MAYER·BROWN

Technology and Innovation in Financial Services

Steve Kaplan

Partner and Co-chair of Financial Services Regulatory & Enforcement Practice

+1 202 263 3005

skaplan@mayerbrown.com

Melanie Brody

Partner

+1 202 263 3304

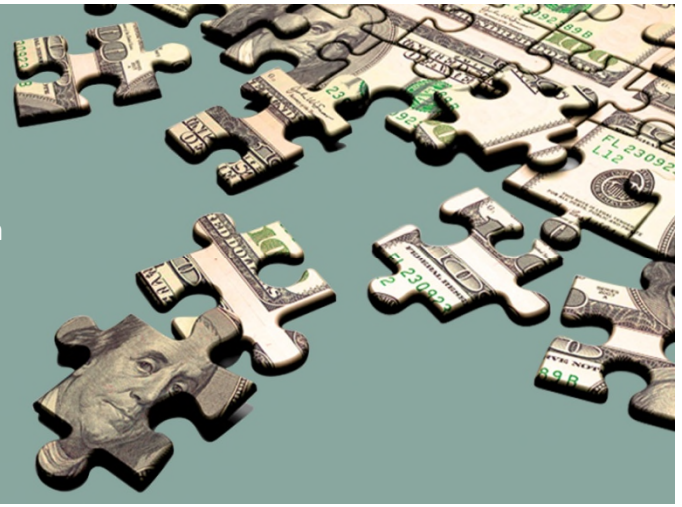
mbrody@mayerbrown.com

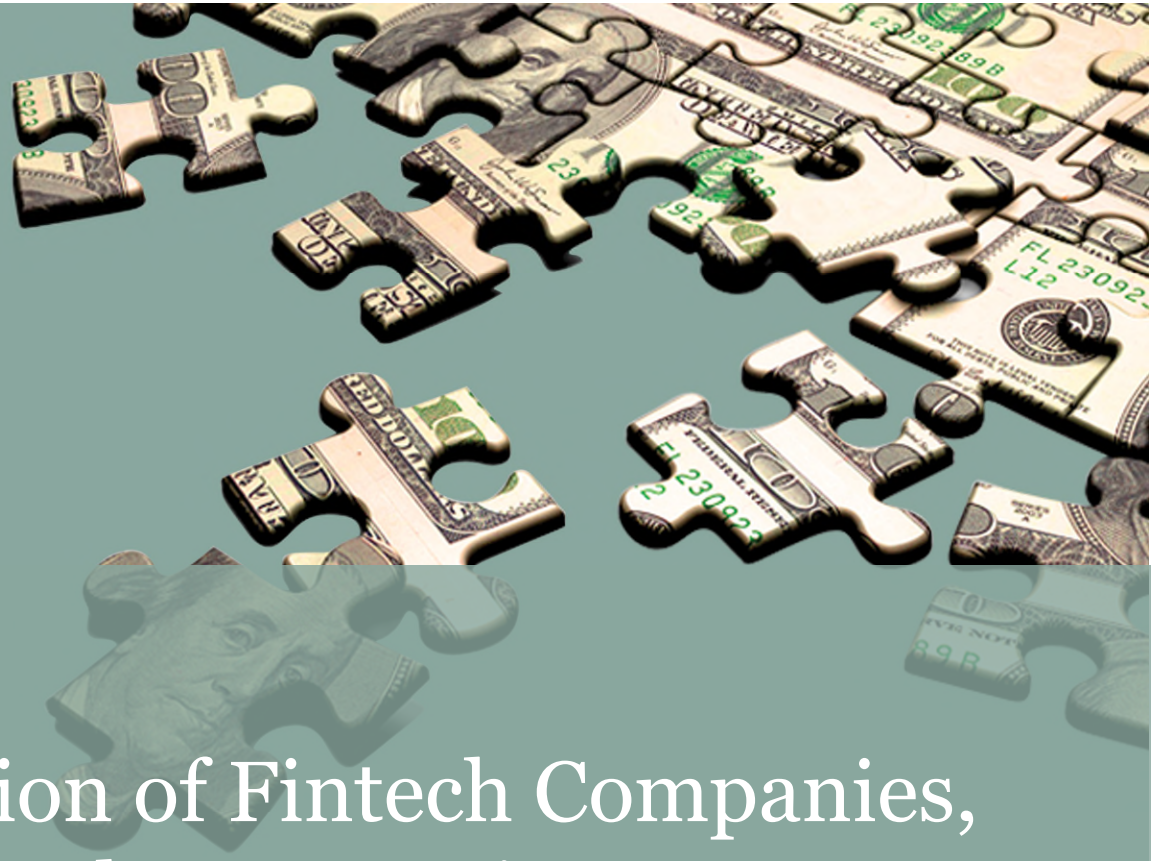
Mark Compton

Partner

+44 20 3130 3388

mcompton@mayerbrown.com





Effective Regulation of Fintech Companies, Including Fintech Charter Options

What is Fintech?

- fin ˌtek/
  - noun
  - computer programs and other technology used to support or enable banking and financial services
- Fintech is a portmanteau of financial technology that describes an emerging financial services sector in the 21st century.
- A “fintech company” is generally a start-up with a business plan of disrupting the financial services industry by offering financial services at lower cost or with more convenience using cloud, advanced data analytics, or other new business models.
- Since 2010, the term has expanded to include any technological innovation in the financial sector, including innovations in retail banking, investment and even crypto-currencies like bitcoin.

Federal and State Regulators of Fintech Companies

- State agencies (banking and financial institution departments, consumer credit agencies)
- Federal banking agencies (FDIC, FRB, OCC, NCUA)
- Consumer Financial Protection Bureau
- Federal Trade Commission
- FinCEN
- OFAC
- Securities and Exchange Commission

State Law Requirements and Impediments

- State licensing
  - Conditions to licensing (in state office, personal disclosures, capitalization requirements)
- Substantive Restrictions
  - Interest rates
  - Disclosures
  - Permissible investments

USURY

- State laws provide civil and possibly criminal usury restrictions
- Federal law provides banks with authority to exceed otherwise applicable usury rates

Who is True Lender?

