

THE US FINTECH MARKET

OPPORTUNITIES & BARRIERS FOR ISRAELI START-UPS



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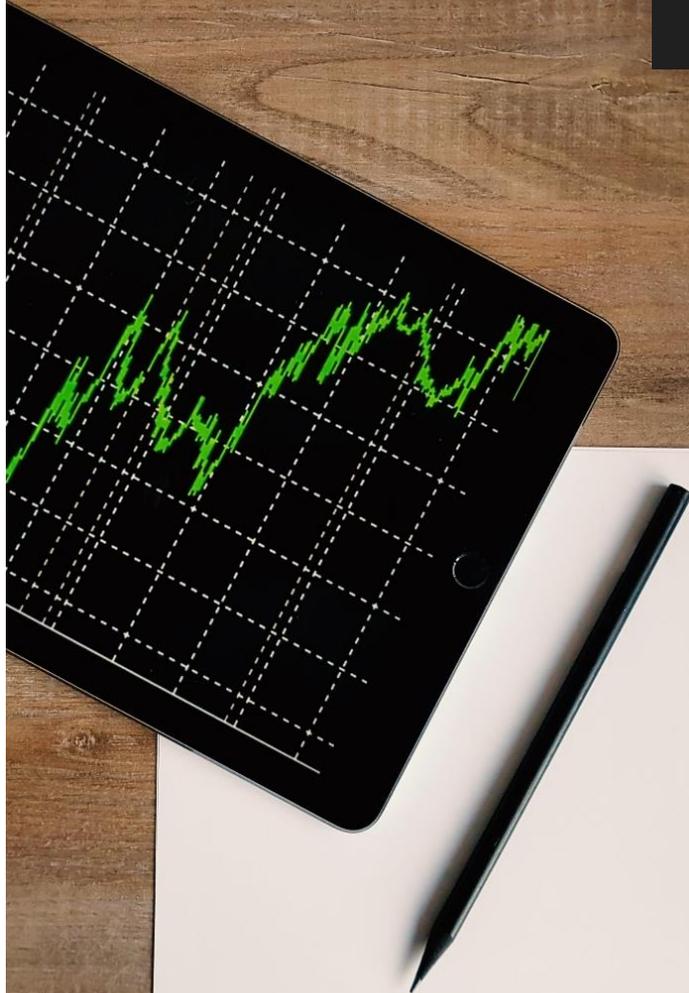
GUY FUCHS

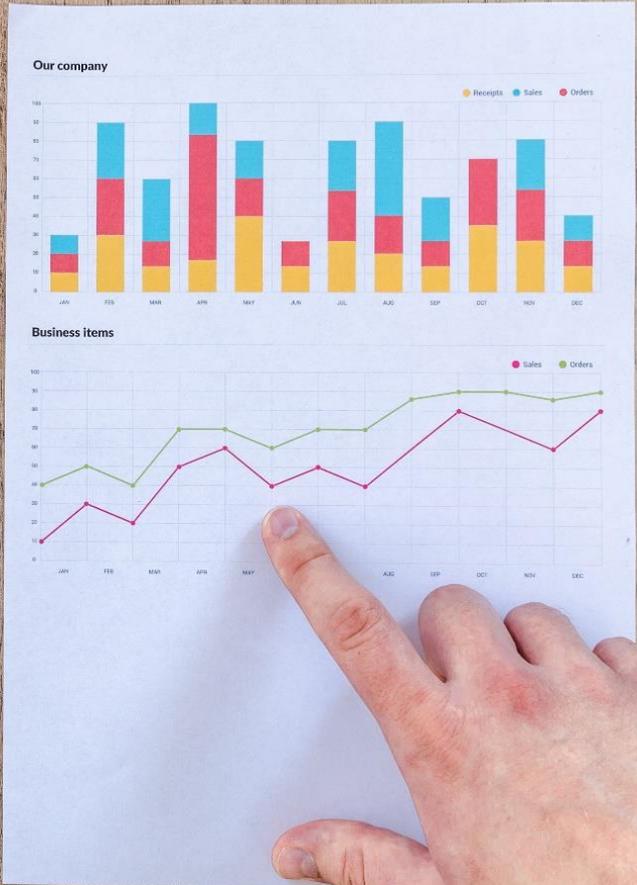
BANKING & FINANCE
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SEPTEMBER 2020



