



FinTech— Perspectives and Legal Issues

February 21, 2017 Bank Roundtable

Jenny Lee

Stuart Hemphill

Kevin Maler

Joseph T. Lynyak III



Agenda

- FinTech—
 - Defining the concept
 - Identifying the opportunity for banks
- Challenges to—
 - Banks
 - Regulators
 - FinTech companies
- Focusing on several legal practice issues for banks
- The 400 pound Gorilla—the FinTech National Bank Charter



FINTECH PERSPECTIVES—FEBRUARY 2017 ROUNDTABLE

2

Defining the Concept

- Is FinTech a mushy buzzword that roughly relates to electronic applications and systems used by financial intermediaries?
 - Is it a panacea?
 - Is it an all-encompassing reason for avoiding licensing obligations?
 - Is it really new?
- The buzz words abound—
 - FinTech
 - P2P money transfers and online/offline payments
 - P2P lending
 - Authentication security
 - API
 - RegTech
 - Providing regulatory compliance
 - Cloud-based
 - Progressive degrees of AI

Identifying the Opportunity

- What does a particular FinTech application or product accomplish?
 - Does it enhance the current delivery of an existing financial service?
 - Bots
 - AI
 - Smart contracts
 - Does it eliminate from the financial transaction process the need for human intervention and costs?
 - Besides cost savings, does a FinTech application provide other economic advantages?
 - Contractual liability relief

Challenges—Banks

- Reputational risk
 - Reliability of legacy systems
 - Demand for 6-Sigma performance
- Economic viability of FinTech Companies
- Vendor management
- Intellectual property
- Privacy



**PRESERVING A
COMPETITIVE
POSTURE—NOT BEING
LEFT IN THE DUST**

Challenges—Regulators

- The Obama Administration's “Framework for FinTech”—
January 2017
- Principles—
 - Think broadly about the financial ecosystem
 - Start with the consumer in mind
 - Promote safe financial inclusion and financial health
 - Recognize and overcome potential technological bias
 - Maximize transparency
 - Strive for interoperability and harmonize technical standards
 - Build in cybersecurity, data security, and privacy protections from the start
 - Increase efficiency and effectiveness in the financial infrastructure
 - Protect financial stability
 - Continue and strengthen cross-sector engagement
 - **AND WORLD PEACE.....**

Challenges—Regulators

- Bank regulators—
 - Starting from safety and soundness perspective
 - But have specifically cautioned that banks are not relieved from their extensive vendor management responsibilities
 - Recognizing that small FinTech companies cannot comply
 - This approach may hinder joint ventures
- Regulators have issued numerous position papers—
 - The CFPB’s Project Catalyst
 - <http://www.consumerfinance.gov/about-us/project-catalyst/>
 - The OCC’s Recommendations and Decisions for Implementing a Responsible Innovation Framework
 - <https://www.occ.gov/topics/bank-operations/innovation/recommendations-decisions-for-implementing-a-responsible-innovation-framework.pdf>

Challenges—FinTech Companies

- Will startups survive?
- Are many FinTech companies solutions looking for problems?
 - Scalability and nimbleness
- Developing standards for the marketplace
 - R3
 - Utility Settlement Coin
 - Global Payments Steering Group
- Compliance capabilities
- Intellectual property concerns
- Corporate representation

Legal Concerns

- Consumer protection regulation, privacy, and fair lending
 - Jenny Lee
- Intellectual property
 - Stuart Hemphill
- Corporate representation
 - Kevin Maler

Consumer Protection – Background

- “FinTech” companies offer several different products or services
 - Marketplace lending (P2P lending, LendingClub Corp., Prosper)
 - Alternative payment systems
 - Mobile payments
 - Consumer lending (including education financing and cash advance products)
 - Blockchain and distributed ledger
 - Virtual currencies
 - Personal finance management / robo-investing or saving
- Possible business models of FinTech firms:
 - Hold risk on FinTech firms’ own balance sheets
 - Form partnerships with financial institutions
 - Interact with depository institutions through the payment system
 - Form partnerships with small community banks and credit unions
 - Connect capital from institutional investors to individual borrowers
 - Sell loans or securities to financial institutions

Consumer Protection – Background

Financial innovation is an area that “merit[s] special attention from financial regulators who must be vigilant to ensure that new products and practices do not blunt the effectiveness of existing regulations or pose unanticipated risks to markets or institutions.”