- Federal and state courts evaluating "true lender" claims have adopted multiple standards for determining when relationships should be recharacterized.
- Some courts have determined the "true lender" solely through reliance on the party named in loan agreements as the creditor
- Some courts have determined the "true lender" through a narrow evaluation of facts regarding which party engages in the three non-ministerial acts that federal banking regulators have identified:
  - Determination to extend credit;
  - The extension of credit itself; and
  - The disbursement of funds resulting from the extension of credit.
- Some courts have taken a more fact-intensive approach, evaluating the totality of the circumstances to determine which party retains the "predominant economic interest" in loans originated under the relationship.

Who is True Lender?

- More recent attacks on "true creditor"
- U.S. District Court for the Central District of California recently issued two "true lender" decisions, with opposite results.
  - *CFPB v. CashCall, Inc.*, No. 2:15-cv-07522 (C.D. Cal.)
  - *Beechum v. Navient Solutions, Inc.*, No. 2:15-cv-08239 (C.D. Cal. Sept. 20, 2016)
- *CashCall* is a tribal partner case, and Beechum is a bank partner.
- The *CashCall* court used the "predominant economic interest" test to find CashCall was the true lender.
- The *Beechum* court relied on California's usury laws, that expressly except loans made by banks.

State Administrative and Legal Challenges

- Colorado Consumer Credit Commissioner Actions
  - Supervised Lender Examinations
  - Recent Complaints
- N.H. Banking Department Settlements
  - Lending Club (April 2016)
  - Prosper (Nov. 2016)
  - Avant (Dec. 2016)
- *Maryland Commissioner of Financial Regulation v. CashCall* (Oct. 2015)

Madden v. Midland Funding

- Plaintiff Madden opened a credit card from a national bank. The debt was ultimately sold to Midland Funding, a non-bank. Madden alleged that Midland's attempt to collect the debt at the rate contracted by the bank violated state usury law.
- The District Court dismissed Madden's usury claims, stating that they were preempted by the National Bank Act.
- The Second Circuit reversed, holding that the NBA did not preempt the state usury law vis a vis Midland, because Midland was not a national bank or acting on behalf of a national bank.
- Midland petitioned the Supreme Court for certiorari, arguing that a loan that is valid when made should be enforceable pursuant to the terms agreed to by the borrower and original creditor.
- The Supreme Court denied certiorari, creating uncertainty as to when secondary market participants can rely on interest preemption on loans originated by banks.

Is Exportation Available to Assignees of a Bank?

- Five basic arguments as to why an assignee is entitled to enforce the loan as written:
  - Common law "valid-when-made principle" - 12 U.S.C. § 85 and its analogues.
  - Applying state usury laws to a national bank would "significantly interfere" with the bank's authority to charge interest in accordance with the laws of the states where it is located.
    - In Barnett Bank of Marion County v. Nelson, 517 U.S. 25 (1996), the Supreme Court held that a state law was preempted if it "prevents or significantly interferes with" a national bank's exercise of its powers.
  - As a matter of state usury law, a contract is not usurious if it was not usurious when made.
  - Assuming that the contract provides that the laws of the national bank's location state governs, those choice-of-law principles should control.
  - UCC shelter principle gives the assignee the same rights as the assignor.

Background - OCC Innovation Initiative

- In March 2016, the Office of the Comptroller of the Currency ("OCC") published a paper titled "Supporting Responsible Innovation in the Federal Banking System."
- On October 26, 2016, the OCC announced the decision to establish an Office of Innovation ("Office") and implement a framework for responsible innovation.
  - The Office will also implement other aspects of the OCC's framework for responsible innovation, including:
    - 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.

Background - OCC Innovation Initiative

- On December 2, 2016, the OCC issued a white paper titled "Exploring Special Purpose National Bank Charters for Fintech Companies" and announced that it was accepting special-purpose national bank ("SPNB") charter applications from fintech companies.
  - Comments on the white paper and thirteen questions were due by January 15, 2017.
  - Senators Sherrod Brown (D-OH) and Jeffrey Merkley (D-OR) wrote to the Comptroller criticizing the new charter particularly as it concerns financial inclusion efforts, consumer protection laws, and the principle of separation of banking and commerce.
  - House Committee on Financial Services wrote to the Comptroller warning that a charter should not be rushed without further public review and OCC analysis of feedback.
  - Other groups, including the CSBS, have also questioned the need for a federal charter with the existing state licensing regime and the legal authority of the OCC to grant this type of charter.

Background - OCC Innovation Initiative

- On March 15, 2017, the OCC issued a draft "Licensing Manual Supplement for Evaluating Charter Application from Financial Technology Companies" and "OCC Summary of Comments and Explanatory Statement."
  - Comments on the licensing manual were due by April 14, 2017.
  - It is unusual for the OCC to solicit comment on procedural manual and supplements; however, the OCC is doing so now to increase transparency and stakeholder engagement with the SPNB chartering process.
  - OCC Summary of Comments was an in depth review of the comments received and counterpoints to the major criticism.

SPNB Charter: Authority and Activities

- The OCC has authority under the National Bank Act ("NBA") to charter national banks, which are legal entities that engage in one or more of the following activities:

•Receiving deposits; •Paying checks; •Lending money; or •Providing fiduciary services.	Core banking functions

- The OCC has authority under the National Bank Act ("NBA") to charter national banks, which are legal entities that engage in one or more of the following activities:

Exportation of Interest Rate and Certain Fees

- 12 U.S.C. § 85 permits a national bank to charge "interest" at the rate permitted by the laws of the state where the bank is located.
- "Interest" encompasses all charges that compensate the creditor for the extension of credit or the borrower's default.
  - Periodic finance charges
  - Late fees
  - Membership fees or annual fees
  - Overlimit fees
  - NSF fees
  - Prepayment fees

SPNB Charter: Preemption

- The NBA and its implementing regulations generally provide national banks with the authority to conduct their activities without regard to certain state laws. SPNBs would benefit from the same preemption.
- Examples of **preempted state laws**:
  - Licensing laws, which can relieve some consumer lenders or more money transmitters from obtaining one or more licenses in all 50 states.
  - Usury laws, permitting SPNBs to follow the restrictions on interest rates and certain loan-related fees under the laws of the state where the bank is located, even when making loans to borrowers located in other states.
  - Certain state law disclosure requirements would also be preempted.

