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2016 INVESTMENT MANAGEMENT CONFERENCE

Entrepreneurial Trends in the Financial Industry - FinTech

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AGENDA

- Robo-Advisers
- Marketplace Lending
- Equity Crowdfunding and SPV Platforms

Robo-Advisers

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ROBO-ADVISERS AND REGULATORY RESPONSES

- "Robo-advisers" implement multiple, overlapping business models:
  - Direct client interaction
    - Favored by younger investors comfortable with social media and virtual relationships
    - Favorable fee structure
  - Traditional advisers relying on robo-advisers for certain functions
    - Refer clients to robo-advisers for certain aspects of portfolio management
    - Incorporate robo-advisers into traditional financial planning
  - Use of robo-advisers in providing investment advice
    - portfolio construction
    - automated tax-loss harvesting
    - portfolio rebalancing
    - "white label" / customized robo-advice platforms

PROLIFERATION OF ROBO-ADVISERS

- Cerulli Associates (2015): assets managed by robo advisers to rise 2,500% between 2015 and 2020, to $489 billion
- Tiburon Strategic Advisors (2016): 51 robo advisers in the market, collectively managing close to $250 billion
- InvestmentNews*:
  - 7.3% of independent advisory firms use a robo-advice platform
  - 63.2% of independent BDs plan to offer robo-advisory services over the next two years
  - Of those, 50% plan to do so by the end of 2016
- Independent robo-advisers (e.g., Betterment, Wealthfront) receive a lot of press, but represent only 3% of digital wealth management AUM**

*Liz Skinner, Robo-Advisers Demand Attention, InvestmentNews, December 20, 2015.

**"The hard truth about the rise of robo advisers," Financial Planning, October 3, 2016.

SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

"*While automated investment tools may offer clear benefits—including low cost, ease of use, and broad access—it is important to understand their risks and limitations before using them.*"

"*Investors should be wary of tools that promise better portfolio performance*."

SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

1. Understand any terms and conditions.
   - Ask an automated investment tool sponsor whether it receives any form of compensation for offering, recommending, or selling certain services or investments.
2. Consider the tool's limitations, including any key assumptions.
   - Be aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation.
   - Automated investment tool may be programmed to consider limited options.
3. Recognize that the automated tool's output directly depends on what information it seeks from you and what information you provide.

SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

4. Be aware that an automated tool's output may not be right for your financial needs or goals.
5. Safeguard your personal information.
   - Collection of personal information for purposes unrelated to the tool.
   - Beware of phishing and other scams.

FIDUCIARY STATUS OF ROBO-ADVISERS

“We're all being disrupted, but regulators are also”

“What would a fiduciary duty mean to a robo-adviser? Or suddenly, is there no fiduciary duty if it's automated advice? How should the SEC be thinking about that and regulating that?”

-Commissioner Kara Stein, Investment Adviser Association Compliance Conference (March 10, 2016)

FIDUCIARY STATUS OF ROBO-ADVISERS

"We are looking at how advisers that provide investment advice with limited, if any, human interaction: (1) provide appropriate disclosures so that their clients understand their services; and (2) obtain information to support their duty to provide suitable advice"

-Chair Mary Jo White, SEC Fintech Forum (Nov. 14, 2016)

FIDUCIARY STATUS OF ROBO-ADVISERS

- Duty of Loyalty
  - Conflicts of interest and disclosure
  - Standard criteria for determining the appropriate investments drawn from a defined universe of potential investments
  - Disclosure of inherent and latent conflicts of interest
- Duty of Care
  - Competence and suitability of recommendations
  - Suitability is the real issue--Knowledge of client's financial status and investment needs may not be sufficiently established by an automated, inflexible set of questions

WHAT IS THE FUTURE OF ROBO-ADVICE?

- The hybrid / advisor centric model

Marketplace Lending

THE MARKETPLACE LENDING ASSET CLASS

- Marketplace Lending as an asset class offers managers the ability to generate fixed-income like returns with relatively low risk of loss
- The last year has proven to be more challenging for the asset class, as entrants to the industry increase
- The industry continues to see growth, but remains small compared to traditional banking

THE MARKETPLACE LENDING ASSET CLASS

- Consumer loans, both fractional and whole loans, remain a significant segment of the market
- Small to medium enterprise business loans are a growing segment of the market
- Marketplace lending has reached a wide variety of other loan types: real estate, student loans, yachts, and more

MARKETPLACE LENDING AND INVESTMENT MANAGEMENT

- Managers may provide services through private funds, separate accounts, and more recently, closed-end funds
- Many managers use proprietary algorithms to select loans with hopefully less default risk than the market average
- Some managers license their algorithms, putting them squarely in the fintech space
- Some managers also operate marketplace lending platforms, and then purchase those loans for clients off the platforms

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POTENTIAL INVESTMENT STRUCTURES

- Private investment funds in the marketplace lending asset class are typically structured either as hedge or private equity style
- Separate accounts are used for institutional investors and other fund managers that want exposure to the asset class
- More recently, managers have been exploring the registered fund structure for the asset class

FUND STRUCTURES—HEDGE STYLE

- A hedge fund structure allows for continuous admission of investors, and potentially for withdrawals and exits
- Investors are typically charged a management fee and a performance fee, often subject to a high-water mark provision
- Relative illiquidity in the asset class requires managers to carefully consider the use of lock-up periods and gates
- Ongoing investor admissions and withdrawals raises valuation considerations