--2016 Financial Stability Oversight Council Annual Report

Consumer Protection - Background

- FinTech is a global phenomenon
- By letter dated July 21, 2016 to the Federal Reserve, OCC, CFPB, FDIC, and NCUA, the Senate Banking Committee suggested that international coordination is needed. The European Central Bank, Australia, World Economic Forum, and the World Bank have published papers that highlight the opportunities and challenges for international regulators that are presented by FinTech.
- The UK Financial Conduct Authority created and began accepting applications for a “regulatory sandbox,” which permits companies to “test innovative ideas without immediately incurring all the normal regulatory consequences.”



Consumer Protection – Background

In the U.S., federal and state regulation of FinTech firms include:

- Under the Bank Service Company Act, the OCC, FDIC, and Federal Reserve may issue regulations, take enforcement actions for violations of law, and examine bank service companies.
- Under title X of the Dodd-Frank Act, the CFPB has separate authority to regulate affiliated service providers that “provide a material service” to entities offering or providing consumer financial products or services, and authority to regulate a “service provider” to the extent that the service provider offers its own consumer financial product or service.
- Agencies have issued guidance regarding regulatory expectations for managing third-party relationships. This guidance includes requirements to assess third party risk and conduct due diligence and ongoing monitoring.
- The Financial Crimes Enforcement Network of the Treasury Department requires money services businesses (money transmission) to obtain licenses.
- New York Dept. of Financial Services is the first state to issue rules specific to virtual currency business activity, including a virtual currency license.

Consumer Protection – Background

Applicable consumer protection regulations:

- Truth in Lending Act/Regulation Z
- Electronic Funds Transfer Act/Regulation E
- Fair Debt Collection Practices Act (and state analogs)
- UDAP (FTC Act) / UDAAP (Title X of Dodd-Frank Act) (and state analogs)
- E-Sign Act
- Telephone Consumer Protection Act
- CAN-SPAM Act
- Servicemembers Civil Relief Act
- Military Lending Act
- Real Estate Settlement Procedures Act
- Home Mortgage Disclosure Act

Consumer Protection – Background

Recent court cases and regulatory developments impacting FinTech:

- *Madden v. Midland Funding LLC* (2nd Cir. 2015) called into question the funding structures used by many consumer marketplace lenders to establish exemptions from state usury laws.
- The Treasury Department published in July 2015 a Request for Information to solicit comments from the public on marketplace lending.
- In December 2015, the California Department of Business Oversight launched an inquiry into online programs – an assessment of the proper scope of licensing and regulatory structures related to online businesses.
- In March 2016, the OCC published a white paper on FinTech and requested public comment by May 31, 2016.

Consumer Protection – Background

Recent court cases and regulatory developments impacting FinTech:

- The CFPB announced in March 2016 that it will begin accepting complaints from consumers regarding marketplace lending.
- *CFPB v. CashCall et al.* (C.D. Cal. 2016) established a liability theory under the Dodd-Frank Act for unfair, deceptive and abusive practices based on collecting or servicing consumer loans with usurious rates of interest.
- In December 2016, the OCC announced that it would begin accepting applications from FinTech firms to become special purpose national banks.
 - The OCC explained there is “no legal limitation on the type of ‘special purpose’ for which a national bank charter may be granted, so long as the entity engages in fiduciary activities or in activities that include receiving deposits, paying checks, or lending money.” –OCC Paper entitled “Special Purpose National Bank Charters for Fintech Companies”

Privacy and Security

- Multiple government agencies regulate privacy and security
 - Securities and Exchange Commission
 - Financial Industry Regulatory Authority
 - Commodities Futures Trading Commission
 - National Futures Association
 - Department of Justice
 - Federal Trade Commission
 - Consumer Financial Protection Bureau
 - State Attorneys General
- Also, the bank regulators review FinTech firms through third-party risk assessment in bank exams
 - Expectations imposed on banks regarding vendor management
 - Data security and safeguards in data handling