Application Process

1. **Prefiling:** Informal and formal discussions with the OCC take place and the business plan is developed.
2. **Filing:** Organizers submit a formal application for a charter.
3. **Review and evaluation:** The OCC conducts background and field investigations to determine whether the applicant has a reasonable chance of success and, amongst other things, will operate in a safe and sound manner and comply with applicable laws and regulations.
4. **Pre-Approval:** Application approved with certain conditions.
5. **Final approval:** The OCC determines that the applicant has met the requirements and conditions to operate under a federal charter.

Points to Consider in Evaluating the SPNB Charter – Permissible Activities

- The OCC has not provided any significant guidance regarding the scope of what is a "fintech company" or if it specifically excludes any types of businesses (beyond payday lenders) based on an impermissible mixing of banking and commerce.
- With respect to permissible activities, lending and payment businesses would almost certainly qualify.
- Other types of companies, however, may require a more detailed analysis and discussion with the OCC before submitting an application.

Point to Consider in Evaluating the SPNB Charter – Additional Laws

- Company focused on lending will need to consider lending limits, credit classification standards and loan loss reserves.
- To ensure competitive equality, safety and soundness, or the needs of the public, the OCC could require compliance with those laws generally applicable to insured depository institutions even if the company does not intend to seek deposit insurance (e.g., CRA-type obligation).
- Restrictions or prior approvals on any transfer of ownership or new investors with controlling interest.
- The OCC could also require the parent of an SPNB to provide financial support through a Capital Assurance and Liquidity Maintenance Agreement or similar agreement.

Points to Consider in Evaluating the SPNB Charter – OCC Examination

- OCC examinations are extensive and will require a significant amount of preparation and follow-up by employees of the SPNB.
- An SPNB and its institution-affiliated parties could face informal, formal, or public enforcement actions as a result of the supervision and examination process.
- In addition to significant monetary penalties, the OCC could require the bank to terminate certain activities, refrain from new activities, replace management or raise additional capital.

Points to Consider in Evaluating the SPNB Charter – Safety and Soundness

- Although the OCC has suggested that it might tailor its supervision of an SPNB charter to some degree, the heightened level of oversight may effectively restrict or limit the operation of the business.
- New restrictions may impair innovation and limit a company's ability to compete with nonbank institutions.
- A company operating under an SPNB charter may need prior approval/non-objection from the OCC to deviate from its three-year business plan, create new subsidiaries, pay dividends or invest in other companies.
- OCC approvals related to transfers of ownership or new shareholders may limit exit strategy or ability to raise capital.

Points to Consider in Evaluating the SPNB Charter – Existing Business Structure

- Activities transferred to the SPNB.
- Location of the SPNB and ability to conduct certain activities from main office (especially if exporting rates and fees of bank's home state).
- Restrictions on transactions between SPNB and its affiliates under Section 23A/B and Regulation W.
- Affiliates providing services to SPNB would be subject to supervision by the OCC.
- Regulation of physical locations of the SPNB other than the main office (e.g., branches or loan production offices).

Key Takeaways

- The announcement of the SPNB charter is an overall positive development for financial services companies.
  - Companies will need to consider the advantages and disadvantages of the charter.
  - Engaging with the OCC may help determine whether this charter is a good fit for a particular organization.
- The SPNB charter might be appropriate for some companies, particularly those burdened with conflicting 50-state compliance obligations or ineligibility issues (e.g., licensing, interest rate exportation and payment systems access).
- Other companies may not find the charter to be a good fit, particularly in light of costs (e.g., capital, liquidity and assessments).
- Applying for an SPNB charter should be a particularly viable option for companies that are well-capitalized, have a strong management team and demonstrated success of business model.

Key Takeaways

- Additional information from OCC still needed:
  - Capital requirements
  - Liquidity requirements
  - OCC assessment fees
  - Financial inclusion obligation
- Additional information needed from other regulators and associations regarding the authority and treatment of an SPNB:
  - FRB discount window,
  - payment systems access (Card Associations, Fedwire and NACHA), and
  - FHLB membership.

The CFPB and "Project Catalyst"

- On October 23, 2016, the CFPB released its first-ever report on Project Catalyst, the Bureau's initiative to support responsible financial innovation.
- Project Catalyst was launched in November 2012, and to date has consisted of four components: (i) "Office Hours" where the CFPB meets with interested parties; (ii) a Trial Disclosure Waiver Policy implemented in 2013 and intended to allow companies to test alternative consumer disclosures; (iii) a No-Action Letter Policy announced earlier this year and intended to provide a limited safe harbor from CFPB enforcement; and (iv) research projects conducted in coordination with industry.
- The report first discusses each of these initiatives, and then discusses eight "marketplace developments that may hold the potential for consumer benefit."

The CFPB and "Project Catalyst"

- The report also describes what the CFPB refers to as "policies to foster consumer-friendly innovation" – namely, the Trial Disclosure Waiver Policy and the No-Action Letter Policy.
- These two policies could provide companies with concrete legal protections. Unfortunately, neither has been used to date.
- Under the Policy, a company may apply to the CFPB to test new disclosure methods for a limited time, during which the Bureau deems the test disclosure to be compliant with any applicable regulatory requirement.
- The trials are intended to provide information about consumer comprehension and decision-making processes.
- Notwithstanding the Policy's implementation over three years ago, to date the CFPB has yet to approve any trial disclosure programs for a waiver.