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FUND STRUCTURES—PE STYLE

- A PE structure allows the manager to draw on commitments over time, as loan purchases are made
- Investors are typically charged a management fee, and share of the profits after receiving a priority return
- The PE structure eliminates redemption concerns because investors are locked up for the life of the fund
- Managers that want the ability to bring on new investors can use a series LP or LLC structure
- Valuation is not an issue with a PE structure that limits admissions and precludes withdrawals

Equity Crowdfunding and SPV Platforms

EQUITY CROWDFUNDING TIMELINE

- **April 2012** - Title III of the Jumpstart Our Business Startups (JOBS) adds Section 4(a)(6) to the Securities Act of 1933, providing an an exemption from registration for certain crowdfunding transactions
  - Requires that the SEC adopt rules implementing crowdfunding within 270 days of enactment (end 2012)
- **March 2013** - SEC staff issues *FundersClub* and *AngelList* no-action letters
  - Allows the offering of "single investment" private funds without broker-dealer registration
- **July 2013** - SEC amends Regulation D to allow general solicitation in private offerings
  - Enhanced due diligence of "accredited investor" status

EQUITY CROWDFUNDING TIMELINE – CONTINUED

- **October 2013** - SEC proposes Regulation Crowdfunding
  - 500 comment letters

- **October 2015** - SEC adopts Regulation Crowdfunding, implementing Title III of the JOBS Act
  - Heavy regulatory burden on issuers and funding portals
  - Contrary to Congressional intent?

- **May 2016** - Regulation Crowdfunding becomes effective
  - 21 crowdfunding portals established in first 6 months

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SPV PLATFORMS

- Historically, compensation in connection with fundraising activities requires broker-dealer registration
  - Funding portals fit this definition
  - Registration and ongoing compliance costs are extremely burdensome
- In 2013, SEC staff issued no-action relief from broker-dealer registration to funding portals that offer “SPVs” investing in single, identified startup companies
  - AngelList LLC and AngelList Advisors LLC, SEC No-Action Letter (Mar. 28, 2013)
  - FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter (Mar. 26, 2013)
- Early Adopters:
  - AngelList
  - FundersClub
  - Gust
  - Wefunder

SPV PLATFORMS – HOW DO THEY WORK?

- A sponsor establishes and privately offers an “SPV” - a vehicle that pools investors to invest in the securities of a single issuer
  - Essentially, a Section 3(c)(1) private fund!
- SPVs offered to accredited investors via online platform
- Sponsor must be registered with the SEC as an investment adviser, or appropriately exempt
  - Reliance on the venture capital fund adviser exemption in Rule 203(1)-1
- No transaction-based compensation
  - But the sponsor may receive carried interest and arrange for fund expenses
- The sponsor may not handle investor funds or issuer securities
- No statutory disqualification

SPV PLATFORMS – BENEFITS / DRAWBACKS

- Benefits
  - No broker registration or FINRA membership
  - May be tailored to address custom uses and target markets
    - Hybrid SPV/VC funds are one possibility
  - Adoption of rule 506(c) allows for general solicitation (at the cost of enhanced investor due diligence)
  - Simplified cap table for startups
  - No limit on capital raise

- Drawbacks
  - Only available to accredited investors
  - Section 3(c)(1) limits the number of investors to 99
  - Ongoing fiduciary obligations for the life of each SPV

EQUITY CROWDFUNDING

- No broker registration for funding portals
- No threshold for investor sophistication
  - But limitations on *aggregate* purchases in crowdfunded offerings
- Crowdfunding is open to any company except:
  - Non-U.S. companies
  - Companies that are disqualified under “bad actor” rules
  - Investment companies and private funds
  - 1934 Act reporting companies
  - Companies without any specific business plan
- Up to ***$1 million*** during any 12-month period
  - Any form of debt or equity securities may be offered
- Issuers with <$25 million in assets do not need to count crowdfunded investors toward 1934 Act thresholds for registration
  - Consider redemption/repurchase rights

EQUITY CROWDFUNDING - ISSUERS

- Disclosures on Form C
  - Identification of directors and officers
  - Information about the business and use of proceeds
  - Information about the offering
  - financial data for the prior two fiscal years
  - Risk factors, intermediary compensation, conflicts of interest
- Reporting obligations
  - Similar to Form C in content
  - Reports filed with the SEC annually and posted to the issuer’s website
  - CEO certification in lieu of audit
- Limited advertising
  - Notices directing investors to funding portal

EQUITY CROWDFUNDING - PORTALS

- Intermediaries must be either brokers or funding portals
- Funding portals must register on new “Form Funding Portal” and must become FINRA members
  - Compliance burden is limited in comparison to broker-dealers
- Funding portals must:
  - Provide investors with educational materials explaining the crowdfunding process
  - Develop policies and procedures to protect investors from fraud and to ensure that investors comply with investment limits
  - Provide communication channels (chat rooms) for investors to discuss a proposed offering
- Funding portals may not:
  - List companies that they have a reasonable basis to believe have the potential for fraud or other investor protection concerns
  - Have a financial interest in issuers (other than as listing compensation)

EQUITY CROWDFUNDING – BENEFITS / DRAWBACKS

- Benefits
  - Allows sales to unaccredited investors
  - No broker registration for funding portals
  - Completion of Form C should be less expensive that bespoke offerings

- Drawbacks
  - Severely limited capital raising and investing opportunities
  - Onerous regulatory compliance burden for issuers and portals
  - Uncertain scope of liability for fraud by third parties

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