Regulations Regarding Data Use and Security

- Unfair and deceptive practices under Section 5 of the FTC Act; and unfair, deceptive and abusive practices under Sections 1031/1036 of the Dodd-Frank Act (*Dwolla*) (conduct should align with data practices promised to consumers)
- Title V of the Gramm-Leach Bliley Act (use of consumer data)
- Safeguards rule in the Gramm-Leach Bliley Act (security measures to safeguard the handling of customer records and information)
- Fair Credit Reporting Act (permissible uses of consumer reports and marketing uses)



Fair Lending Concerns

- Since a FinTech company may not be directly regulated by banking agencies, there are emerging concerns that applicable consumer protection laws may not be scrutinized as closely in transactions where consumers are interacting with FinTech companies.
- FinTech firms often use alternative data and proprietary underwriting algorithms to decide loan applications.
- ***Inherent tension:*** the goal of increasing access to consumer credit is balanced against the potential for violating the fair lending laws and the Fair Credit Reporting Act.
- Equal Credit Opportunity Act and the Fair Housing Act, both of which include disparate impact theories of liability, do apply to FinTech firms.

Fair Lending Concerns

- Underwriting based on social media (Facebook, LinkedIn), alternative data (cell phone bills or utilities), or other non-traditional data present unique challenges under a disparate impact theory.
 - Possible disconnect, however, between the aspirations of proprietary scoring methods and reality (prevalent use of FICO anyways)
- Regulators and industry grapple with fair lending issues regarding FinTech innovations
 - Consequence is an increased need for internal fair lending audits
 - Satisfy bank partners whose examiners are probing fair lending compliance in their vendor management and third-party relationships
 - No-Action Letters? Project Catalyst?
- In addition, because FinTech firms may not have physical locations, concerns emerged regarding how regulators would apply the Community Reinvestment Act to alternative systems for delivering retail banking services.

Intellectual Property in FinTech

- IP relevant to FinTech includes—
 - Patents
 - Copyrights
 - Trade secrets
 - Trademarks, and
 - Unfair Competition
- As in most fields, IP in FinTech is about identifying and protecting the intangible rights held by an owner
 - Innovations in software, data and (possibly) hardware used in FinTech may include IP
 - Innovators expect to “own” – have exclusive rights to – technology they create; protection encourages innovation (?)
 - For TMs, other brand IP, FinTech is no exception

Intellectual Property in FinTech

- Patents for business have an inconsistent history—
 - No financial patents in past, because new approach viewed as a business method—not technology
 - Technology became intensively used in finance with software tools and internet for communication, need/ability to handle massive data
- The *State Street* case in 1998 opened the door to “financial method patents” but now largely closed
 - Broadest form of protection—no copying required
 - Industry backlash on scope, patent trolls and litigation
 - The open source movement
 - Scotus rulings in *Bilski* 2010 and *Alice* 2013 addressed “abstract ideas”
 - Current patentability state of the law—
 - No ban on business methods, but requirement of specific, non-abstract improvement in technology
 - USPTO rejects all except high “technicality” innovations

Intellectual Property in FinTech

- Copyrights (work of authorship)—possible alternative for patented software—but does not protect:
 - Business methods
 - Broad ideas, and
 - Data/facts per se
- Trade secrets—often present and useful with software/data, but protection requires secrecy measures, corporate discipline
- Trademarks—protect branding but not technology
- IP of others—necessity of patent clearance and “clean” development”
 - FinTech patents issued by the dozens pre *Bilski*
 - enforcement now uncertain