The CFPB and "Project Catalyst"

- The Policy on No-Action Letters is similarly intended to promote the development of new consumer financial products and services.
- The Policy allows companies to apply for a No-Action Letter from the CFPB, which would indicate that "the Bureau staff has no present intention to recommend enforcement or supervisory action with respect to particular aspects of the company's product and under the provisions and applications of statutes or regulations that are the subject of the letter."
- No-Action Letter does not bind other regulatory agencies or prevent private litigation and letters may be conditioned on a company implementing particular safeguards to mitigate consumer harm.
- As with the Trial Disclosure Waiver Policy, the CFPB has yet to issue a no-action letter

Regulatory Oversight and Innovation

- Does regulatory oversight affect and impact innovation?
  - Technology may raise concerns; including security of information and systems
  - Disclosure and licensing may require longer rollout and testing
  - Laws may not allow proposed operations

Alternative Data and Credit Underwriting: Opportunities and Risks

Introduction

- Most credit decisions and pricing determinations are based heavily on information in credit reports generated by three national consumer reporting agencies
- Therefore, consumers who have limited or no credit history can have difficulty obtaining credit
- However, a large number of consumers are either:
  - Credit invisible, i.e., they do not have a credit report
  - Unscored, i.e., they do not have enough credit history to generate a score or their credit history is stale

Introduction

- The CFPB published a study in 2015 stating that:
  - 26 million consumers (10% of American adults) are credit invisible
  - 19 million consumers (8% of American adults) are unscored
  - African-American and Hispanic consumers are more likely to be credit invisible or unscored than white or Asian consumers
    - 15% of African-American and Hispanic consumers are credit invisible as compared to 9% of white consumers
    - 13% of African-American consumers and 12% of Hispanic consumers are unscored compared to 7% of white consumer
  - Consumers in low-income neighborhoods also are more likely to be credit invisible or unscored

Introduction

- The CFPB issued a RFI on the use of alternative data in credit transactions in February 2017:
  - The Bureau is seeking to learn:
    - Whether data from unconventional sources can help consumers to build a credit history
    - How to minimize risks related to the use of such data
  - Areas of interest include:
    - Whether the use of alternative data could make credit decisioning too complex
    - Impact of alternative data on operating costs for lenders, costs for consumers, transaction speed
    - Privacy and security implications
    - Potential fair lending impact

Alternative Data and Non-Traditional Underwriting

Alternative Data and Non-Traditional Underwriting

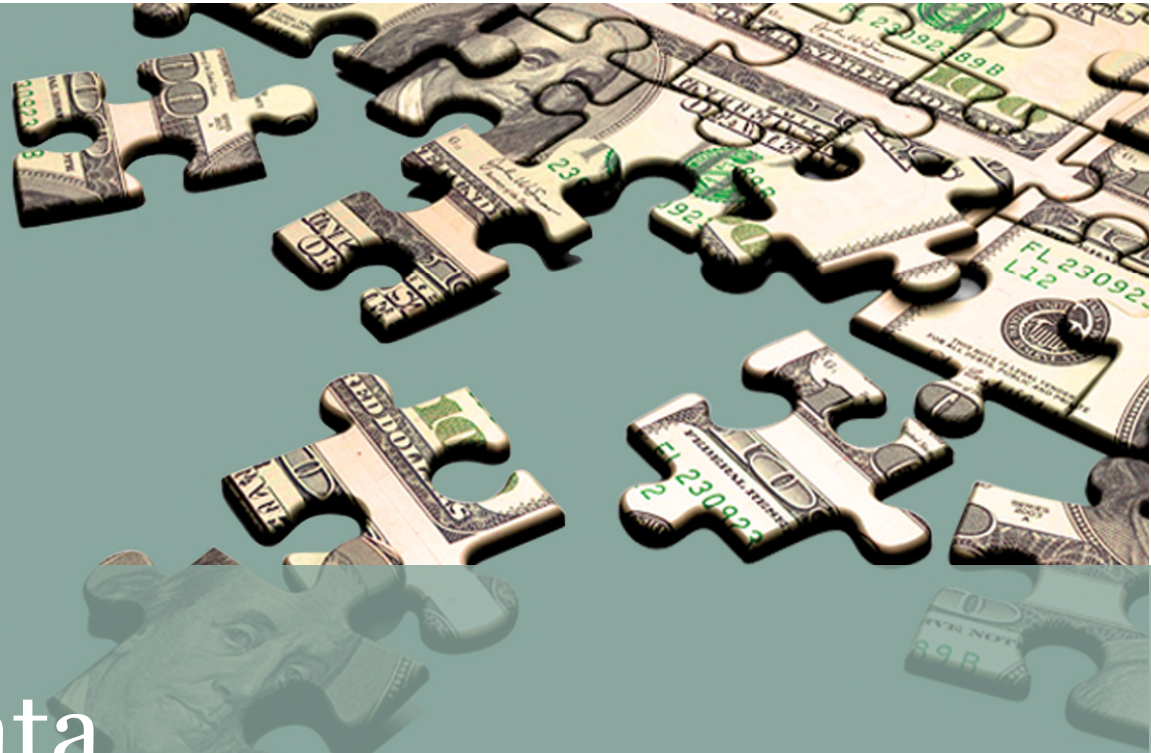
- Some segments of the consumer credit industry has provided for non-traditional credit for many years
  - For example, if a loan applicant does not have a credit score, Fannie Mae requires the lender to establish a non-traditional credit history for at least two non-traditional credit sources for each borrower, one of which must be housing-related (rent)
  - DU Version 10.0 provides for automated underwriting for unscored borrowers
- Alternative data has rapidly expanded sources of non-traditional credit data well beyond evaluations of rental payments and utility bills
- LexisNexis RiskView credit risk score is calculated using alternative data, e.g., educational history, property and asset ownership, professional licensing, evictions, recreational licenses, address instability
  - LexisNexis states that RiskView can score 86% of consumers who do not have a credit bureau score