MAYER | BROWN





ISRAELI GROWTH AND CHALLENGES



Equity investment figures, and mega rounds



Growth rounds continuing into 2020



More to come?

EXTENSIVE SKILLS
IN BIG DATA AND
REAL-TIME ANALYTICS



EXCELLENT FINTECH
TESTING GROUND



CYBERSECURITY
KNOW-HOW



AT THE FOREFRONT OF
BLOCKCHAIN
TECHNOLOGY



Initial issues for an Israeli 'start-upist' to consider



IP ownership



Past employment limitations



Incorporation: where and when

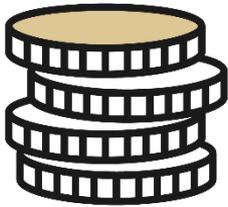


Jurisdiction



Timing

Understanding Equity:



Understanding your Capitalization Table: (authorized, issued and outstanding, fully-diluted)



Employment issues.



ESOP: Important to adhere to filing requirements; otherwise you risk losing tax advantages.



Other corporate considerations.

01

Know-how developed under an approved research and development program or rights associated with such know-how may not be transferred to third parties outside Israel, except in unique circumstances and subject to the IIA's prior approval.

Said approval may generally be obtained in a situation providing repayment of up to 600% of the grant amounts.

02

The R&D Law imposes reporting requirements with respect to certain changes in the ownership of a grant recipient.

Generally this means that the grant recipient and its controlling shareholders and foreign interested parties must notify the IIA of a change in control of the recipient or a change in the holdings of the "means of control" of the recipient that would make a non-Israeli an "interested party".

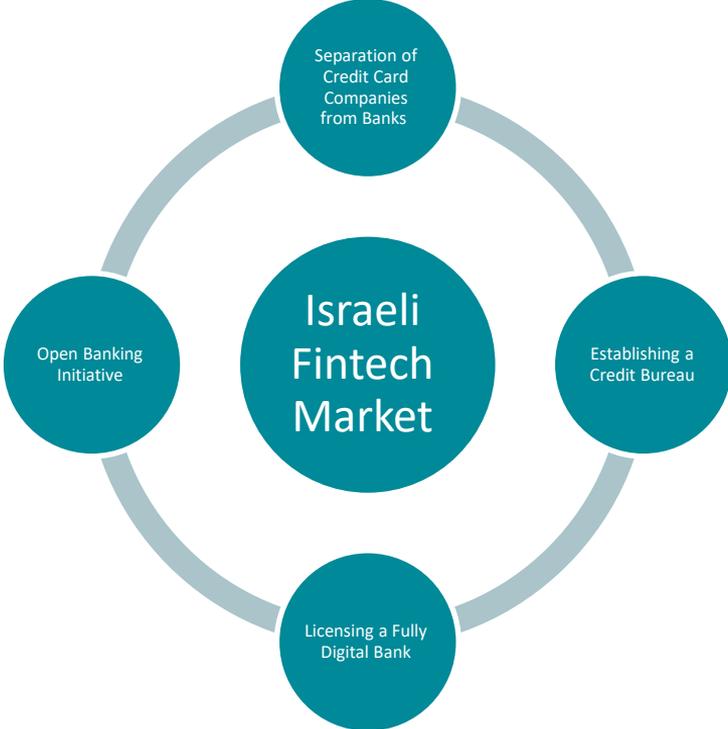
In this case the non-Israeli "interested party" must provide an undertaking to the IIA to comply with the R&D Law.