Intellectual Property in FinTech

- When considering IP in a FinTech situation—
 - Ownership of innovations starts with identifying the innovator/author
 - Hardware inventor
 - Software authors
 - Data author
- Ownership involving data is problematic—who is the author?
 - How is data created and collected?
 - Is possession by collector an indicator of ownership?
 - Is each source of collected data an author?
 - Data from analysis (AI) of collected data?
 - Related issue is control by person who is data subject
 - The intersection of GLB and consumer privacy
- Licensing of IP in order to utilize
- New Tech Standards: Open Source concepts vs exclusive/proprietary
- Understanding tech’s implications requires understanding tech
 - Blockchain see <https://blockchainedu.org/learn/>
 - Risk: Changing “Trust boundaries”

Bank Decisions for Developing FinTech

- Banks and other financial intermediaries face a buy-versus-build decision (*i.e.*, internal development vs. license-ing, SaaS or outsource)
 - Advantages of ownership—
 - Control
 - Security
 - IP Ownership
 - Branding
 - Disadvantages of ownership—
 - Cost
 - Speed to market (nimbleness)
 - Multiple internal stakeholders
 - Implementation risk
 - Operational risk

Bank Decisions for Developing FinTech

- Advantages of licensing/outourcing—
 - Lower initial cash investment
 - Reduced implementation risk and operational risk
 - Predictable fee structure
 - Potential ability to shift risk and liability to vendor
- Disadvantages of licensing/outourcing—
 - Security compliance
 - Use of cloud storage and hosting
 - Control/development roadmap
 - Measuring operational performance (SLAs)
 - Ownership of IP
 - Vendor insolvency
 - Termination transition, etc.
- The “typical” vendor-offered agreement broadly disclaims liability and provides very limited assurance of performance—and is often contrary to the vendor management requirements of the bank regulators and the CFPB

Vendor Selection/Preliminary Issues

- Type of Technology Involved
 - Incremental
 - Transformative
 - Customer-facing
 - Back-office
 - Categories of data involved
- Type of Vendor
 - Larger, established
 - Newer, emerging
 - VC-backed
 - Service/exclusivity tied to equity investment
- RFP Process
 - Driven by business teams and focuses on functionality
 - Legal compliance often becomes involved late in process
 - Battle of forms for vendor services agreement

Negotiation - Key Contractual Issues

- Key Contract Terms are difficult to resolve easily—
 - Implementation/Launch Date
 - Firm commitment or “best efforts”
 - Milestone payments
 - Refund of prepayments for failure to meet launch date
- Operational Performance
 - Scope of contractual commitment (“Subject to terms and conditions of Agreement, Vendor will make the Services available to Customer ...”)
 - Service Level Agreement and remedies
- Data security and data offshoring
- Vendor subcontracting

Key Contractual Issues (continued)

- Scope of Indemnities
 - What does vendor cover
 - What does customer cover
- Limitations of Liability
 - Disclaimers of consequential damages and exclusions
- Caps on Liability
 - Trailing 12 months
 - Exclusions from caps
- Term
- Termination Transition
- Vendor Bankruptcy
- Dispute Resolution

The OCC's Initiatives

- The OCC's proposals—
 - On October 26, 2016 the OCC established Office of Innovation to be the central point of contact and clearing house for requests and information related to innovation, with stated goals—
 - establishing an outreach and technical assistance program for banks and nonbanks
 - conducting awareness and training activities for OCC staff
 - encouraging coordination and facilitation
 - establishing an innovation research function, and
 - promoting interagency collaboration
 - In December of 2016, the OCC issued “*Exploring Special Purpose National Bank Charters for Fintech Companies*”
 - <https://www.occ.gov/topics/bank-operations/innovation/index-innovation.html>

The Proposed OCC FinTech National Bank Charter

- A special purpose national bank
 - Insured or uninsured (probably uninsured)
 - Having National Bank Act preemption
 - Required to comply with all safety and soundness regulations
 - A robust business plan
 - Governance structure
 - Capital
 - Liquidity
 - Recovery and resolution strategies
 - Consumer protection
 - Limited to bank-permissible activities
- Oh Yes—the FinTech companies want no compliance obligations—just the federal preemption and access to the payments system

