FINTECHS, WHY IT'S TIME TO MAKE COMPLIANCE FRONT OF MIND

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THE GO-GO DAYS OF 2019/2020 WHEN FINTECHS COULD ATTRACT VENTURE CAPITAL (VC) FUNDING WITH A SNAZZY POWERPOINT DECK AND A KILLER IDEA ARE A DISTANT MEMORY. IN A FEW SHORT YEARS THE LANDSCAPE HAS CHANGED DRAMATICALLY FOR FINTECHS LOOKING TO RAISE FUNDS AND MOVE FROM START-UP TO SCALE-UP.

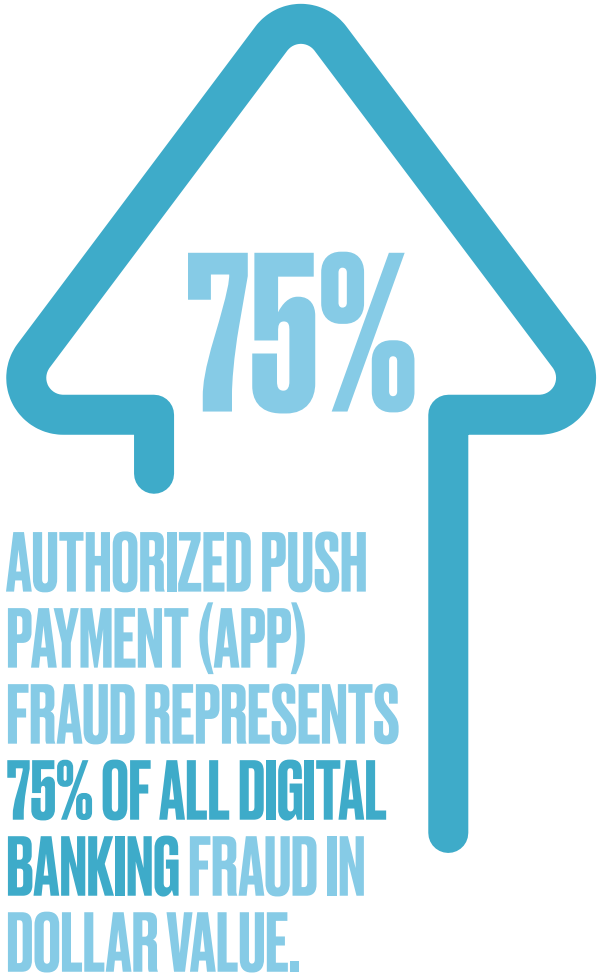
The USA doesn't have an overarching compliance regime for its Fintechs, making it difficult to determine which regulations and licences they need to follow at any given time. The more a Fintech grows, expanding its marketing, increasing its profile and attracting press attention (both positive and negative), the more likely it is to be exposed to state and federal scrutiny of its compliance status. Non-compliance can quickly lead to huge fines, jail time, and reputational damage. US Fintechs have seen an increase in the scrutiny of their compliance status in 2022. If you're one of the 73% of Fintechs without a dedicated Compliance Officer, or a startup looking for investment, now is the time to get an idea of what you need to know.

The VCs still willing to invest in Fintech are increasingly looking at the compliance policies of start-ups to assess their longevity and success potential well before they make that final decision to invest. Compliance frameworks can be a deal breaker.

Getting compliance wrong can be the difference between getting funding and not securing it. It's not just VC funding at risk either. Without the right compliance, the doors to banking partnerships remain firmly closed. Cutting corners on compliance just doesn't, well, cut it anymore.

With technology making it increasingly easy for bad actors to infiltrate a shiny new platform, there's never been a more urgent need for Fintechs to get their compliance right. We look here at the key compliance issues facing Fintechs, how they can get compliance right and by doing so attract much-needed VC funding to grow.

FOR FINTECHS, REGULATORS AND INVESTORS, THE YEAR AHEAD IS DIFFERENT



Fintechs are vulnerable

Regulations exist to protect consumers and investors; ensuring that no laws are broken (accidentally or by design). If a Fintech launches a new business model, designs software or a consumer-facing website without checking it aligns with existing regulations it is at risk of being fined or shut down.

