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AICPA Issues Draft Guidance on Valuing Equity Interests Within Complex Capital Structures

By Michael Aronow and Craig Ter Boss

As we have previously written about in the third quarter edition of EisnerAmper's *Asset Management Intelligence*, the *AICPA's Accounting and Valuation Guide: Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies* (the "Guide") describes possible methods for valuing equity interests within complex capital structures as well as provides a few examples.

Given the higher risks associated with investments by venture capital and growth private equity investors, they typically will demand downside protection and significant control over certain activities of the portfolio companies. This is typically accomplished through the issuance of different classes of equity, which have different rights, privileges and preferences. The rights provided to preferred stockholders fall into two categories – economic rights and non-economic rights. Economic rights include liquidation preferences, preferred dividends, participation rights, conversion rights and anti-dilution rights. Non-economic rights include voting, board, veto and management rights. These rights, privileges and preferences present an additional layer of complexity when allocating the value of the company to the various classes and specific ownership interest held by an investor. When estimating the value of an investment, it is necessary to determine how each class of equity participates in future distributions from a liquidity event and assess the impact on fair value for each of the classes.

METHODOLOGY

To value equity interests for companies with complex capital structures, four methods are generally utilized:

1. Scenario-based methods, including simplified scenario analysis, relative value analysis and full scenario analysis ("PWERM");
2. The Option Pricing Method ("OPM");
3. The Current Value Method ("CVM"); and
4. The Hybrid Method, a combination of PWERM and OPM

Scenario-based methods consider the payoff to each class of equity based on a range of exit scenarios that then may be discounted back to the valuation date. A simplified scenario analysis is based on a post-money value of the company on a pro rata basis assuming all classes of equity are converted. This analysis can be suitable for situations where a company will either be successful or there will be limited value to distribute if unsuccessful. A relative value scenario analysis will consider the estimated pro rata share of the various equity interests and then calibrate a post-money value by applying probabilities to different outcomes and payoff values. This approach typically ignores discounting. A full scenario analysis (PWERM) estimates the value of the different classes of equity interests by analyzing potential future values, based on different outcomes (generally IPO, sale, dissolution). The future values for each equity class are discounted back based on the required return for each class considering potential dilution from future financings. A PWERM approach is more typically used when a company is closer to an exit and different potential outcomes can be more readily ascertained.

The OPM model treats common stock and preferred stock as call options on the enterprise's equity value, with exercise prices based on the liquidation preferences of the preferred stock. Under this method, the common stock has value only if the funds available for distribution to shareholders exceed the value of the liquidation preferences at the time of a liquidity event (e.g., a merger, sale or IPO), assuming the company has funds available to make a liquidation preference meaningful and collectible by the shareholders. The common stock is modeled as a call option that gives its owner the right, but not the obligation, to buy the underlying equity value at a predetermined or exercise price. Thus, common stock is considered to be a call option with a claim on the equity at an exercise price equal to the remaining value immediately after the preferred stock is liquidated. The OPM begins with the current equity or enterprise value and estimates the future distribution of outcomes using a lognormal distribution around that current value. A key limitation of the OPM is the assumption of a lognormal distribution based on the subjective assumptions of volatility and term until exit. Additionally, holders of the preferred stock may have influence on the timing of an exit if the company is performing above or below initial expectations.

The CVM estimates the value of various classes of equity by allocating the current total equity value on a controlling basis, assuming an immediate sale of the company. While this methodology is easy to apply, for purposes of valuing a fund's equity interest may be limited because it does not capture any of the option value for certain classes of equity. As such, this methodology is most appropriate when a liquidity event is imminent and when a fund's position has sufficient elements of control over the timing of the exit.