Alternative Data and Non-Traditional Underwriting

- Increases in computing power have enabled massive increases in the amounts of data that can be stored, processed, and analyzed.
  - "[L]arge, diverse, complex, longitudinal, and/or distributed datasets generated from instruments, sensors, Internet transactions, email, video, click streams, and/or all other digital sources available today." ("Alternative Data: Seizing Opportunities, Preserving Values," Executive Office of the President, May 2014)
  - For example: web browsing history, social media presence, shopping patterns, data from fitness trackers, Facebook friends
  - Alternative data can involve almost anything
- Increases in computing power have also led to developments in analytics.
  - Instead of starting with a hypothesis and then carefully collecting data to validate it, collect all possible data and then look for any patterns that might emerge

Alternative Data and Non-Traditional Underwriting

- Using alternative data can create opportunities for lenders to increase business generally
- It also can help mitigate fair lending risk by expanding the ability to extend credit to minority borrowers
- On the other hand, alternative data can also create potential fair lending risk



Alternative Data

The Legal Framework-ECOA

Alternative Data: The Legal Framework–ECOA

- Prohibits discrimination in any aspect of a credit transaction on the basis of race/color, religion, national origin, sex, marital status, age, receipt of public assistance, and exercise of any right under the Consumer Credit Protection Act (e.g., FCRA, TILA, ECOA, FDCPA)
- Broad definition of creditor
  - Any person who, in the ordinary course of business, regularly participate in the credit decision, including setting the terms of the credit
- Also note:
  - Fair Housing Act: prohibits discrimination in residential real estate-related transactions on the basis of race/color, religion, national origin, sex, familial status, and disability

Alternative Data: The Legal Framework–ECOA

- State antidiscrimination laws
  - Example: California's Unruh Civil Rights Act: prohibits discrimination on the basis of sex, race, color, religion, ancestry, age, disability, medical status, sexual orientation, genetic information, medical condition, citizenship, primary language and immigration status

Alternative Data: The Legal Framework–ECOA

- Theories of Liability:
  - Overt Discrimination
    - Explicit refusal to lend or explicit variation in terms or conditions based on a prohibited factor
  - Disparate Treatment
    - Different treatment because of a prohibited factor
    - Application of discretion is most common risk factor (but note that disparate impact theory also has been used to challenge discretionary conduct)
    - Intent not required
    - If defendant cannot show non-pretextual reason for difference in treatment, intent will be inferred

Alternative Data: The Legal Framework–ECOA

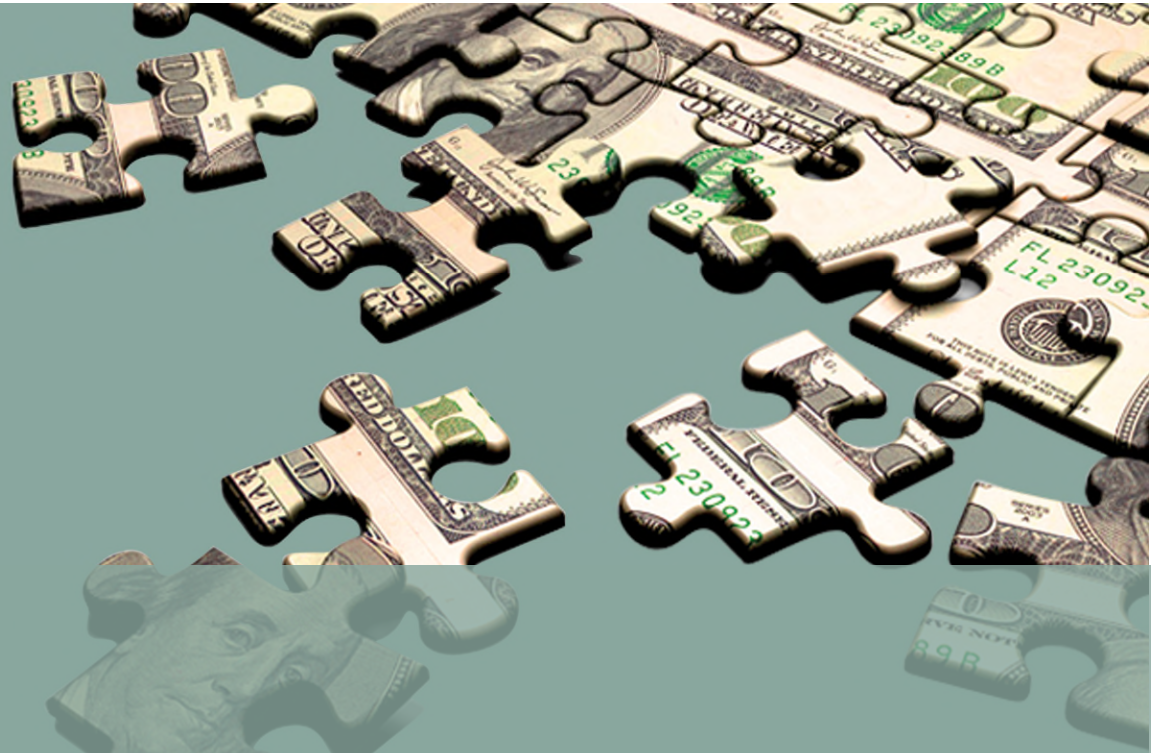
- Disparate Impact
  - A neutral policy or practice has a disproportionate and negative effect on a protected class
  - May be defensible if the challenged policy or practice serves a legitimate business interest
  - Challenged policy or practice may still be impermissible if the articulated business interest can be served through a less discriminatory means
- Generally, increased automation in credit decisions reduces risk of disparate treatment, but could increase risk of disparate impact