An all too real example of this is fraud. The continued digitization of the financial system has completely reshaped the fraud landscape. Customers tricked into sending money to scammer-controlled accounts. Digitization has made it easier for bad actors to use payment diversion fraud techniques.

Other methods include:

- Remote access trojans,
- e-skimming malware,
- Phishing as a service (PhaaS) subscription models,
- Business email compromise schemes,
- Invoice redirection,
- Salary diversion and account takeover fraud

In 2023 it is a Fintech's responsibility to make sure that their customers and investors are protected against these fraudulent activities. To ignore this is to risk not being compliant.

Venture Capitalists have gone from bullish to cautious

2023 was meant to be the year things changed. US Fintechs had been lining up to push for a more progressive regulatory agenda that would make the sector more dynamic, innovative, and competitive.

Then Silicon Valley Bank (SVB) reminded us all of another unique feature of America's banking system: its ability to utterly terrify the world when things go wrong. The response to the crisis has pushed US Fintech reform down the Government's priority list, but the two aren't mutually exclusive.

Investors have become more reluctant to spend, just ask any post-Series A Fintechs who haven't proven their place in the market. The days of having a great idea being enough for VCs are gone. As a result of this more cautious approach, Fintechs are struggling to access the funding they need to survive. Increasingly, investors are asking about companies' approaches to risk when they are trying to raise funds. This is especially so when they are serving certain jurisdictions or using crypto.

Regulators are getting more exacting

Regulation for Fintechs is not going away. If anything, it is getting more rigorous. We are in an ever-changing environment where 1-in-200-year events are happening regularly. This has put a lot of stress on regulators, with more elements being brought in to protect consumers. In this new landscape, Fintechs need to become operationally resilient.

It is a Fintech's responsibility to keep an eye on the extensive regulatory changes taking place:

- The Biden administration is tackling illicit financial flows and building a crypto regulatory framework.
- The EU is preparing to roll out a comprehensive AML regulation package.
- Regulators continue to increase fines for Fintechs that have ineffective or deficient anti money laundering (AML) or counter financing of terrorism (CFT) programs.
- There are ongoing measures to prepare for upcoming Financial Action Task Force (FATF) evaluations. Fintechs need to address any deficiencies that have already been identified, or if they have been added to the gray list, undergo increased monitoring.

On top of this Fintechs should ensure they can update their AML and CFT systems and controls to remain up to date.

FINTECHS, WHEN ABOUT TO RAISE, RAISE YOUR COMPLIANCE GAME

There is still investor funding to be had for business to business (B2B) Fintechs. One way for Fintechs to attract VC funding and stand out from the competition is to show they have an excellent understanding of compliance. They need to show that compliance is a core part of their program in-house, and/or show that they have outsourced compliance to a reliable, external vendor and have an effective governance framework to manage this.

Investors will be thinking about a Fintech's exposure and time to market; they will want to know they are not buying into any risks hidden within existing compliance practices. A company's approach to risk now has a significant influence when raising VC.

Fintechs need to be active players in their compliance journey

When a Fintech decides to launch via a Principal firm, it's the Fintech's responsibility to do due diligence into the Principal: in other words, vet the vettor. A Fintech can benefit greatly by researching and vetting the Principal firm, gaining a complete understanding of what regulations the Principal is covering and truly understanding who they are working with.

Don't automatically accept the sales spiel of what you are getting from your Principal or outsource provider. For example, a BaaS provider may bundle separate concepts/ services into one product as part of their undeniably convenient offer. The decision to build, buy or partner should always be an active and informed one. Fintechs need to educate themselves on the pros and cons of different options and how these fit into the over plan for your firm.