The hybrid method, a combination of the PWERM and OPM, can be appropriate when there are expectations of a near-term liquidity event with a high probability; yet if the transaction is not consummated, the alternate path for the company is more uncertain, with a potential exit further out in the future. The PWERM component would apply the probabilities associated with a range of values for the near-term liquidity event to determine one component of the estimated value and the remaining probability would use an OPM over a more extended period. Conceptually, the hybrid method provides a good framework for valuation as it captures both expectations of different future values and potential optionality of certain equity classes; however, it can be complex to develop considering the numerous assumptions needed.

CONCLUSION

Each of the methods described have relative strengths and weaknesses and circumstances that are most conducive to use. It is important to understand the relationship of the different classes of equity, including gaining an understanding of the rights, both economic and non-economic, associated with each class.

These methods can be used to calibrate to the most recent round of financing and develop an appropriate valuation framework, which can be updated to reflect changes to the company and market conditions in subsequent periods. The use of calibration can also help to assess the impact of control and illiquidity issues relating to an investment.

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Innocent Until Proven GILTI – Not Anymore: The New Global Intangible Low Taxed Income Regime

By Simcha David, CPA, JD

Many private equity funds have historically invested in foreign operating corporations. The tax issues inherent in such acquisitions and the proper tax structuring surrounding these purchases and dispositions have always been complex. In the past, the actual ownership of the foreign operating entity did not require the inclusion of operating income on a current basis, except to the extent the company paid a dividend. The net income of such operations remained in the corporation and there was no "phantom income" flowing up to the fund. That is no longer the case. Welcome to the new Global Intangible Low Taxed Income (GILTI) regime.

The Tax Cuts and Jobs Act of 2017 (the "Act") was the largest overhaul of the Internal Revenue Code (the "Code") since the Code itself was completely overhauled in 1986. Prior to the Act, business income earned by a foreign corporation overseas was generally not taxed to a U.S. corporate parent until a dividend was paid to the U.S. parent and the cash was repatriated to the U.S. With U.S. corporate taxes being 35%, this caused many multinational corporations to leave the cash earned in the foreign corporate subsidiaries offshore. To prevent this behavior and encourage multinational corporations based in the United States to repatriate cash being held overseas for investment in the U.S., the Act established a participation exemption system under which certain earnings of a foreign corporation could be repatriated to a U.S. shareholder without U.S. tax. This is accomplished by allowing a 100% dividends received deduction ("DRD") for greater than 10% U.S. corporate partners of controlled foreign corporations. (A controlled foreign corporation [a "CFC"] is a corporation that has greater than 50% of its shares [by vote or value] owned by greater than 10% U.S. shareholders.)

To transition to this new system and to capture repatriation of pre-Act earnings and profits, a one-time repatriation tax was instituted under Code Sec. 965 for the tax year ending December 31, 2017. With the new participation exemption system in place beginning January 1, 2018, however, Congress recognized that without further base protection measures, the new system could incentivize taxpayers to allocate income from intangible property that would otherwise be subject to full U.S. corporate tax rates (now at 21%) to controlled corporations operating in low or zero-tax jurisdictions. Intangible property can be held anywhere in the world, while tangible property is not as mobile or is not mobile at all.

In a simple scenario, a U.S.-based corporation could house its intellectual property licenses in a foreign corporate subsidiary and charge the U.S. parent for use of that intellectual property. The U.S. parent has an expense that reduces the net income otherwise subject to U.S. tax, and the foreign corporate subsidiary picks up the income and, if in a low- or no-tax jurisdiction, pays a lower tax or no tax at all on that income. If under the pre-Act system, the money paid to the foreign corporation was repatriated to the U.S. parent, there would have been full U.S. tax at that time to the extent of the earnings and profits of the foreign corporation. Under the new participation exemption system, the cash related to foreign earnings can be repatriated to the U.S. parent and not be subject U.S. tax. The perfect storm: low taxing jurisdiction with the ability to bring the cash back tax-free. Because of this, Congress enacted additional measures to prevent this type of base erosion.

