RESEARCH PAPER

THE REGULATORY SPACE OF FINTECH

European General Data Protection Regulation (GDPR) will prevent Facebook and Google from using unprecedented amounts of data in their possession or face penalties.

Source: Business Insider 2018

The business news are replete of headlines of regulators cracking down on Tech Firms for client privacy infringement (e.g. Facebook-Cambridge Analytica), digital asset theft (e.g. MtGox bitcoin theft), unauthorized marketing (e.g. FTC fining of Marketing Architects Inc.), illegal sales (e.g. Amazon illegal pesticide sales) and flawed transaction execution (e.g. FINRA fining of E*Trade).

One harsh fact stands clear that the online markets and digital service providers are no longer opaque, sprawled and fluid beyond independent oversight. I guess the street race is over! Or perhaps not!

FINTECH is a no safe onlooker to this ruckus. Financial Regulators typically apply a CAMELS Rating (i.e. Capital Adequacy, Asset Quality, Management Capability, Earnings, Liquidity and Sensitivity) to assess the threats or risks the various Banks, Credit Unions and other lending institutions impose on the overall financial system of a certain jurisdiction. Once your CAMELS rating deteriorate and your volumes of business grow, expect the Regulator to be a frequent visitor. This scenario manifests itself in the burgeoning FINTECH sector where venture capitalist corporate culture and rapid growth take precedence over internal checks and balances.

We are neither flagging regulations as growth mufflers nor judging FINTECH as industry renegades. This report provides “Digital Transformation” and “FINTECH” leaders with a “FINTECH Regulatory Map” to help them evolve their existing digital products and business models in a regulation-conscious way ensuring good repute and operational continuity.

The “FINTECH Regulatory Map” overleaf provides the FINTECH and Digital Transformation leaders with a holistic view of the regulatory space facing them by introducing structure and relationships to a rather complex world.

What is the regulatory world look like?

Maintain a holistic understanding of regulations while leaving the nuances to your legal team

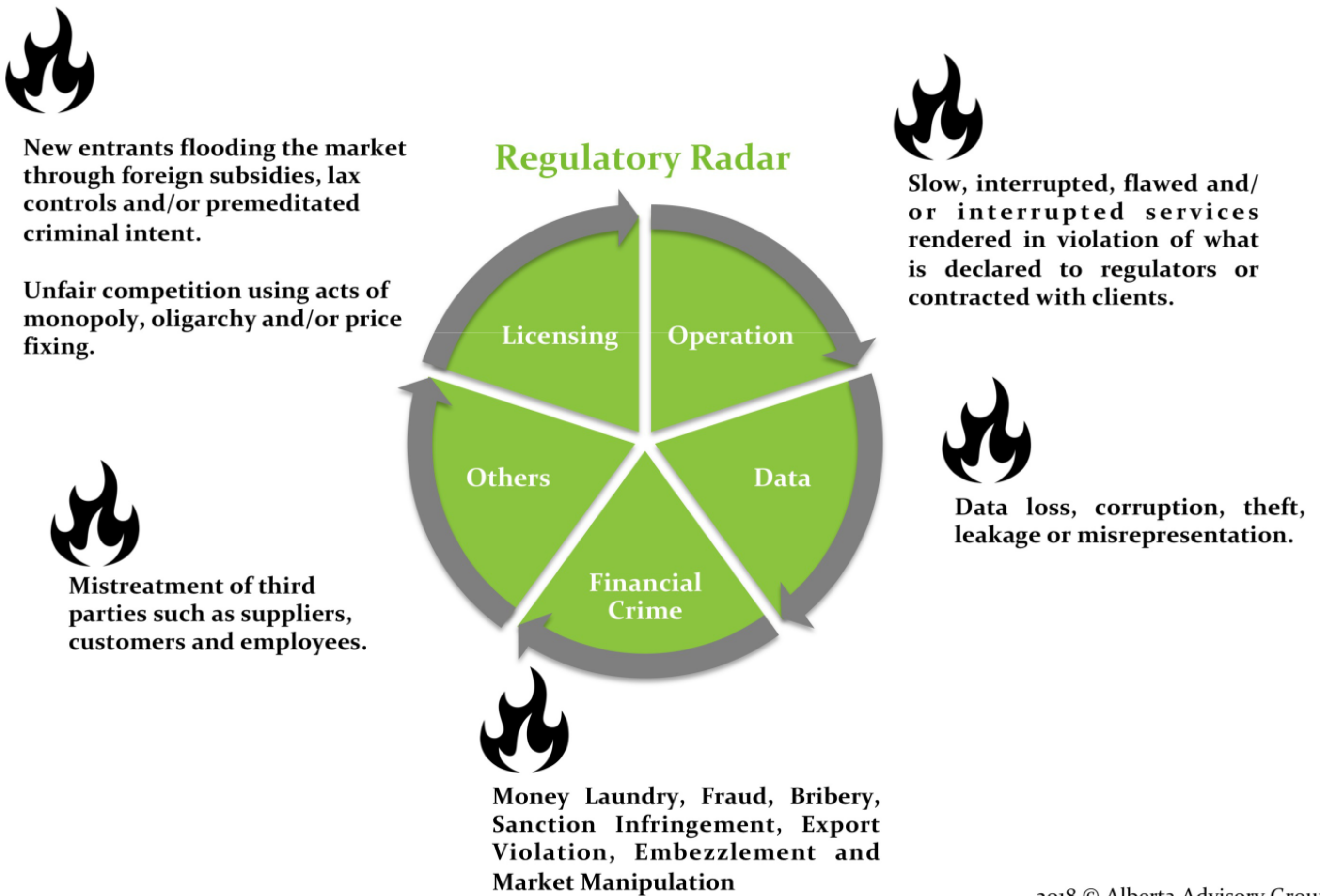
The world of regulations is complex and ever sprawling. As a FINTECH leader, you need to be cognizant that regulations typically fall into one or more of 5 key categories, depending on- (i) whom the regulation is attempting to protect and (ii) against what risks. Tackling regulations from the perspectives of "Constituent" and "Risk" not only enables you to accelerate your learning process, but also make the right trade off between "Business Potential" and "Compliance Cost".