Alternative Data: The Legal Framework–ECOA

- *Texas Department of Housing & Consumer Affairs v. Inclusive Communities* (135 S. Ct. 2507 (2015))
  - Disparate impact theory can be used to establish liability under the Fair Housing Act
  - But limitations on the disparate impact theory apply at the pleadings stage:
    - a plaintiff must satisfy a "robust causality" requirement by identifying a specific policy of the defendant and its link to a statistical disparity
    - policies are not contrary to the disparate impact requirement unless they are artificial, arbitrary and unnecessary barriers

Alternative Data: The Legal Framework–ECOA

- HUD's 2013 disparate impact rule is arguably inconsistent with *Inclusive Communities*
  - Contemplates challenges to entire processes (vs. requiring analysis of a specific policy)
- Does *Inclusive Communities* decision apply to ECOA and non-mortgage credit?
- Technical application of judicial precedent vs. regulators' interpretation



Compliance Challenges and Strategies

Potential Fair Lending Concerns

- Alternative data raises potential fair lending risk in three main categories:
  1. Marketing / advertising
  2. Credit determinations
     - Underwriting (approvals/denials)
     - Product choice
     - Pricing
     - Line adjustments
  3. Servicing / collections

Potential Fair Lending Concerns: Marketing

- Marketing and advertising practices -- three potential fair lending risks:
  1. Direct violation of ECOA's prohibition on "discouragement"
  2. Can serve as evidence supporting discrimination claims
  3. Impact on lending patterns

"In most cases, a company's advertisement to a particular community for a credit offer that that is open to all to apply is unlikely, by itself, to violate ECOA, absent disparate treatment or an unjustified disparate impact in subsequent lending." *"Alternative Data: A Tool for Inclusion or Exclusion,"* Federal Trade Commission, January 2016.

Potential Fair Lending Concerns: Marketing

- Whether targeting a specific group (e.g., minority consumers) presents risk often turns on whether the product being advertised is viewed as beneficial or harmful
  - Generally, using alternative data to advertise and make credit available to underserved / protected class groups is viewed favorably
  - Risk of “reverse redlining” can be mitigated with product selection controls

Potential Fair Lending Concerns: Marketing

- Using social network or internet habits to target advertising can perpetuate a lack of access to credit for consumers who have a limited digital presence
- Consider the entire marketing strategy
- Unless marketing / advertising practices are clearly discriminatory, the primary risk arises from actual lending patterns

Potential Fair Lending Concerns: Credit Determinations

- Use of alternative data can expand credit opportunities to underserved groups
  - Alternative data used to extend credit to applicants who would otherwise be denied for lack of a traditional credit history may be less likely to prompt regulatory concern than when the data is used as the primary method of evaluating eligibility
- Reliance on alternative data "may exclude certain populations from the benefits society and markets have to offer" (FTC Report)
  - Data quality, including uncorrected biases, can lead to inaccurate predictions, which can lead to "erroneous" outcomes
  - Difference between correlation and causation
    - Can impact strength of business justification

Potential Fair Lending Concerns: Credit Determinations

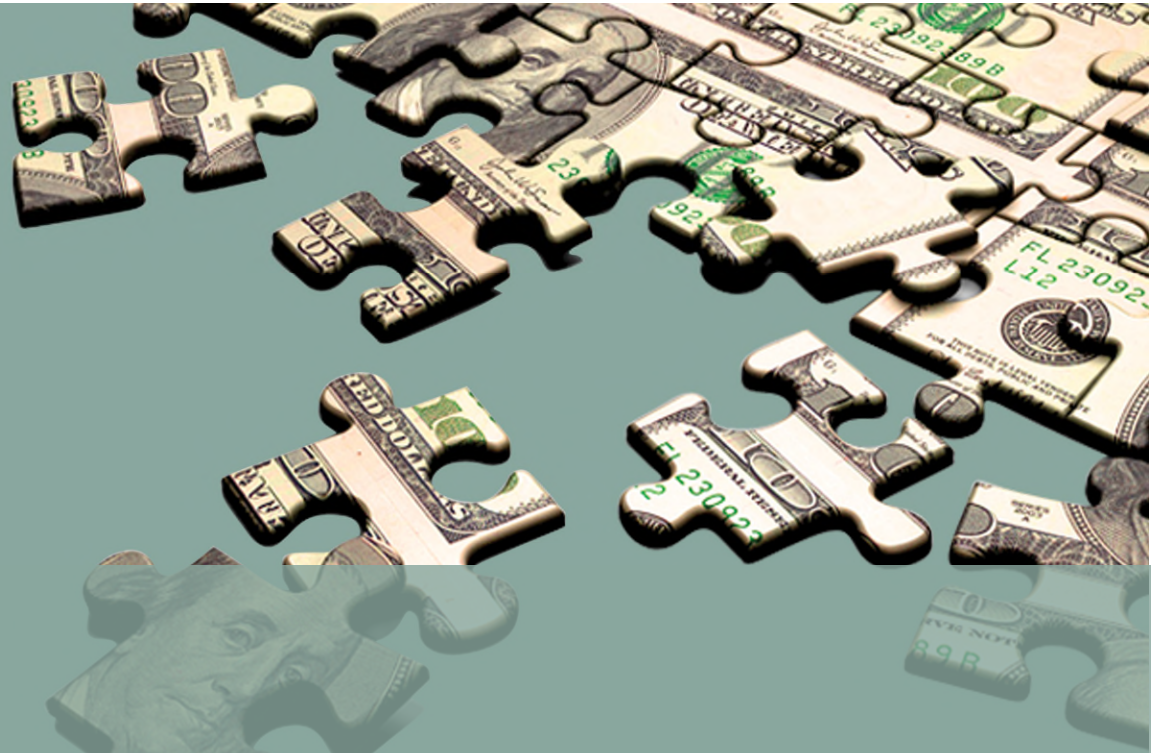
- Denials / line reductions based on shared characteristics can raise fairness concerns
  - Poor credit history of customers who buy the same products
  - Use of credit for medical conditions or tire repair