The name GILTI is a misnomer. While the purpose of this tax is to tax foreign income related to the use of intangible property in low taxing jurisdictions, Congress understood it would be extremely difficult to identify income specifically associated with the use of intangible property and so instead instituted the GILTI tax, with a formulaic approach utilizing certain assumptions about the generation of income. The basics of the calculation is to allow for a return of net operating income equal to 10% on certain tangible assets and to assume that all other net operating income is a return on intangible assets and subject to the GILTI regime. In order not to harm U.S. corporations competing in foreign jurisdictions by saddling them with a full U.S. tax in addition to the foreign tax, the GILTI income is effectively taxed at a lower rate by allowing a U.S. corporation to pay the GILTI tax on only 50% of the GILTI income, and tax credits are allowed for taxes paid to foreign jurisdictions.

GILTI is imposed only on greater than 10% U.S. shareholders ("U.S. Shareholder") of CFCs. The term U.S. Shareholder includes a U.S. limited partnership. In the partnership context, there are times that the Code views a partnership as the aggregate of its partners and at time views a partnership as an entity. With regard to the 10% ownership rule, the U.S. limited partnership will be viewed as an entity and the ownership test will be at the partnership level rather than at the partner level. What this means for private equity fund investors is that they might very well have a GILTI inclusion even though they indirectly own much less than 10% of the foreign corporation. The Fund would record the GILTI inclusion and allocate this income to its partners.

The GILTI regime introduces many new terms, and the calculation can be quite complex. The IRS issued proposed regulations in October 2018 to help explain some of these complexities. The proposed regulations discuss how to determine a shareholder's pro rata share of all of the items necessary to perform these calculations. There are specific examples related to corporate partners of U.S. partnerships that own CFCs. The regulations also discuss how to handle preferred shareholders.

The basic calculation is as follows where every defined term has pages of regulations associated with it:

GILTI is the excess of a U.S. Shareholder's "net CFC tested income" for the tax year over the U.S. Shareholder's "net deemed tangible income return" for the tax year.

"Net CFC tested income" is the excess of the aggregate of the shareholder's prorata share of the "tested income" of each CFC of the U.S. Shareholder over the aggregate of the shareholder's prorata share of the tested loss of each CFC. "Tested income" of the corporation is the gross income of the corporation less the following: deductions properly allocable to that gross income, income effectively connected with a U.S. trade or business, subpart F income (subpart F income includes foreign personal holding company Income which generally consists of passive income such as interest, dividends, net foreign currency gains, net gains from sales of property that do not generate active income, certain rents and royalties and income from personal services contracts), dividends received from related parties, foreign oil and gas extraction income and gross income excluded due to exception for high foreign taxes. Net CFC tested income is trying to calculate the aggregate annual foreign sourced earnings of the foreign corporations that are due to operations, with some exceptions and adjustments. It is interesting to note that unlike under the subpart F regime where the subpart F income of each foreign corporation owned is viewed on its own and no benefit is allowed for corporations with losses, under the GILTI regime all of the income and losses of the various foreign owned corporations are aggregated at the shareholder level.

"Net deemed tangible income return" is the excess of 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC over the amount of interest expense taken into account in determining the Net CFC tested income of such corporation. QBAI is the average of the corporation's aggregate adjusted bases as of the close of each quarter of the tax year in specified tangible property used in a trade or business of the corporation and which is allowed a deduction under Code Sec. 167. In other words, depreciable property. The aggregate adjusted bases must utilize the ADS system of depreciation rather than the Modified Accelerated Cost Recovery System (MACRS) or other system of depreciation. The new regulations clarify that if there is a tested loss corporation (which is a foreign corporation that has "tested income" that calculates to a loss) that is used in the aggregate calculation of Net CFC tested income, the basis of the assets of that corporation are not allowed to be used in determining the net deemed tangible income return. The regulations also note that a foreign corporation needs to recalculate depreciation on all of its assets both pre- and post-Act using the ADS system in determining their QBAI.