Consider the FINTECH sub-sector of specialized or micro lending. Lending money against investors' funds draws far less regulatory prudence than lending money against depositors' funds. Many regulators foresee investors to be more risk-conscious and daring than depositors. The investor understands and contractually accepts the risks associated with lending in hope of higher returns, while the depositor seeks capital preservation in return of modest proceeds. Consequently, as a FINTECH leader, you may opt to serve the micro-lending customers through investors' funds, rather than, depositors' funds to control your compliance overhead and risks.

Also, consider the FINTECH sub-sector of retail or micro payment. National, low-value payments draw less regulatory prudence than commercial, international payments. This holds despite regulators' disclosure requirements for payment companies to report on aggregate payments per beneficiary exceeding a certain threshold over a set period of time. The risk of money laundry in transactions of low value, executed within the same jurisdiction, by natural persons for retail goods is considered quite low. Consequently, as a FINTECH leader, you may opt to grow your micro payment platform nationally first.

In Figure 1 overleaf, we attempt to simplify the regulatory world by classifying the regulation into 5 categories based the risks targeted. In the following section, we go deeper to discuss specific regulations.

FIGURE 2 – COMMONS RISKS TARGETED BY REGULATORS



What regulations apply to us?

The European Union is considered a de facto leader in setting cross-country regulatory frameworks for financial services

Intuitively, the regulations in-force varies depending on many parameters; key of which are-

1. Jurisdiction in which your head office is registered.
2. Type of company you registered (e.g. Sole Proprietorship, Limited Liability, Publicly Listed).
3. Type of products offered (e.g. payment, lending, advice or mediation).
4. Type of customers targeted (e.g. sophisticated corporate clients versus retail).
5. Type of legal terms and conditions applied in day-to-day transactions.

As a FINTECH leader, you need to pay heed to the above parameters and continuously vet the legal advice you receive accordingly. Do not be surprised if different advisors rendered opposing views on what regulations apply to your company and how. Unfortunately, this is the nature of the beast.