Be prepared

It's essential that Fintech start ups have both a short-term and long-term plan to ensure that everything is done to get the business on the right regulatory path. Things to consider include:

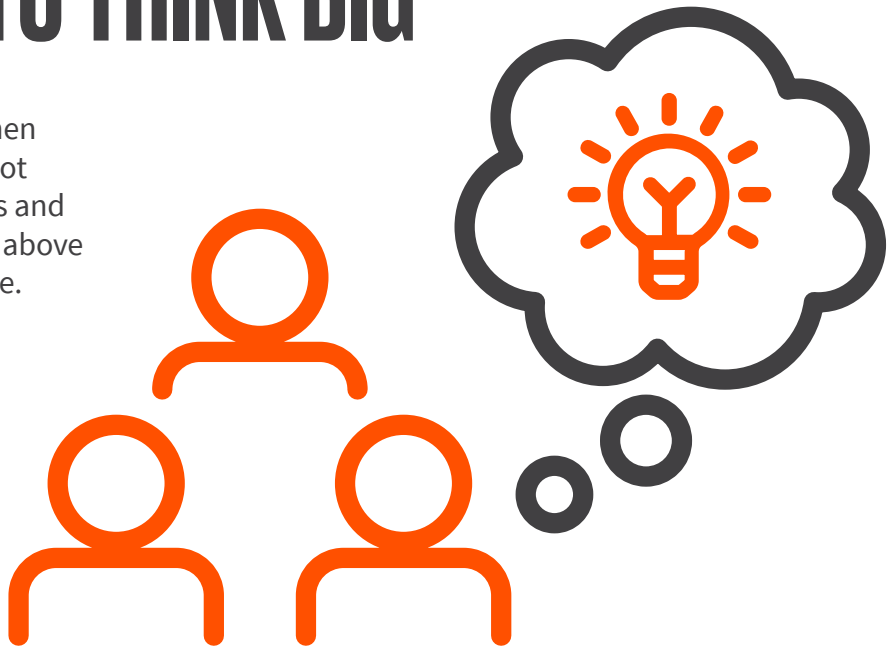
- How you are going to get to market
- Understanding your vulnerabilities
- Any limits to the customer experience
- What your long term plan is
- What your governance is
- You level of risk appetite
- How will you hire more people during growth

“A ROBUST COMPLIANCE FRAMEWORK IN THE EARLY STAGES CAN PAY DIVIDENDS FOR FINTECHS, SERVING AS A BRIDGE TO TRUST, LONGEVITY, AND SUCCESS. EMBRACING COMPLIANCE, NOT JUST AS A REGULATORY OBLIGATION BUT AS A COMMITMENT TO SAFEGUARDING THEIR CUSTOMERS, INVESTORS, AND THEIR OWN FUTURE, IS CRITICAL. THE FINTECHS WHO IMPLEMENT FORWARD-THINKING AUTOMATED COMPLIANCE PROGRAMS AND CONTROLS FROM THE START WILL EMERGE AS WINNERS.”

Neepa Patel, Founder and CEO, Themis

FOR SMALL START UPS, IT PAYS TO THINK BIG

A small start up of three of four individuals is still expected to act and think big when it comes to compliance. Yes, regulations are frustratingly opaque and seemingly not written in plain English, ever changing and complex. But by asking a few questions and taking the right steps can stand even the smallest of startups head and shoulders above other Fintechs who have not asked these questions or put the right culture in place.



It's important to remember that just because you have a legal opinion that says you don't need to be regulated doesn't mean Fintechs don't have to comply. Banks, money service businesses, other Fintechs and payment companies, will all have a host of requirements that mirror regulatory requirements because they are regulated and will expect the Fintechs they work with to adhere to their standards. Each component of the global financial industry plays a different role and each will have its own set of requirements you'll need to navigate.

1 Try to understand compliance as much as possible. Whether you are working with a vendor, a consultant, a lawyer, really get back to basics and try to understand compliance in detail. This will make everything so much easier.

2 From a practical standpoint, leverage suppliers and partners. They are going to be able to help so much when it comes to putting things in place.

3 Ensure you have a good compliance culture from day one. This means having a risk committee set up before you launch, even if you're a small company and there's not much to discuss. This sets the right tone and makes sure that compliance is front of everyone's mind. Make sure you have all the controls in place, from data protection to screening if you need to screen and the right training for your team.