03

An "interested party" of a company includes a holder of five percent (5%) or more of its outstanding share capital or voting rights, its chief executive officer and directors, someone who has the right to appoint its chief executive officer or at least one director.



REGULATORY DEVELOPMENTS





Methods of
Operation for
Foreign
Corporates

Working
with a US
bank Tier
3 vs. Tier 1

Innovation
Grants

Venture Capital Investment

Participate in fintech company's funding round. Typically motivated primarily by financial return and potentially to address investor's strategic objectives, including higher priority access to technology, protecting potential technology/innovation from competitors and setting up a future acquisition of insurtech company or its talent. Potential early mover advantage.

Minority Investment

Purchase of non-controlling stake (*i.e.*, less than 50% of equity interests). Often motivated primarily by financial return, and potentially preferred access to insurtech company technology, data, etc. Potentially less risky than venture capital investment but early strategic investors in the insurtech company may have preempted opportunity for other strategic investors.

Majority Investment

Purchase of controlling stake (*i.e.*, greater than 50% of equity interests). Often motivated by desire for day-to-day control over operations, while allowing for equity "upside" for managers or strategic players.

Full Company Acquisition

Acquisition of the fintech company or its business, via stock deal, asset deal or merger.

Emphasis on due diligence to understand Israel company's compliance with law, strength of relationships with employees, suppliers and customers and if applicable, ability to operate outside of Israel

Considerations of investor's own compliance with US banking, financial services and other US laws and regulations in connection with a cross-border investment



Data privacy and cybersecurity



Technology transfer restrictions under export/import laws



FCPA/OFAC



Regulations restricting control of invested entities

Ability of the US investor to secure standard corporate governance protections and investor rights while conforming to Israel law and business practices

Understanding the treatment of Israel employees and consultants and the development of benefit and incentive plans; especially if the Israel company may become integrated with the US company

Pilot Programs:
Adhering to the US investor's procurement requirements and IT audits of the fintech company to protect integrity of the US company's legacy IT systems, data privacy policies and strict compliance procedures

Consideration of tax issues in light of US investor's and Israel fintech company's corporate structures

01

Reputational risk on regulatory issues significantly higher for US financial institution investor than the fintech company – this often leads to slower decision-making than that which a fintech may be accustomed

02

Buy/invest scenarios may trigger “change of control” requirements, depending on type of business operated by the fintech company

03

Diligence (buy/invest and collaborations) often reveals regulatory issues:

- Compliance with financial services licensing laws regarding the fintech company’s business model
- Use of artificial intelligence (AI), machine learning and other advanced data analytic tools may be more heavily scrutinized by regulators
- Know your customer and marketing/sales law compliance

RESTRICTIONS

Certain US financial institutions are subject to investment restrictions – a Bank Holding Company (BHC), US savings & loan holding company (SLHC) or a company that is controlled by a BHC or SLHC is subject to US Federal Reserve supervision and regulation

CONDITIONS

Under the BHCA, a company has control over another company if an investor:

- Directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the target company;
- Controls in any manner the election of a majority of the directors of the target company; or
- The Federal Reserve determines, after notice and opportunity for hearing, that the investor directly or indirectly exercises a *controlling influence* over the management or policies of the target company (emphasis added)

CONCLUSION

The Federal Reserve adopted regulations that implemented and interpreted aspects of the statutory definition of "control" and published various interpretations and policy statements

CERTAIN US FINANCIAL INSTITUTIONS MAY BE RESTRICTED FROM “CONTROLLING” A FINTECH



Control is presumed if the US financial institution controls one-third or more of the total equity of the fintech, regardless of the US financial institution’s voting securities percentage



Total equity calculation is based on GAAP with adjustments in the final rule

- Despite industry comments on the proposal, it remains unclear to calculate total equity for investments in start-ups and companies with **negative GAAP equity**; a US financial institution may exceed one-third threshold (potentially to infinity) by making an equity investment in a fintech with negative equity



Preamble to the final rule notes that the statutory framework for control does not contemplate different definitions of control for companies in different jurisdictions

- Federal Reserve states that the final rule is "generally consistent with the Board's current practice and, as a result, the final rule is not expected to result in substantially different outcomes for questions of controlling influence involving foreign companies."

