- The OCC also emphasized the importance of financial inclusion in a Fintech company's business plan

OCC Special Purpose National Bank Charter *(cont'd)*

- In April 2017, the Conference of State Bank Supervisors filed a lawsuit challenging the legality of the OCC Fintech charter
- In May 2017, the New York Department of Financial Services filed a similar suit
- Also in May, the CSBS announced Vision 2020 for Fintech and Nonbank Regulation including:
  - Redesign and expansion of its multistate licensing system
  - Creation of a working group to harmonize multistate supervision
  - Plans to establish an industry Fintech advisory panel
  - Education programs to assist state banking departments
  - Efforts to make it easier for banks to provide services to non-banks
  - Support for federal legislation that would allow state and federal regulators to better coordinate supervision of bank service providers

State Bank Charters

- On May 1, 2017 the Federal Deposit Insurance Corporation released a new Handbook for Organizers of De Novo Institutions
  - The Handbook does not establish new policy or guidance, but seeks to clarify the process
- State-chartered industrial banks are not considered to be banks under the Bank Holding Company Act, so the parent Fintech company would not become a bank holding company

QUESTIONS?

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