Develop a plan

Having a really strong compliance monitoring plan is important. This involves making sure that compliance is part of all elements of the business and not left till the last minute when a decision is being made or a new service is being added for example. So, an Operations Director wanting to implement a new payroll process and hire a new supplier would need to evidence due diligence that they've undertaken an actual compliance process for that new outsourcer. Compliance should be involved at this stage even though it's a completely operational decision: it's about oversight. Ideally, all decisions in the business should have a second level of oversight. Having a really simple checklist that says - we've looked at a supplier's website, we've looked at the financials, we've looked at five different businesses, and then put this in a folder so you can show it to a compliance officer.

1ST LINE OF DEFENSE: the doers eg Client onboarding.

2ND LINE OF DEFENSE: the ones that tell you how to do it and that you are doing it correctly.

3RD LINE OF DEFENSE: the auditors.

Take a look at yourself

Think about what you're going to offer and break that down into really detailed services. So, if you choose a compliance consultant, they will understand from your specific services what kind of a regulatory path you will need to take.

...and the competition.

USA-based Fintechs should look at their competitors' website, and see what other businesses are out there offering similar products or services as you: see what permissions they have. It's likely yours will be the same. This will give you a clear idea of what regulations you are going to need to follow.

Focus on the customer

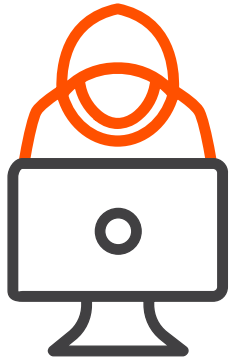
The regulators will be getting stricter and is now looking for very simple things that could be an indicator of compliance issues further down the line. An area to focus on is how a startup or established Fintech is approaching the new consumer duty legislation. This means showing up front that you are complying in the basic areas like having all the information a consumer needs on your website, making it easy for customers to contact you, showing that you have a process in place to deal with customer complaints and requests. All these public-facing elements are very easy.

If you get these wrong, they will want to dig deeper into your other processes. This is a relatively easy area for even the smallest of startups to tackle.

Test and test again

Fintech start-ups are at a high risk of being at best tested, or at worst, attacked by bad actors wanting to see how easily they can get into a platform. They will want to know if they can use the start up for money laundering. They will tell other criminals if a startup is an easy target. Most Fintechs won't see it coming.

One of the best things a Fintech company can do to mitigate against criminals exploiting their platform is through testing their compliance system. Test at the outset and on an ongoing basis once there's data in there. Testing informs about what provisions are needed to be put in place as a Fintech grows and onboards clients. Fintechs will need to test all the platforms they have implemented as well as the risk-based approach they've undertaken. Then they should consider how to use the data they've collated to identify the criminals and get them out.