Taking a step back, it is important to understand the impact that such income inclusions can have on shareholders of the foreign corporation. Generally, income earned by a corporation is taxed within the corporation, and such income is not deemed to be earned by the shareholder on a current basis. When cash is paid out of the corporation to the shareholders, such income is taxed as a dividend to the extent such corporation has earnings and profits. This is sometimes referred to as a "double level of taxation." This is in stark contrast to partnerships where the income earned by the partnership is deemed to have been earned by the partners on an annual basis and is not taxed at the partnership level. Under the GILTI regime, the GILTI income earned within the foreign corporation will be taxed on a current basis to the U.S. Shareholders. In many ways, this is similar to the subpart F inclusions that the asset management industry has been dealing with for many years.

Before the Act, the CFC designation was important as it required certain tax reporting on the tax return of the U.S. Shareholder and required the inclusion of subpart F income earned in a CFC to be included in income on a current basis. Subpart F income inclusions from CFCs are commonly referred to as sources of phantom income. It is described as phantom income as the taxable income is generally not caused by an event that generates cash to the shareholder (such as a sale). The GILTI regime may be viewed as a similar provision for the operating (non-passive) income of a foreign corporation attributable to its foreign operations. In the past, if a fund invested in a foreign operating company it would generally not have any current income inclusions for tax purposes unless it was paid a dividend by the foreign operating company or it sold the company. Under the new rules, a portion of this operating income of the foreign company will be subject to U.S. tax on a current basis.

One of the major differences between the GILTI inclusion and the subpart F inclusion is that subpart F inclusion of each specific CFC is calculated on its own. If a U.S. Shareholder owns multiple CFCs, the subpart F inclusion of each CFC is determined separately. Under the GILTI regime, all of the items that are necessary for the calculation are aggregated at the shareholder level prior to the calculation of the GILTI inclusion. In its simplest form, this means that losses can offset income inclusions from other CFCs. So as not to get a double benefit, QBAI of a tested loss CFC does not get included in the aggregate QBAI when determining the 10% benefit.

Another important aspect that is relevant to the asset management industry is the fact that the deduction of 50% of the GILTI inclusion that is built into the system to allow for a lower level of tax is only allowed for U.S. corporate shareholders. In the Fund context, if a private equity fund owns an investment in a foreign corporation that is a CFC, and the Fund is a Delaware Limited Partnership that is a greater than 10% shareholder of the foreign CFC, the Fund will pick up the GILTI amounts and pass those amounts along to its partners. A U.S. partnership is deemed to be a shareholder on its own in this context, and you do not look through to the partners to determine ownership of the CFC. Individuals who will be allocated this GILTI income will have to pay up to the highest rate of federal tax of 37% on the income. A corporation that can deduct 50% of the GILTI income allocated to it will have an effective tax rate of 10.5% (21% (new corporate tax rate) x 50%). There may be a way for individuals to have the lower rate of tax through an election at the individual level or Funds will need to put proper tax structuring in place to accommodate for the new rules.

Overall GILTI is a complex set of rules with a clear mission but an unclear methodology to accomplish that mission. The old way of structuring for efficient tax purposes may no longer work and it is imperative that you discuss this provision as well as all of the other provisions of the Act with your tax service providers.

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Asset Management Update: FASB Modifies Fair Value Disclosure Requirements

By Matt Maulbeck and Melissa Miro

ASU 2018-13 significantly reduces disclosure requirements related to level 3 investments held by private investment companies.

INTRODUCTION

In August 2018, the Financial Accounting Standards Board issued Accounting Standards Update No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement.[i] This update is part of the FASB's larger disclosure framework project intended to improve the effectiveness of financial statement footnote disclosure. ASU 2018-13 modifies required fair value disclosures related primarily to level 3 investments. The ASU impacts non-public[ii] and public entities differently; a summary of changes to disclosure requirements categorized by nonpublic and public entities is presented below.

