The Impact of FinTech on Financial Services Businesses

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OVERVIEW

- Crowdfunding, Blockchain and Robo Advice – Todd Gibson
- FinTech and Corporate Activity – Tom Wallace
- Platforms – Jacob Ghanty
- Social Trading – Rodney Smyth
- Panel discussion
WHAT IS FINTECH?

- In the investment management context FinTech includes:
  - Platforms
  - Use of blockchain
  - Robo Advice
  - Technology to support regulatory reporting (so-called “RegTech”)
  - Trading via tablets and smartphones
FCA’S APPROACH TO FINTECH AND INNOVATIVE BUSINESSES

Project Innovate

Innovation Hub
Advice Unit
Regulatory Sandbox
THE FCA REGULATORY SANDBOX

Criteria are introduced as a prerequisite for sandbox to ensure consistent treatment of firms and advancement of FCA objectives.

Criteria for using Sandbox
Firm in scope / Genuine innovation / Consumer benefit
Need for Sandbox / Background research

1. Firm proposal to use sandbox
   A firm submits a testing proposal to the FCA setting out the new solution and how it meets the criteria.

2. FCA assessment
   FCA reviews the proposal. The proposal is accepted if eligibility criteria are met. A case officer is allocated as a contact person for the firm.

   - No
   - Yes

3. Firm and FCA collaborate and agree a testing approach
   If the proposal is accepted, the FCA works with the firm to establish the best sandbox option, testing parameters, measures for outcomes, reporting requirements and safeguards.

4. Delivery of sandbox option
   FCA allows the firm to start testing.

5. Testing and monitoring
   The firm starts testing and engages with the FCA according to what was agreed in step 3.

6. Firm submits final report
   The firm submits a final report about the outcomes of testing and the FCA reviews the report.

7. Firm decides whether it will offer solution
   After the FCA receives and reviews the final report, the firm decides whether it will offer the new solution outside the sandbox.

* The FCA Regulatory Sandbox, November 2015, page 11
REGULATION CROWDFUNDING

- Effective in May 2016 (Title III of JOBS Act)
- Allows small issuers to raise capital publicly from small investors through broker-dealers or a new type of entity, “funding portals”
- Funding portals exempt from registration as broker-dealers
- Offerings exempt from registration under the Securities Act of 1933 (Section 4(a)(6))
WHAT IS “BLOCKCHAIN”?

- Detailed set of rules for tracking and transferring data utilizing the internet
- Public or private network of participants running same blockchain software
- Peer-to-Peer (P2P) network
- “Distributed ledger” technology allowing for distributed consensus
A BLOCKCHAIN ILLUSTRATION

Blockchain – a shared, replicated, permissioned ledger
WHY USE BLOCKCHAIN?

- Incorporates ledger of data transfers
- Verifies ownership ex-ante
- Verifies transfer of ownership ex-post
- All participants have copy of ledger
- Ledger is encrypted & tamper-proof
- Removes need for intermediaries
- Reduces costs and increases efficiencies
BLOCKCHAIN IN THE ASSET MANAGEMENT INDUSTRY

- Clearing and settlement of trades (e.g., DTCC)
  - Repo & Sec Lending
  - Swaps
- Trading and distribution of fund shares
- Working group of UK asset managers evaluating potential blockchain uses
- IPOs and other securities transactions
BLOCKCHAIN IN THE REAL WORLD

**NASDAQ Linq** – first use of blockchain ledger technology to complete and record a private securities transaction for **Chain.com**.

**Overstock.com** issues public shares of its stock on its **t0** blockchain platform - traded, settled and recorded “entirely on a decentralized ledger.”
Banks and FinTech - Integration
DRIVERS OF FINTECH INTEGRATION

- **FinTech:** Odds, Time, Scale, Grow up

- **Banks:** Death by a thousand cuts, low fees/margins, category killers, slow development
IS THERE A DEAL TO BE DONE?

- **FinTech Want:** Customers, Trust, Finance, Compliance/Risk Management

- **Banks Want:** Technology, Innovation, Efficiency
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<th><strong>STRENGTHS</strong></th>
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<td>Innovative culture</td>
<td>Integration</td>
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<td>Appeal to millennials</td>
<td>Reduce costs</td>
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<td>Agile and mobile technology</td>
<td>Brand building</td>
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<td>Single product excellence</td>
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<th><strong>WEAKNESSES</strong></th>
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<td>Regulatory compliance</td>
<td>Culture clash &amp; loss of key staff</td>
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<td>Data security</td>
<td>Brand contamination</td>
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<td>Financial controls</td>
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MANAGING RISKS IN PARTNERSHIP/M&A

