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FINTECH JUMPS THE TRACK

Talkative Clients Are Good Clients

In a changing industry like FinTech, developers need to seek their lawyers' guidance

*Alexandra Villarreal O'Rourke and **David Reidy** co-chair the FinTech practice group at **McGuireWoods**, and even a short conversation with them would tip you off that there's a lot going on in that sector. And as it turns out, they are big believers in conversation. One of their favorite scenarios is when clients call because they're developing financial products and want to get early input from their lawyers. That can save them from long, less pleasant conversations later on. The McGuireWoods' attorneys also encourage their clients to call federal and state regulators and establish relationships. In this swiftly evolving industry, O'Rourke and Reidy believe that lots of communication can benefit everyone. The interview has been edited for style and length.*

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– Alexandra Villarreal O'Rourke

What do you see as the biggest opportunities for FinTech companies?

Alexandra Villarreal O'Rourke: Online lenders and other companies that work with financing are finding ways to reach customers that were either outside the credit market or were underserved by the traditional credit market. I think that's been a huge source of growth and opportunity, especially for online lenders. It's really been a positive win-win for lenders and customers. Many of these customers didn't have traditional credit files or had thin files, and this had been a barrier to credit for them. For a lot of customers and many small businesses, these online lenders are their primary opportunity for financing. In the last five years we've seen a ton of growth there.

David Reidy: I'd also say two big opportunities for FinTech companies are, first, to provide back-end services to banks. FinTech companies have done a lot of work on consumer interface, underwriting, on lending decision-making, all of which have broad applications for financial institutions. And banks have invested in FinTech companies for that reason. Second, FinTech companies can target markets that might not be a priority for major banks. For example, we saw small-business lending decline after the recession because of the cost of underwriting those loans, and several FinTech companies stepped in and have targeted small-business lending. These are potential customers who are creditworthy, and it's a large market, so it represents a real opportunity.

O'Rourke: Right. One more area where I think we've seen a lot of success and promise are companies that take something that is already available and make it really easy to access and really attractive to millennials and other folks who prefer to work online. You think of companies that, for example, provide information and advice on your finances online. Some of that information you could probably get if you dug deep through the different credit bureaus. Making it really easy to access and having an attractive interface, having good, responsive service – packaging it in a way that makes it easy to use and understand – has been a real competitive advantage that some of these companies have used. They're just more pleasant to use than some of the traditional systems. That sometimes makes all the difference.

On the other side of the ledger, what regulatory hurdles do you see on the horizon for this sector?

O'Rourke: I think a big one is that FinTech is not super new, but fairly new to the market. Regulatory changes are usually slow to come. At the moment there is a lot of uncertainty and some confusion as to how different state laws might apply to new models. States often have their own definitions of terms within lending, or of what it means to engage in a particular type of financial business. Sometimes those definitions are different for every state, or different for many states. That's been a real challenge for some of these new models. As they find their place in the market, they're also having to find their place in the regulatory framework. Something that we see a lot is companies that really, truly are trying to comply with every state law they're aware of. Sometimes the regulations are not written for a business like theirs and don't contemplate some of the ways in which they work. That's been a place where the law has yet to catch up to the market. Folks are having to make do and having to file many different applications with states to try to fit their model within that framework.

That's been a challenge, but it is also an opportunity. Regulators are really taking note of some of these challenges and some of the ways regulatory uncertainties are preventing innovation. I think they're trying to address that.

Can you think of specific examples where the law, or these state laws, haven't contemplated the technological innovations you're referring to?

Reidy: The phrase you hear all the time is "the patchwork of state regulations." Banks get to avoid that patchwork because they are governed at the federal level. If you are entering the financial services business and you're not a bank, you're constantly dealing with not just numerous state regulations but also regulations at the state level that are sometimes contradictory or different. It's very difficult to operate across multiple states when the rules are all different. For example, the licensing requirements in some states require equity investors in a FinTech company to submit detailed paperwork regarding their investment; different states apply different interest-rate caps to different kinds of loans; and so on. The patchwork is really the issue at least as much as the specifics of any given state's regulations. Just the task of tracking what you're supposed to be doing in every state can be onerous, particularly when your business doesn't fit a clean definition of the old categories of lender, credit furnisher or whatever it is.

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– David Reidy

What can outside or inside counsel do now to prepare for these kinds of challenges?

O'Rourke: Something that I work with clients on a lot is creating a structure where the lawyers are involved in and aware of and connected to the product development process. Folks often come to me and say, "I have this great idea for this new financial product, and here's how it's going to work." And I will say, "If you tweak these two things and if you add this layer of oversight, you're going to avoid a lot of regulatory headaches."

The only way to make that happen is to have a system where the lawyers are sitting next to the developers and working hand in hand, trying to make a product robust and compliant. It works less well when you have the product team building a product, and they get it all ready for market and then come to you for vetting. The model that we promote with our clients, and we see a lot of our clients adopt and do very well with, is where you have counsel who are incentivized to be part of the team and care about the development of the product, to make sure it develops in a way that is going to avoid problems in the future. Creating teams that are designed to all have the same goal in mind has been really productive.