NONPUBLIC ENTITIES *(including private investment companies such as hedge and private equity funds):*

DISCLOSURE REMOVALS

- Valuation process for level 3 measurements.

  Insight: Specifically, the ASU deletes[iii] ASC 820-10-55-105, which required a description of the group responsible for valuation policies and procedures, its methods of calibration and back testing, its process for analyzing changes in fair value measurements, its process for analyzing third-party information used in valuation, and its methods used to develop and substantiate unobservable inputs.

- Policy regarding the timing of transfers between levels in the fair value hierarchy.

  Insight: ASU 2018-13 eliminates the requirement to disclose this policy, however, entities will still be required to set and consistently follow a policy on transfer timing (typically (a) the date of the event or change in circumstances that caused the transfer, (b) the beginning of the reporting period or (c) the end of the reporting period).

- Changes in unrealized gains and losses for Level 3 fair value measurements still held at the end of the period.

  Insight: Previously, this disclosure was often presented as a supplement to the "level 3 roll-forward" table.

DISCLOSURE MODIFICATIONS

- In lieu of a reconciliation of opening and closing balances "roll-forward" of level 3 fair value measurements, disclosure is required of transfers into and out of level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities.

Insight: Each of the elements noted above, purchases, issues, transfers in, and transfers out must be disclosed separately under the ASU. Similar to existing GAAP[iv], the reasons for transfers into or out of level 3 must also be disclosed.

- For investments valued using the practical expedient (unadjusted net asset value), the requirements to disclose (1) an estimate of the timing of liquidity events of the investee and (2) the timing on when limitations on redemptions related to the investee may lapse only apply if the investee has already disclosed this information publicly or directly to the reporting entity.

  Insight: This modification eliminates the need for entities to make its own estimate on timing of such events. Disclosure is now required only if it is known.

- Deletion of the words "at a minimum" from the phrase "an entity shall disclose at a minimum" throughout the guidance to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditors when evaluating disclosure requirements.

  Insight: Disclosure of weighted average and range of unobservable (level 3) inputs for nonpublic entities.

  Prior to ASU 2018-13, all entities were required to provide quantitative information about significant unobservable inputs for level 3 fair value measurements. This has not changed under the ASU. General practice for investment companies has developed such that the range and weighted average of unobservable inputs are generally disclosed to comply with this requirement. As discussed below, the ASU added an explicit requirement for public entities to disclose range and weighted average of unobservable inputs. Non-public entities are exempt from this specific requirement, however, the requirement to provide quantitative information about unobservable inputs remains. Entity management must use judgement in determining the most appropriate quantitative information about unobservable inputs to disclose going forward.

PUBLIC ENTITIES *(Including 1940 Act mutual funds, BDCs and broker-dealers)*

DISCLOSURE ADDITIONS

- Explicit requirement to disclose the range and weighted average of significant unobservable inputs used to develop level 3 fair value measurements and how the weighted average was calculated. Other quantitative information (such as the median or arithmetic average) may be disclosed in lieu of the weighted average if it is determined to be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop level 3 fair value measurements.

- Changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period.

  Insight: Investment companies will not be significantly impacted by this requirement as under ASC 946, they recognize unrealized gains and losses related to investments on the income statement, not a statement of other comprehensive income.

DISCLOSURE REMOVALS

- Details on transfers between Level 1 and Level 2 of the fair value hierarchy.

  Insight: Note that nonpublic entities are exempt from this requirement under current GAAP and ASU 2018-13.

- Policy regarding the timing of transfers between levels in the fair value hierarchy.

- Valuation process for Level 3 measurements.

DISCLOSURE MODIFICATIONS

- For investments valued using the practical expedient (net asset value), the requirements to disclose (1) an estimate of the timing of liquidity events of the investee and (2) the timing on when limitations on redemptions related to the investee may lapse only apply if the investee has already disclosed this information publicly or directly to the reporting entity.