- IP/IT DD and Integration Planning
- Preserve innovative culture
- …while making compliance and regulatory integration and early priority…
- Data security
- Data integration
- Merger of systems
Platforms
PLATFORMS

- What is a platform?
- Regulation of crowdfunding platforms
- Developments in marketplace or peer-to-peer lending
Social Trading
Authorisation
1. PLATFORM ESTABLISHED IN THE UK (FSMA INVESTMENTS)

- Discretionary investment management (with the social trader as the client): RAO, 37 – if the platform automatically executes (for the trader) the trade signals of a third party trader preselected by the trader. The automatic execution constitutes discretionary investment management. The mandate is the instruction to the platform to execute automatically.

- Dealing as agent (for the social trader): RAO, 21 – by executing the trader’s trades (whether or not the platform is also discretionarily managing)

- Investment advice (given to the social trader): RAO, 53 – unlikely, but possible
2. SOCIAL TRADER ON A PLATFORM ESTABLISHED IN THE UK (FSMA INVESTMENTS)

- Authorisation unlikely to be required
- No holding out – securities: RAO, 15 – and/or:
- Dealing through an authorised person (= the platform) – derivatives: RAO, 16
3. PLATFORM ESTABLISHED IN THE EEA EX-UK (MiFID INVESTMENTS)

- UK-authorised by FSMA, 31(1)(b), if “passporting” into the UK under MiFID
4. SOCIAL TRADER IN THE UK ON A PLATFORM ESTABLISHED IN THE EEA EX-UK (MiFID INVESTMENTS)

- Apply the law of the ex-UK EEA state in which the platform is established
Financial Promotion Regulation
1. PLATFORM ESTABLISHED IN THE UK (FSMA INVESTMENTS)

- Financial promotion by the platform is permitted: FSMA, 21(2)(a) (authorised person)
- FCA COBS 4 – “retail clients” “MiFID business” rules regulate the content of the promotion – e.g., it must be “fair, clear and not misleading,” and past performance (= track record) information heavily restricted
- Does the platform “cause” promotions by social traders? – e.g., in the form of comments posted by them on the platform’s website: FSMA, 21(3)
- Even if it does, the promotions are regulated only if made by a trader “in the course of business”: FSMA, 21(1). Arguably, though, this may catch comments by “lead traders” who are paid by “followers”.
2. PLATFORM ESTABLISHED IN AN EEA STATE EX-UK, “PASSPORTING” INTO THE UK UNDER MiFID (MiFID INVESTMENTS)

- Financial promotion by the platform is permitted: FSMA, 21(2)(a)
- Rules of the ex-UK EEA state in which the platform is established regulate the content of the promotion, either because the platform is carrying on “electronic commerce activity” (ECA); or, to the extent it is not (e.g., where there is telephone dealing), because it is carrying on “MiFID business”: COBS 1, annex 1. In either case, the effect is that MiFID applies, as transposed into the law of the state, because the state is in the EEA
- Note that UK general and civil law still apply (e.g., conspiracy to defraud and misrepresentation): Electronic Commerce Regulations, 4(4) and sch., 3, and 5(1)
Practice
CUSTOMER AGREEMENT WITH PLATFORM

- Special social trading terms
  - Trading always for non-commercial purposes
  - Follow lead traders at own risk
  - Followers agree that lead traders are not making recommendations to them (so that no investment advice)
  - Lead traders not to comment on specific securities
  - Lead traders not liable to followers
  - Consent to other traders on the platform viewing your trades
  - Consent by lead traders to being followed
  - Each lead trader must act independently
  - Platform not liable to followers for lead traders’ acts or omissions
  - Platform not liable to pay lead traders (you are)
  - Suggestions welcome!
WHAT SOCIAL TRADERS LOOK FOR

- Minimum investment (e.g., US$10 or US$10,000)
- Average EUR/US$ spread
- Broker choice
- Instruments traded
- Account currencies
- Cost per trade
- How many lead traders can you copy?
- Automated lead trade copying?
WHAT SOCIAL TRADERS LOOK FOR (continued)

- Demo. lead trader accounts allowed? – or only real money accounts?
- Lead trader compensation – amount; results–linked?
- How far back does available lead trader history go?
- Can you publicly rate traders?
- Lead trader qualifications (e.g., none or minimum number of trades + minimum return over given period)
- Trader account protection - what if your lead trader suddenly loses his touch?
SOCIAL TRADING STATISTICS

- One platform claimed:
  - >4,500,000 traders “already” registered
  - 187,946,727 trades “opened” (= c.40/registered trader) –

as of when accessed on 16 June 2016