INVESTMENT AND M&A TRANSACTIONS



JOINT VENTURE / STRATEGIC PARTNERSHIP

Co-ownership of a new venture with an existing company to develop and commercialize specific new ideas or products



MINORITY / MAJORITY INVESTMENT

Monetary investment in an existing company (early or late stage) that results in a minority or majority ownership interest in the company



ACQUISITION

Monetary investment in an existing company (early or late stage) that results in 100% ownership of the company or establishment of a start-up newco

COLLABORATION TRANSACTIONS



LICENSING

Financial institution obtains right to use new technology



SERVICES AGREEMENTS

Outsourcing, Software as a Service (SaaS), data analytics, etc. offer opportunities to collaborate, develop and commercialize new ideas



PLATFORM COLLABORATION / WHITE LABEL ARRANGEMENT

Commercial arrangement between financial institution and insurtech to obtain “white label” services or technology “powered by” arrangement



Company formation and developing an efficient tax strategy



Managing US employees and developing employee incentive plans



Complying with regulations/licensing and developing a government affairs strategy



Complying with technology transfer laws



Avoiding and dealing with disputes



Protecting intellectual property



Developing financing options and potential exit plans

Federal vs. State

- Federal Trade Commission (“FTC”) and Consumer Financial Protection Bureau (“CFPB”)
- State regulatory agencies and State Attorney General

Different interpretations of law

- Eg: Unfair or Deceptive Act or Practice (“UDAP”) vs. Unfair, Deceptive, or Abusive Act or Practice (“UDAAP”)



Cost of obtaining and maintaining state licenses (\$1-\$30M estimate)



Substantive, state-specific requirements for licensees

- Consumer Disclosures
- Recordkeeping



Risks: forced business shutdown, money penalties, voided loans or contracts

2015: PayPal Office of Foreign Assets Control (“OFAC”) Settlement

- \$7.7 million settlement
- Allegation that PayPal failed to screen transactions with OFAC-sanctioned companies
- Fine was discounted because PayPal self-reported offenses and cooperated with OFAC

2018: LendingClub Massachusetts Settlement

- \$2 million settlement
- Unlicensed loan-servicing and small-loan lending by a wholly-owned subsidiary

2018: AriseBank Securities and Exchange Commission Asset Freeze

- Court order stopping allegedly fraudulent initial coin offering, in which AriseBank misrepresented itself as a decentralized bank

PARTNER WITH OR ACQUISITION BY TRADITIONAL US FINANCIAL INSTITUTION



Financial institution familiar with expectations of its own bank regulators



Exemptions from state licensing

CHALLENGES



Biggest challenge for US financial institutions in working with fintechs?*

- Differences in IT security, management and culture, business models
- Regulatory uncertainty



Structuring the transaction:

- Bank partnerships
- “True Lender”/Madden risk

This is in relation to the TSP agreement
template that you sent us, correct?



Venture/Minority Investment

- Focus on capitalization / ownership of equity
- Red flag review of contracts, IP, employee benefits, labor, real estate, etc.
- Venture/Minority investment would not typically trigger contractual restrictions on change of control (although board / protective clauses should be considered)
- Accounting/financial due diligence



Majority Investment

Will generally track scope of diligence for full company acquisition



Full Company Acquisition

Legal

- Capitalization/Ownership
- Review contracts with focus on data security, compliance, change of control/assignment, exclusivity, non-competes, etc.
- Data Privacy / Compliance
- Review IP disputes/ownership, including Source Code
- Employee Benefits / Labor (liabilities and post-closing integration)
- Real Estate (leases / title)

Tax

Accounting
Finance



Venture/Minority Investment

- Antidilution / preemptive rights
- Veto rights over “Major Decisions”, such as:
 - Hiring/Firing of Key Executives
 - Debt
 - Changes in Business
 - Approval over Annual Budget
- Right to appoint board member?
- Information Rights (financial statements, etc.)
- Will you be able to prohibit your competitors from becoming shareholders?
- **All of the foregoing to be balanced against regulatory implications, and the specific % ownership will drive what is reasonable/ appropriate



Majority Investment

How much negative control will be conceded to the minority investors (same topics as left-hand column but opposite perspective)?