The Proposed OCC FinTech National Bank Charter

- The FinTech charter has been soundly criticized
 - By Congressional Democrats
 - By many banks
 - Why give a substantial competitive advantage to a non-bank with none of the compliance obligations?
 - Staff of the OCC have indicated that strict compliance with OCC regulations would be required
 - Most of which FinTech companies can't or don't want to do...
 - Commentators have raised systemic risk
 - Funding concerns
 - Ultimate FDIC liability
 - Difficult—if not impossible—to avoid accepting deposits
 - But if you accept deposits—the FinTech charter becomes an internet bank

Examples of FinTech that May Succeed

- Collaboration with banks in joint ventures
 - Banks assuming control and compliance obligations
 - FinTech charter may only work if affiliated with an FDIC-insured bank
- Fannie Mae initiatives—
 - Appraisals
 - Title
 - Waiving origination representations and warranties
- Rocket Mortgage
- Aberoon—
 - 50% reduction in false red-flags for AML compliance
- International trade financing
- The Asian/African payments alternative

QUESTIONS?

Contacts



Joseph T. Lynyak III – Dorsey & Whitney LLP

Joe Lynyak is a financial services partner in Dorsey & Whitney's Financial Services Practice. Focusing his practice on the regulation and operation of financial service intermediaries, he provides counsel on strategic planning, application and licensing, legislative strategy, commercial and consumer lending, examination, supervision and enforcement and general corporate matters. He has extensive expertise across a comprehensive range of issues before federal and state regulatory agencies such as the Federal Reserve Board, OCC, FDIC CFPB, SEC, FTC and California and New York Banking Departments. Mr. Lynyak's representative clients include foreign and domestic banks, savings associations, holding companies and mortgage banking companies. He can be contacted via email at Lynyak.joseph@Dorsey.com or at 310.386.5554.



FINTECH PERSPECTIVES—FEBRUARY 2017 ROUNDTABLE

Contacts



J.H. Jennifer Lee – Dorsey & Whitney LLP

Jenny Lee is a trial partner in Dorsey & Whitney's Financial Services Litigation Practice. Drawing upon her experiences leading CFPB investigations as a former Enforcement Attorney, she assists clients with responding to Civil Investigative Demands from the CFPB and defends their interests in ongoing enforcement investigations or supervision examinations. She also represents banks and financial services firms in informal or formal CFPB rule making proceedings and advises companies on best practices and compliance issues pertaining to consumer financial regulations. She has extensive experience assisting large banks, mortgage companies, credit card issuers, consumer reporting agencies, student loan companies, short-term small-dollar lenders, retail-installment lenders, individuals, and financial technology start-ups. She can be contacted via email at lee.jenny@dorsey.com or 202.442.3572.



FINTECH PERSPECTIVES—FEBRUARY 2017 ROUNDTABLE

36

Contacts



Stuart R. Hemphill – Dorsey & Whitney LLP

Stu Hemphill is a partner in Dorsey & Whitney’s Intellectual Property and Technology Group. He draws on a background in computer science and practices in the area of intellectual property, including acquisition of patent, trademark, copyright and trade secret rights. Stu’s practice also includes licensing and other transfers of technology and intellectual property rights, particularly for computer hardware and software businesses; and advising on litigation concerning intellectual property rights and unfair competition. He can be contacted via email at Hemphill.Stuart@dorsey.com or at 612.340.2734.

Contacts



Kevin Maler – Dorsey & Whitney LLP

Kevin Maler is a partner in Dorsey & Whitney’s Corporate Group and is a member of its Technology Commerce practice group. In his practice, Kevin helps clients, both large and small, develop, acquire, commercialize, license and sell their technology assets. Kevin regularly advises clients in structuring, drafting and negotiating complex commercial agreements, including intellectual property licenses, SaaS agreements, technology platform agreement, distribution agreements, supply agreements and joint ventures. He works closely both with vendors that provide technology services to large customers and with large and small customers that are negotiating to receive services from technology vendors. His experience crosses several industry sectors, including the financial sector and healthcare and benefits sector. Kevin can be contacted by email at maler.kevin@dorsey.com and by phone at 612.492.6149.