Reidy: Talk to the regulators. One of the tensions inherent in FinTech is that, on the one side, companies have to – and generally want to – comply with the regulatory framework and existing laws. On the other side of the coin, however, these companies are innovating, and innovation, by definition, is disruptive. It's trying to change the old ways of doing things. So there are unavoidable areas of regulatory uncertainty. Being actively engaged with regulators, therefore, is key to managing risk. And regulators are not the enemy. What we've seen over and over again is that whether it's at the OCC [Office of Comptroller of the Currency] or the CFPB [Consumer Financial Protection Bureau] or at the state level, regulators are interested in innovation and want to foster the industry to grow and innovate and provide credit and services to a broader group of people. There are still many people in this country who are unbanked or underbanked and don't have access to basic financial services, and we talked about small business as well. A key message to clients, then, is to be engaged with the regulators and to build those relationships. That's been really productive.

O'Rourke: Regulatory trouble often starts with consumer or other groups raising concerns about a particular model or practice. We've seen a lot of success with clients who have great relationships with consumer groups and who actually work with them to say, "Hey, look. I'm about to put this out. I know you've had concerns with this particular aspect of the financial market in the past. Can you walk me through what I should be thinking about?" You really avoid a lot of problems that way, because frequently you're able to say, "Here are the concerns. Here's how I'm going to address them. Here is what worked with addressing them before."

Regulators love hearing that you're thinking about these issues, and obviously consumer groups also welcome being included in the process. We're seeing more of that collaboration than we saw in the past. Same for FinTech companies that are trying to partner with or sell a product to banks. We are seeing a lot more of that proactive, preventative engagement, where people are saying, "Here's our product. Here's what we're trying to do. Can you walk us through what your compliance team would care about and would ask us about if we were pitching to you today?"

Speaking of the regulators, do you see regulators doing anything to adapt at the federal and/or the state level?

Reidy: The biggest news probably is the OCC's announcement at the end of 2016 that it would move forward with a special purpose bank charter for FinTech companies. With the changes at the OCC following the election, it's not clear whether the OCC intends to go forward with that charter. So far, the proposal is still alive. This would give FinTech companies the option to apply for a special purpose bank charter, just like the credit card banks did before, and avoid state-by-state regulation while submitting to OCC oversight. That's the big change, but as of yet it hasn't been confirmed that that's going to happen.

It would be up to the FinTech companies to decide whether to opt in?

Reidy: That's correct. There are risk management, consumer protection, and capital and liquidity requirements that would have to be met. It's not clear how many companies would decide to voluntarily submit to that regime, if it happens. That's certainly the proposal that has gotten the most attention, and it's the subject of litigation by the New York Department of Financial Services and others.

O'Rourke: Even more recently, the conference of state bank supervisors has released its own plan. It is being seen, I think, as the competing idea to the OCC charter. It's called Vision 2020. It's essentially a plan to better coordinate among the states to ensure that financial regulation and FinTech regulation make sense. They're talking about an integrated FinTech licensing system and coordinated supervisory systems. The idea is to counter the OCC's complaint that "this patchwork's not working. We need to federalize it." The state regulators are saying, "We don't need OCC to do that. We can work together to make that happen organically among our states." Rather than an application system that would benefit those that choose to apply for the charter, it really is supposed to be a grassroots organic change to the way that regulators approach financial regulation, so that it would ideally benefit all those affected by the licensing and supervisory and other regulatory requirements.

Let me ask a pretty basic question about the OCC plan. The new administration has been in place since the end of January. Who is going to decide whether the proposed charter is still going forward? When do you expect to have some sort of definitive answer?

Reidy: To be honest, reading the political tea leaves on this is not foolproof. [Acting OCC chief] Keith Noreika has endorsed the plan. And while [Former OneWest CEO] Joseph Otting has been nominated as Comptroller of the Currency, he has not yet been confirmed, and I don't know which way the administration is leaning on this issue.

Lawyers are often risk-averse, sometimes overly so. How can in-house or outside counsel advise their clients without falling into the "office of no" trap?

O'Rourke: One big way that I see a lot of my clients work this successfully is by doing a lot of engagement and education early on. They do a lot of lunch and learns. Helping people understand what some of the traps are, and how to identify them and make sure you work through them early, is really valuable. It's more preventative medicine and less emergency medicine. The preventative medicine approach also engenders good relationships and trust, in a way that only being there when things are going badly might not.

Reidy: It's the job of inside and outside counsel to evaluate risk and communicate to the client a spectrum of risk. This model of saying, "Yes, you can do this. No, you can't do that," doesn't really work in an evolving market like this. There's so much uncertainty. You can't just be saying yes and no, and calling balls and strikes. It doesn't really work that way.

O'Rourke: It's really a function of, "How do you see your job?" If you see your job as just problem detector, that's going to be a lot less popular than if you see yourself as a problem solver. Incentivizing people to be part of the problem-preventing and problem-solving team makes all the difference.

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