Potential Fair Lending Concerns: Credit Determinations

- ECOA applies to all aspects of a credit transaction, including collection decisions
- The same issues that apply in the origination context apply to servicing and collections
- Servicing is a CFPB focal point

Managing Risk

- Test whether a factor has a disparate impact on one more protected classes of consumers
- Test the factor's predictive power
  - Certain factors may be viewed negatively even if they have strong predictive power
- Consider alternatives
- Carefully document fair lending evaluations
    - Important from CMS perspective
    - Regulators may rely on your analyses rather than performing their own
- Tension between compliance and analytical teams
- Third party vendors
  - CMS / Vendor oversight
  - Reps and warranties



Project Innovate: The UK Financial Conduct Authority's approach to the regulation of Fintech

What the FinTech firm say …

- "The UK is a global gold standard for the progressiveness of its regulatory regime. … the FCA has established a programme that FinTechs describe as supportive and collaborative, and significantly simplifying regulatory complexities."

  E&Y Report 2016

- "In the UK, the FCA has been moving forward with plans to implement a "regulatory sandbox" to increase the pace of financial services innovation. … This helps encourage innovation by enabling trials before incurring the costs and burdens of a full regulatory review".

  Jason Albert, Assistant GC Regulatory Affairs, Microsoft Corporation recommendation to Thomas J. Curry, Comptroller of the Currency, 31st May 2016

Why is the FCA focusing on FinTech?

- "Bureaucracy destroys initiative. There is little that bureaucrats hate more than innovation …"

  Frank Herbert – Heretics of Dune

- The FCA has an overarching statutory objective to ensure financial markets function well.
- To support this it has three operational objectives:
  - to secure an appropriate degree of protection for consumers;
  - to protect and enhance the integrity of the UK financial system; and
  - to promote effective competition in the interests of consumers.
- "Part of the competition objective involves promoting competition in the interests of consumers. One way that all sorts of competition regulators have thought about that is around disruptive innovation …"

  Chris Woolard, the FCA's director of strategy and competition

Regular Stakeholder Engagement 1

- "The start-up motto is to ask for forgiveness, not permission. We also won't have got this 100% right first time. So we are going to keep asking how to make it work better"

  Martin Wheatley, Chief Executive of the FCA – October 2014

- July 2014 FCA published a consultation – "Project Innovate: Call for input" – the findings from which formed the basis for the FCA's innovation hub.
- June 2015 FCA consulted on the barriers to digital and mobile solutions for financial services, and specific rules and policies that should be introduced to facilitate innovation in this area.
- Since September 2015 the FCA has held a series of themed weeks, designed to stimulate engagement with stakeholders interested in a particular area of innovation, such as robo-advice and the payments sector.
- November 2015 a "Call for Input" to seek broader views on how FCA should progress and prioritise its RegTech work.

Regular Stakeholder Engagement 2

- March 2016 the FCA published a feedback statement which set out its roadmap to address the issues raised by market participants.
- March 2016 bilateral meetings and four roundtables convened to obtain further face-to-face input.
- November 2016 regulatory “Sandbox” begins operation - designed to learn and develop from each cohort
- FCA seeks regular feedback from all FinTech firms that approached them and recently received the following feedback:
  - 83% rated their overall experience of Innovation Hub as excellent (39%) or good (44%)
  - 87% rated the promptness of the FCA’s response as excellent (59%) or good (28%)
  - 92% rated the effectiveness of the FCA’s communication as excellent (64%) or good (28%)

The Innovation Hub 1

- October 2014, FCA launched “Project Innovate” to remove uncertainty over compliance for businesses developing FinTech products that could improve financial services for consumers.
- In the first year Project Innovate directly supported 177 firms – 8 months later that number had increased to nearly 300.
- The launch included the creation of an “Innovation Hub”

The Innovation Hub 2

- There are two main strands to the Innovation Hub:
  - giving direct support to innovators
  - considering how the FCA adapt the regulatory regime to foster innovation.
- Through the Direct Support function of the Innovation Hub, the FCA offers:
  - a dedicated team and contact for innovator businesses
  - help for these businesses to understand the regulatory framework and how it applies to them
  - assistance in preparing and making an application for authorisation, to ensure the business understands our regulatory regime and what it means for them
  - a dedicated contact for up to a year after an innovator business is authorised
  - identification of areas where the FCA's regulatory framework needs to adapt to enable further innovation in the interests of consumers.

The Regulatory Sandbox 1

- "… aims to create a 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms in a live environment while ensuring that consumers are appropriately protected"
- "This is as much an experiment for us as it is for firms … It is the first time we are allowing firms to test in this way, so naturally some pilots will go better than others."
- High degree of bespoke engagement from FCA staff, so only be able to work with a small number of firms at a time.
- Uses a cohort approach, not dissimilar to how accelerators operate, and initially runs two cohorts a year.
- Allows FCA to learn what works and what doesn't, and improve the sandbox for subsequent cohorts.

The Regulatory Sandbox 2

- First Cohort: 69 applications from a diverse range of sectors, geographies and sizes.
- Firms to submit applications explaining their proposition and how it meets the sandbox eligibility criteria of:
  - genuine innovation
  - benefit to consumers, either direct or indirect
  - the idea is meant for the UK financial services market
  - a need for testing in the sandbox alongside the FCA
  - readiness to test – in other words, being in a sufficiently advanced stage of preparation to mount a live test
- 24 applications were deemed to meet the sandbox eligibility criteria and were accepted to develop towards testing
- First Cohort included early stage start-ups, challengers and incumbent firms like HSBC and Lloyds Bank.