- Deletion of the words "at a minimum" from the phrase "an entity shall disclose at a minimum" throughout the guidance to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditors when evaluating disclosure requirements.

- Clarification that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date rather than sensitivity to future changes in fair value.

Insight: Note that nonpublic entities are exempt from this requirement under current GAAP and ASU 2018-13.

EFFECTIVE DATE AND TRANSITION

ASU 2018-13 is effective for all entities for annual periods beginning after December 15, 2019 and interim periods within those annual periods. Early adoption is permitted. Entities are permitted to early adopt any removed or modified disclosures and delay adoption of additional disclosures until their effective date.

The prospective method of adoption is required for additional or modified disclosures related to (1) changes in unrealized gains or losses included in OCI, (2) range and weighted average for significant inputs to level 3 investments and (3) uncertainty in measurement as of the reporting date. All other disclosure changes resulting from the ASU should be applied retrospectively.

i Hereafter referred to as the "ASU" or "ASU 2018-13".

ii A "Nonpublic entity" is an entity that does not meet any of the following conditions:

a) Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.

b) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).

c) It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d) It is required to file or furnish financial statements with the Securities and Exchange Commission.

e) It is controlled by an entity covered by criteria (a) through (d).

iii Accounting Standards Codification.

iv Generally Accepted Accounting Principles.

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Alternative Investment Industry Outlook for Q4 and Beyond

By Elana Margulies-Snyderman

Institutional investors and family offices alike are on track to continue allocating to various alternative asset classes for the remainder of this year into next despite their concerns, namely hedge funds not meeting performance expectations, high valuations for private equity funds, and cycle risk for real estate, amongst others. Yet these concurring allocations come on the heels of managers, particularly in the hedge fund space, lowering management fees and boosting incentive fees. Finally, with respect to new fund launches, EisnerAmper has heard that there is a growth in less liquid asset classes and credit strategies.

INVESTOR OUTLOOK

HEDGE FUNDS

Alternative investment data provider Preqin revealed that 69% of the 530 institutional investors surveyed are expected to make their next hedge fund investment this year and 16% will invest in 2019. Systematic commodity trading advisors appear to be the most popular, followed by macro strategies which offer downside protection in the event of a possible equity market correction.

Additionally, EisnerAmper has heard that family offices are paring down their long/short exposure in anticipation of a market correction in favor of other hedge fund strategies, especially emerging markets and Pan Asia, due to concerns about high pricing in developed markets.

ILLIQUID INVESTMENTS: PRIVATE EQUITY/ VENTURE CAPITAL/REAL ESTATE

Preqin revealed that over 86% of surveyed investors plan to increase their private equity investments this year, with more than half committing capital this year and a further 16% expected in early 2019. There is a strong preference toward small to mid-market buyout funds and venture capital.

EisnerAmper can confirm the growth in private equity investments.

“There has been a continued evolution to the conventional private equity mindset that has pushed the boundaries of the ‘typical’ investment in a fund,” said Elena Newman, partner in EisnerAmper’s Financial Services Group. “The private equity secondary market has grown rapidly and has become an active platform for investors to gain exposure to private equity in non-traditional ways.”

In addition, EisnerAmper has heard that family offices continue to eye private equity, venture capital and real estate, especially the increasingly popular qualified opportunity funds.

FEES

As especially the hedge fund industry has experienced the last few years, managers will continue to lower their management fees but increase their incentive fees, a trend EisnerAmper can confirm.

"We're seeing some lower management fees but higher incentive fees/allocations," said Jeff Parker, Partner in EisnerAmper's Financial Services Group. "Some funds are passing through expenses rather than management fees."

Earlier this year, Hedge Fund Research data confirmed that hedge fund management fees have fallen to a record low of 1.43% in the first quarter as managers seek to entice investors to invest amid sub-par performance.