Full Company Acquisition

Unnecessary



Venture/Minority Investment

- Tag-along rights
- Registration Rights
- Right to sell to third parties, potentially subject to going through a ROFR process exercised by other investors



Majority Investment

- Drag-Along rights (in addition to having Tag-along rights over other investors' sales to third parties)
- ROFR over other investors sales to third parties



Full Company Acquisition

- Full control over disposition



Venture/Minority Investment

- Reps/warranties may be more limited in scope to “Fundamental” reps (ownership, capitalization)
- Since investor will own only a fraction of the total fintech company, the investor’s share of losses for “company level” issues is limited to the ownership percentage.
- Dynamics of being lead investor vs. following lead investor



Majority Investment

- Similar to full company acquisition
- Will need to negotiate shareholders’ agreement or similar document at same time to address the topics previously discussed.



Full Company Acquisition

- Reps/Warranties and indemnities key mechanism to protect value (recourse to seller)
- Interim operating covenants
- Closing conditions / antitrust / regulatory approvals



In April 2019, the Federal Reserve proposed a rule to clarify, rationalize, and memorialize its approach to the controlling influence prong

- Replace the approach to regulation of "Federal Reserve lore ... receiving the wisdom of their elders through oral tradition"



In January 2020, the Federal Reserve issued a final rule to review and codify its approach to the controlling influence prong

- Largely consistent with the proposal
- Styled as presumptions that would be applied in control proceedings by the Federal Reserve, although such proceedings have not occurred in decades
- Codifies many existing standards, but introduces new concepts

Final rule was to become effective on April 1, 2020, but implementation was delayed until September 30, 2020 due to COVID-19.



01

Final Federal Reserve rule adopts a GAAP-based methodology for determining an investor's total equity percentage in the target company

- Pari passu classes of preferred stock (i.e., classes of preferred securities of the same seniority in liquidation) are treated as a single class

02

Final rule includes a provision whereby debt or other interests may be treated as equity if the interests are functionally equivalent to equity

- Excludes nominally equity instruments from total equity if the equity instruments are determined to be functionally equivalent to debt

03

Does not include a proposed provision that would have required an investor to include a pro rata share of equity securities held by a non-subsiary

04

Requires re-calculation of total equity only when an investor acquires control over additional equity of the target company

US FEDERAL RESERVE REGULATIONS: SUMMARY OF TIERED CONTROL PRESUMPTIONS

(Presumption triggered if any relationship exceeds the amount on the table)

	Less than 5% voting	5-9.99% voting	10-14.99% voting	15-24.99% voting
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
Business Terms	N/A	N/A	Market Terms	Market Terms
Officer/Employee Interlocks	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less	BHCs - Less than 1/3 SLHCs – 25% or less

THANK YOU FOR JOINING US!

Don't hesitate to contact us if you have any questions or queries.

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Deloitte US-Israel Strategic Relationship



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Fortune '100 Best Companies to Work For' 'Best Workplaces for Diversity' & 'Best Workplaces for Parents'



107,000
Employees



105
Cities

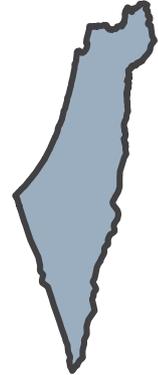
The Strategic Relationship



Better serves clients with a strong presence in both **US and Israel**

Enhances access and services to Deloitte Israel's dynamic startup & innovation ecosystem

Leverages size and depth of Deloitte US to enhance quality, solutions and services.