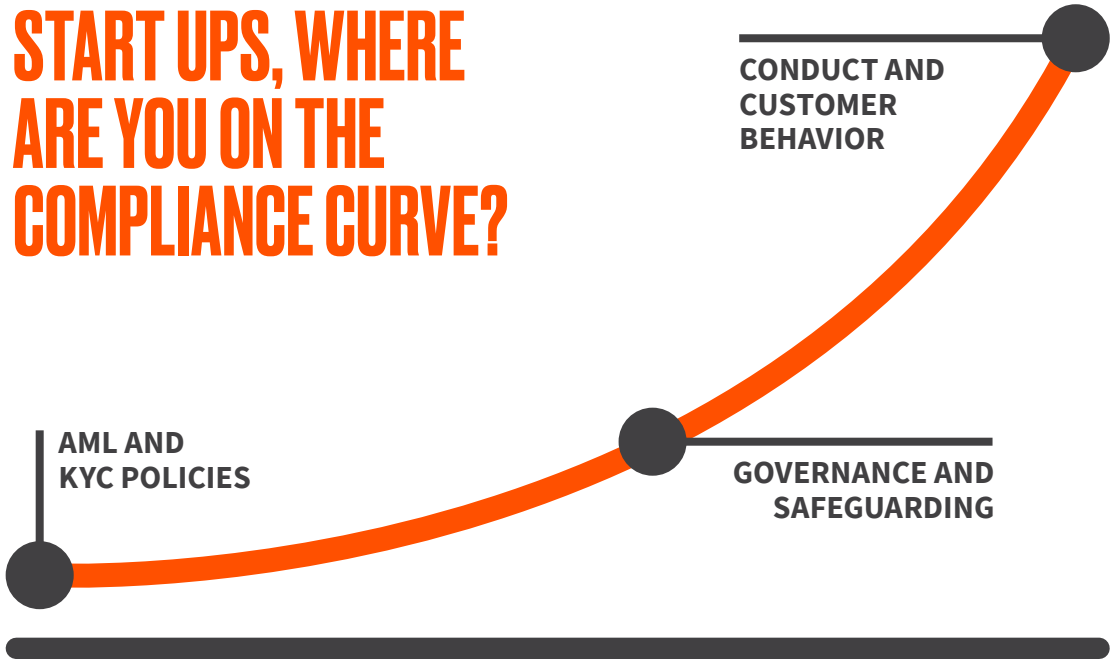


There are thousands of ways people can access your systems. Think: what sort of person would want to access your account. Sit down and think through what type of crime you could be potentially assisting.

Show your workings

Evidencing your daily compliance procedures in your documented policy and procedure framework is a key tool to showing regulators that you are actively compliant. A start up will need to quickly transition from having a set of compliance policies to translating them to procedures that actively show how the policies are going to work, and accurately reflect a risk-based assessment. For example, a startup could say they are going to outsource onboarding, but that they are going to take care of sanctions screening as it's embedded in their platform. If a third party, either a VC or regulator, looks at you they will expect the framework to reflect absolutely what you are doing on the ground.

START UPS, WHERE ARE YOU ON THE COMPLIANCE CURVE?



The expectation from VCs now is that new firms journey up the compliance curve very quickly.

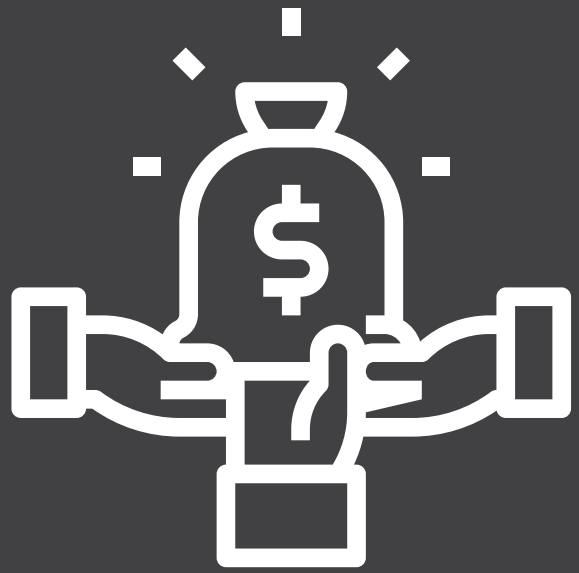
IT'S ESTIMATED THAT 44% OF FINTECHS WITH UNDER $10 MILLION IN REVENUE WILL NEED TO RAISE CAPITAL IN THE NEXT 12 MONTHS.

VENTURE CAPITALISTS ARE NOW MORE RISK-AVERSE

In 2023 Venture Capitalists are looking at compliance with a much finer eye than they were just a few years ago. The market has become a slightly more difficult place to achieve investment opportunities, so VCs are being a lot pickier about who they ultimately get into bed with. VCs now expect Fintechs to evidence that they're compliant with the FCA regulations that correspond to their business.

But the responsibility is not all in the start-up's court. It is important that VCs understand what they are actually investing in. As a starting point, they should ask what regulatory regime the firm is under. Is it a credit, investment, payment, services, emoney, or a regulatory regime? This is important because each regime comes with its own challenges and its own regulatory concepts and requirements. It's really important that investors in a firm understand what it is that they are investing in. And just saying that the concept looks great and the financials that fine probably isn't going to really cut it.