Given that the spirit of FINTECH is to reach the masses across states, countries and continents, we chose the European Union regulations to serve as a case study in demystifying the regulatory space of FINTECH. Many regulators around the globe adopt and adapt EU regulations in their own jurisdictions given the maturity and rigor of EU regulations. This is not to hurt the national pride of any reader, but regulators do like to learn and copy each other given the gargantuan efforts involved in policy making and enforcement.

Figure 2 overleaf pinpoints the key EU regulations for each category of the “Regulatory Map”. Be warned that the regulation list provided is not comprehensive. For example, it does not list the regulations for manufacturing investment products, taxation, public company disclosures and accounting standards. As a FINTECH Leader, your job is drive your company growth with a clear view on associated “Compliance Cost” and “Compliance Risk”, not to become a regulatory advisor.

FIGURE 2 –KEY EUROPEAN UNION REGULATIONS

Insurance: Insurance Distribution | Motor Insurance | Solvency II

Payment: SEPA | PSD | Cross-Border Payment | eMoney

Investment: MiFIR | MiFID

Lending: Access To & Supervision Of Credit Institutions | Deposit Guarantee Schemes | Mortgage Credit Directive

EU typically embeds operational requirements in the licensing regulations to ensure ease of reference and continuity of oversight

Payment Accounts | Investor Compensation Scheme | Consumer Protection & Rights

GDPR | Security Of Network & Information Systems

General: Fight Against Fraud | Prevention Of Money Laundry

Investment: MAD | MAR

Do not view regulations as growth mufflers. Regulations give you rights to access new markets and protect you from unfair competition

As you deal with Regulatory / Legal Experts, make sure to explore 4 important angles-

- **Your Rights**; regulations do not only demand controls to be deployed and disclosures to be made. Regulations grant you many rights that could propel your business growth, such as- access to markets, capital requirements waivers and preferential access to government contracts.

- **Your Exemptions**; regulations typically use the concept of "*Fit For Purpose*" which acknowledges that regulated entities will match the scale of their governance and control structures to their size of operation. Regulations might even exempt small players from the full burden of compliance.

- **Market Practices**; regulators often tune their audits and detailed requirements to the prevailing market practices. You may consider partnering with companies operating in the target jurisdiction to benefit from their regulatory licenses and port their compliance policies and procedures.

- **Technical Standards**; the European Union further clarifies many regulations by issuing detailed implementation guidelines called "Technical Standards" which are publicly available. By reading these Technical Standards, you save yourself big bucks on Regulatory / Legal Experts which can be rightly channeled to your core business activities.

For the purpose of this research paper, we use the terms Regulation and Directive interchangeable for ease. From a legal stand point, a Regulation is a law enforceable across all EU Member States jointly at a set timeframe, while a Directive articulates the results that must be achieved but each Member State is free to decide how to transpose directives into national laws.

Now lets dig into **some** of the EU regulations and directives to understand their scope in terms of whom they apply to and what they tackle.

Table 1 – Key Regulations Likely Impacting FINTECH

REGULATION	WHO DOES IT APPLY TO?	WHAT IS IT ALL ABOUT?
IDD – Insurance Distribution Directive (EU 2016/97)	Any person or company, who advises, proposes, prepares contracts, administers contracts, service contracts or provides information based on client requests in relation to insurance and reinsurance contracts irrespective of channel used.	Defines the professional and organization requirements for registering insurance and re-insurance intermediaries along with operational controls pertaining to employee remuneration, product-customer need fit analysis, customer disclosures, cross-selling and product governance and oversight.
MID - Motor Insurance Directive (EU 2009/103/EC)	Applies to all vehicles normally based (i.e. owned, registered or used frequently) in any of the member states of the European Union.	Enforces compulsory civil liability insurance on all vehicles using a single premium and stipulates common controls with respect to insurance information management, compensation responsibilities, minimum insurance coverage (e.g. EUR 1 M per victim) and dispute resolution.
Risk management and supervision of insurance companies (Solvency 2) - Directive 2009/138/EC	Applies to all direct life and non-life insurance and re-insurance undertakings established in the European Union including- contracts, pension funds, capital redemptions based on actuarial, collaborative insurance and annuities.	Enforces controls on minimum capital requirements, solvency capital calculation, valuation of assets & liabilities, risk management, regulator and customer disclosures, own fund management and overall governance.