Deloitte Israel

Catalyst Tel Aviv connects our large MNC innovation-seeking clients to local innovators

Creates a **Cybersecurity Center of Excellence** in Israel to serve US clients **globally**

Dedicated US-IL Tax Desk



1,250
Employees



5
Cities

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technologies and innovators locally accessible to deliver the unmet needs of your business and its customers.

Our Domains

Cyber Security • Life Sciences and Health Care • Automotive & Future of Mobility • Fintech, InsurTech, and Blockchain • Retail Technology • Industry 4.0 • Energy, Resources and Industrials • Future of Work

90%

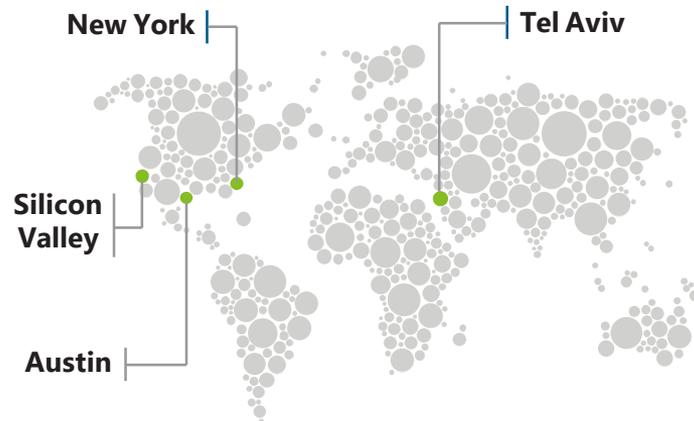
of startups

Succeed when they engage a growth partner with access to scale opportunities

30%

faster growth

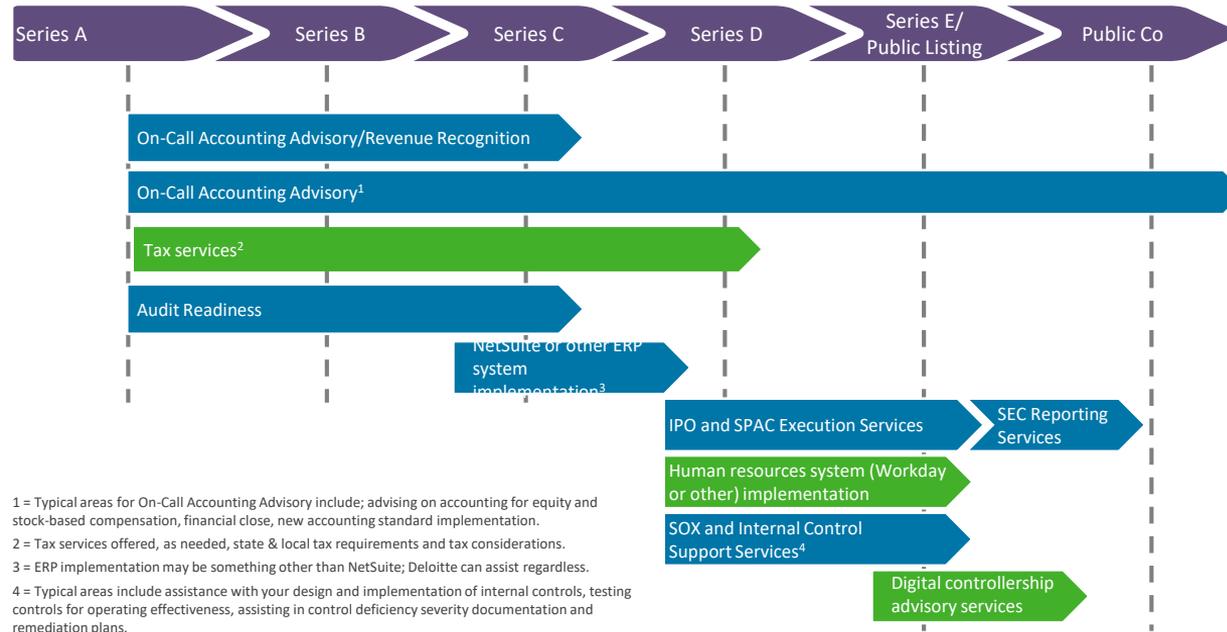
For organizations that align their growth strategies, collaborate and experiment with tech providers and services partners.