The Regulatory Sandbox 3

- Option for unauthorised firms:
  - A tailored authorisation process, to allow testing by firms who need to become authorised to trial their new products
  - Restricted authorisation - allowing firms to test their ideas but no more (restricted
  - Once the firm is able to meet 'full' requirements, firm can apply to have restrictions lifted.
- Options for authorised firms and outsourcing arrangements:
  - No Enforcement Action Letters for testing activities where FCA satisfied of no harm to its objectives - FCA reserves the right to close the trial.
  - Individual Guidance on the interpretation of applicable rules in respect of testing activities - if the firm acts in accordance with this guidance the FCA would not take action against them.
  - Rules Waivers where it is clear that testing activities do not meet FCA rules but the firm can meet the waiver test - allows what would otherwise be a temporary breach of our rules

The Regulatory Sandbox 4

Safeguards:

- **Approach 1:** As in clinical trials, sandbox firms can only test their new solutions on customers who have given informed consent to be included in testing. Customers are notified of the potential risks and the available compensation.
- **Approach 2:** FCA agrees on a case-by-case basis the disclosure, protection and compensation appropriate to the testing activity.
- **Approach 3:** Customers have the same rights as customers who engage with other authorised firms
- **Approach 4:** Sandbox firms are required to compensate any losses (including investment losses) to customers and must demonstrate that they have the resources to do that.

International Cooperation 1

- International engagement supports the competition objective by promoting the UK as a centre for innovation in financial services:
  - Facilitating the entry of innovative overseas firms to the UK, thereby increasing innovation and competition in UK financial services markets.
  - Facilitating the expansion of UK-based innovative firms into overseas markets, making them potentially more sustainable challengers in the UK.
- FCA has signed co-operation agreements and frameworks with overseas regulators in order to support the above.
- Most of the agreements include a referral mechanism for innovative businesses seeking to enter each other's market.
- The regulators will provide support to innovative businesses before, during and after authorisation to help reduce regulatory uncertainty and time to market.

International Cooperation 2

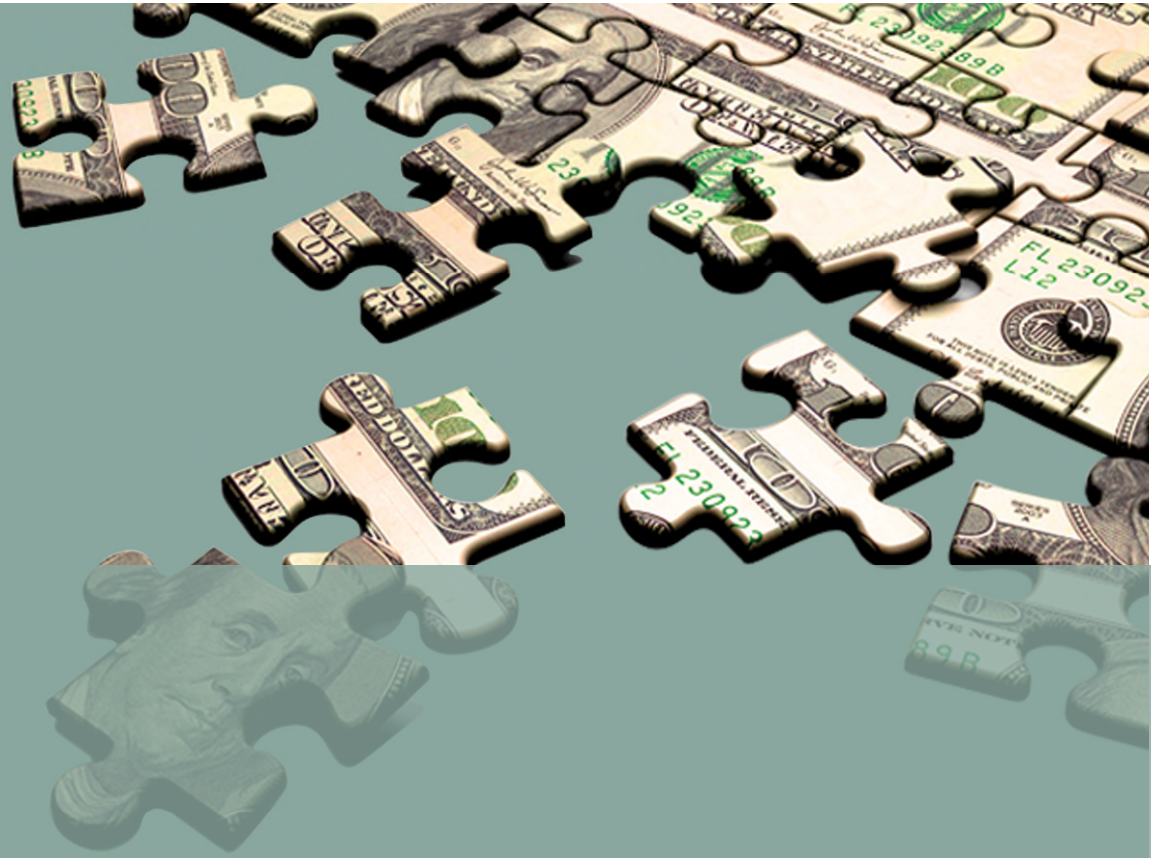
- Innovator firms seeking referral will need to meet the eligibility criteria of their home regulator's Innovation Hub equivalent.
- Once referred by the regulator the firm will have access to a dedicated team or contact person who will help them to understand the regulatory framework in the market they wish to join, and how it applies to them.
- These firms will be given help during the authorisation processes with access to expert staff and, where appropriate, the implementation of a specialised authorisation process.
- Following authorisation, the firms will have a dedicated contact to turn to for a year.

International Cooperation 3

Cooperation agreements have been signed between the FCA and:

- Australia – Australian Securities and Investments Commission, Innovation Hub
- Singapore – Monetary Authority of Singapore, Financial Technology and Innovation Group
- Hong Kong - Hong Kong Monetary Authority
- Canada - Ontario Securities Commission
- Japan - Financial Services Agency of Japan
- Korea – Korean Financial Services Commission, FinTech Center
- China - Peoples Bank of China

Questions?



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