REGULATION	WHO DOES IT APPLY TO?	WHAT IS IT ALL ABOUT?
SEPA - Single Euro Payment Area (260/2012)	Applies to credit transfer and direct debit transactions denominated in euro within the Union where both the payer's payment service provider and the payee's payment service provider are located in the Union, or where the sole payment service provider (PSP) involved in the payment transaction is located in the Union. Excludes card payments, cash payments and large value payments (i.e. RTGS)	Defines minimum standards to allow the execution of credit and direct debit transactions across all Member States. The standards include- minimum data requirements, ISO20022 message formats, use of International Bank Account Number (IBAN), rejected transaction processing and processing fees.
Payment Services Directive I & II (2015/2366)	Generally applies to all payment services (except cash, check and securities) executed by Banks, Electronic Money Institutions, Postal Giro Service Providers and Other Payment Institutions. The payment services include- remittances, maintenance of a payment account, issuance/receipt of payment instructions, account information services, direct debits, credit transfers and others.	Defines the rights and obligations of the various parties (i.e. payer, payee, payment service providers) of a payment transaction throughout the various phases of initiation, authorization, execution and rejection. It sets controls on minimum capital requirements of payment service providers (EUR 20-125 K), segregation of own funds from client funds, access to payment services, party authorization, disclosures and agreement of charges, interest rates and exchange rates and accounting.
Cross Border Payment Directive (924/2009)	Applies to all cross-border payment transactions executed electronically where the payer and payee payment service providers	Ensures that charges for cross-border payments within the Community are the same as those for payments in the same currency within a

REGULATION	WHO DOES IT APPLY TO?	WHAT IS IT ALL ABOUT?
	reside in different member states.	Member State. It covers all charges directly or indirectly levied on payment transaction including inter-change fees.
eMoney - Prudential supervision of the business of electronic money institutions (2009/110)	Applies to all institutions holding an "Electronic Money Authorization" under EU laws. Electronic Money refers to any stored monetary value as represented by a claim on the issuer and is issued on receipt of funds for the purpose of making payment transactions. Key examples include prepaid cards, redeemable money vouchers and electronic wallets.	Sets controls in relation to initial capital requirement (EUR 350 K), own funds management, prohibition of deposit taking by eMoney issuers and the issuance and redeemability of all e-Money instruments at par value.
MIFIR / MIFID: Markets In Financial Instruments	Any person or company professionally and regularly marketing, selling or executing investment services including- Order execution, Dealing, Portfolio Management, Investment Advice, Underwriting and Operating Markets.	Defines the licensing requirements and lays down the operational requirements of licensed investment firms in terms of- organization, capital, efficient, fair and transparent execution of various client orders, timely and accurate reporting of market data, orderly function of various markets, prevention of conflicts of interests and ongoing governance. Once licensed, the investment firms can operate across all member states and gain access to various trading venues and centralized settlement counterparties.

REGULATION	WHO DOES IT APPLY TO?	WHAT IS IT ALL ABOUT?
Access To The Activity Of Credit Institutions And The Prudential Supervision Of Credit Institutions And Investment Firms Regulation & Directive (2013/36/EU)	Applies to Credit Institutions (Banks) and their holding companies that take deposits or other repayable funds from the public and to grant credits for its own account, as well as Investment Companies involved in similar activities.	Define the licensing requirements in terms of- Initial Capital (EUR 5 M), Operation Program and Organization. It lays a wide spectrum of prudential requirements including capital adequacy, remuneration policies, recovery and resolution plans and calculation and management of credit, market, operational and settlement risks.
GDPR - General Data Protection Regulation	Applies to the personal data of natural persons (i.e. individuals) living within the EU. Personal Data include any piece of information that may identify an individual directly or indirectly such as- a name, an identification number, location data, an online identifier or to one or more factors specific to the physical, physiological, genetic, mental, economic, cultural or social identity of the individual.	Allows for Personal Data to be shared freely across the member states, while preserving the right of individuals for privacy and controlling the sharing of Personal Data outside the European Union. It sets a wide array of controls on data classification, lawfulness of collection and processing, required consents, rights of data subject for data access, erasure, rectification and restricted processing, data-driven profiling and the responsibilities of Data Processors and Data Controllers.

Thank You