Venture Capital firms are of course looking at the potential return on investment and market fit, but they are also looking to see if the team and the structure is there to support a business not only now, but as it grows. The compliance processes are something that will definitely be looked into if the VC is looking to invest in a Fintech. A banking partner will be looking at a start up's compliance processes in much more detail than a VC at a very early stage - but this changes when someone leading a B round will want to go into much more detail in every level of the business.



REGULATORY CHALLENGES FACING FINTECHS TODAY

There's a host of compliance laws on both state and federal levels that every Fintech operating in the US needs to be aware of and follow. These laws ensure that financial transactions proceed smoothly, with safety and security at every stage. They should be a non-negotiable element of every Fintech's business.

Three key federal regulations for Fintechs to be aligned with:

Financial Crimes Enforcement Network (FinCEN)

- gathers information about financial transactions to help prevent and mitigate financial crimes.

Commodities Future Trading Commission (CFTC)

- regulates US derivatives markets.

The Office of the Comptroller of Currency (OCC)

- one of the primary banking regulators in the United States overseeing, regulating, and examining chartered banks.

Other key federal regulators:

- **The Securities and Exchange Commission (SEC)**
- **Federal Deposit Insurance Corporation (FDIC)**
- **The Federal Trade Commission (FTC)**
- **Consumer Financial Protection Bureau (CFPB)**
- **Financial Industry Regulatory Authority (FINRA)**

But it doesn't stop there. Fintechs must stay up to date and compliant with a whole range of regulations that cover data privacy, security, and chartered banking laws. To add even more complexity, these laws vary from state to state.

Each state can have several industry regulators as well as the State Attorney General's Offices who oversee often overlapping portions of the Fintech industry. Banking, mortgages, loans, credit cards, insurance, money transfer, checks, consumer protection and privacy are all subject to an individual state's regulatory authority.

1 ANTI MONEY LAUNDERING

Anti Money Laundering (AML) procedures and regulations are designed to prevent criminals generating income through illegal activity. Failure to comply with AML regulations leads to fines, damaged reputation and in some cases the withdrawal of a Fintech's license. Fintechs starting up in 2023 are facing increasing scrutiny on their AML and Know Your Customer (KYC) by regulators thanks to the increased digitization and sheer number of Fintechs. Any history of failure to comply with AML regulations is detrimental to a Fintech's ability to gain VC funding (and customer trust).

2 COMPLIANCE

The increased regulatory scrutiny is a significant challenge for Fintechs in 2023. Staff need training, procedures need to be followed and documented, all while operating a fast-paced business. Unlike banks, Fintechs are new and lack the baked-in compliance structures they need. This leaves them exposed to fines from the regulator and open to bad actors.

The proliferation of Fintechs has meant that regulators are becoming much more vigilant. The mobile banking app Robinhood was fined $70million by US-based Financial Industry Regulatory Authority (FINRA) in 2021)or not adhering to watertight systems (manually inputting customers' financial data instead of automating it is one example).Large UK-based fintechs and digital banks are similarly under increased scrutiny by regulators, concerned about their systems and controls.

In 2021 the San Francisco-based neobank Chime was ordered by the California Department of Financial Protection and Innovation (CADFI) to pay a fine and to cease and desist language that the regulator said falsely portrayed the Fintech as a bank. They ordered Chime to stop using chimebank.com, and to stop using the word 'bank' or 'banking.'

OFTEN, WHEN FINTECHS DEVELOP A SOLUTION OR OFFER THERE'S A PUSH AND PULL BETWEEN SPEED TO MARKET AND SAFETY - WHICH CAN LEAD TO SKIPPING THE FINE DETAIL WHICH KEEPS INVESTORS AND CUSTOMERS SAFE.

IN AN UNCERTAIN ECONOMIC GLOBAL MARKET, IT IS THE FINE DETAILS AROUND REGULATION AND BEING PART OF A STRONG NETWORK THAT VC INVESTORS WILL BE LOOKING AT FIRST.

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