FinTech Accelerator—Where are you on the lifecycle?

No matter where you sit, we may advise on long- and short-term scalable strategies to develop the business processes to help get your FinTech to the next level.



Why Deloitte?

Knowledge

We have strong FinTech capabilities, ranging from early-stage, through listing as a public entity or other exit strategy, and we understand the issues you will encounter along your company's lifecycle.

Advice

We can help advise FinTech companies on the accounting challenges, financial reporting matters, and internal controls that may become relevant as they navigate through the revenue recognition complexities. And, we understand where the company's independent auditor may focus.

Resources

We have local resources and can engage thought leaders from across Deloitte to help.

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Deloitte Catalyst Core Services for Startup Clients



Audit

Extensive annual audit of statutory financial statements and other necessary reporting requirements, such as the statutory income tax return in Israel, supplemented by ongoing guidance and advice on financial and accounting aspects of startups.



Tax

Building a tax strategy that complies with the company's business model and strategy; including local tax compliance, international and local tax strategies, employee stock option plans, transfer pricing and more.



Government Incentives

Professional and personal guidance in the preparation and submission of early and growth stage grant applications, and international and bilateral grant applications to the Israel Innovation Authority.



Storytelling

Strategize and distill a high-impact investor story that highlights the company's unique value and positions its technology, solution and business and project assets in the most persuasive manner possible.



NetSuite

Implementing NetSuite cloud ERP to support the startup's growth. Covering all implementation aspects including processes and requirements, configuration and customization, change management, integration and data migration and localization.



Strategy Validation

A thorough examination of a company's existing strategy in light of its ecosystem, product and technology, customers' needs and habits, and ability to successfully execute this strategy.



M&A

Identifying and approaching potential buyers and advising the client through the negotiations and deal closing. This includes an M&A readiness review and preliminary screening of any potential issues that might affect the deal.

Deloitte Catalyst Services for Corporate / Government Clients



Immersion

An intensive, curated experience, including meetings with transformative startups, leading venture capitalists, R&D centers and government officials. Conducted live or virtually.



Scouting

Identifying the innovative companies and technologies within the ecosystem to achieve your growth, investment, talent, or innovation objectives. Delivered as a single report or ongoing service.



Proofs of Concept

Shape and support execution of startup PoCs to meet a client's specific objectives, in concert with Deloitte's extensive technology capabilities.



Soft Landing

Customized support in establishing and operating a local presence in an ecosystem, whether a corporate venture capital fund, innovation lab, or R&D center. Currently offered in Tel Aviv.



Incubation

Prototyping new solutions in collaboration with startups and our other leading alliances to create innovative platforms that address the unmet needs of your business and customers.

Meet the team



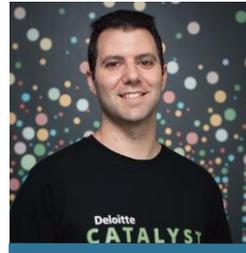
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EMEA Technology Fast 500™

Quarterly Industry Report

The quarterly industry reports capture key industry trends, recent investment activity, and Deloitte insights on the most active industry domains in the local Israeli ecosystem.



The DNA of digital challenger banks



Future of Work Tech in the Startup Nation



The future of Fintechs



Fintech by the numbers



Israel Fintech Landscape Report



Digital Trials: Israeli Startups at the forefront of the Digital R&D Revolution



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