LAUNCHES

EisnerAmper has seen a mix of new launches this quarter, ranging from hedge funds to more illiquid investments including private equity, venture capital and real estate.

In the New York City area, considered the epicentre of the alternative investment industry, EisnerAmper has seen a mix of these above-mentioned strategies. The West Coast has also seen a pick-up in new launches, both in the hedge fund space and private equity.

"We have seen a pick-up in new hedge fund launches, especially coming out of Southern California," said Eugene Tetlow, business development manager in EisnerAmper's financial services group in San Francisco. "Additionally, the firm has seen more private equity launches in and around Los Angeles."

Meanwhile, across the pond in Europe, Ray Kelly, partner in EisnerAmper Ireland's Financial Services Group, said the firm has seen an increase in the number of credit launches particularly in light of the continued challenges faced by the European banking system.

"Ireland was the first European jurisdiction to offer a regulated loan-origination fund product and we are seeing an increase in interest in this product," he said. "When one considers that in the United States, roughly 80% of credit comes from non-bank sources, whereas it is the reverse in Europe, the potential for growth in this area as the European market matures is significant."

CONCLUSION

As 2018 concludes and 2019 begins, alternative investment managers should be poised for inflows as both institutional investors and family offices are anticipated to allocate to various asset classes. And hedge fund managers especially are expected to keep their fees competitive to lure such allocators.

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Disruption: Fintech Companies and Lending Activities

By Michael Shuster

Traditional banks have always been the main source of lending for most consumers. In most cases, a borrower would proceed to a national bank to apply for a loan whether purchasing a new home, funding a business transaction or having other financial needs. These banks are highly regulated to ensure fair practices and overall compliance. While there were other lending institutions such as credit unions, private banks and hedge funds, consumers were comfortable with the larger, regulated traditional banks. However, beginning with the 2008/2009 financial crash, certain functions have started to shift to non-traditional sources. Over the last several years, there has been a technological boom and disruption to the banking and lending industry. For example, lending services that were traditionally provided by financial institutions are now also being delivered by fintech companies. These companies have taken an initiative to pursue innovative strategies to grow and expand their businesses. They are forcing traditional banks to adapt in order to remain relevant and competitive. Consumers desire convenience, accessibility, and ease of use and companies continue to develop, offer and enhance new financial products and services to meet the needs of their users. Customer preferences continue to evolve with the use of technology, and companies need to embrace this innovation to meet the demands of the changing landscape.

On July 31, 2018, the Office of the Comptroller of the Currency ("OCC") announced they will begin accepting applications from non-depository fintech companies engaged in lending activities. The federal government highly regulates and supervises each traditional institution, but fintech companies were regulated on a state-by-state basis. This charter would allow fintech firms to operate under a single federal license and compete with traditional banks. In order to be eligible for the special purpose national bank charter, the company needs to engage in one or more of the core banking functions of paying checks or lending money, but not offer depository accounts. Successful applicants will be required to comply with the rules and regulations that apply to all national banks and will be subject to the same high standards. In addition, they will be subject to ongoing oversight; and will be supervised similar to national banks including in areas such as capital, liquidity, and risk management; and will need to demonstrate a commitment to financial inclusion.

Applicants will be required to submit a business plan discussing their proposed business operations. They must also develop a contingency plan to address financial stress. During the application process, the OCC will consider whether the proposed bank has a reasonable chance of success, will be operating in a safe and sound manner, will provide fair access to financial services, will provide fair treatment to customers and will comply with applicable laws and regulations. Further, the OCC will determine whether the proposed bank can reasonably be expected to achieve and maintain profitability and foster healthy competition. The OCC will evaluate each submitted business plan and determine if the risk is acceptable and the charter should be approved. If approved, the OCC will continue to supervise and monitor the bank to ensure that they are executing their strategy and meeting their goals and objectives.

While the charter will provide opportunity to fintech companies, there are still challenges and concerns ahead. An approved fintech will not receive all of the benefits of a full-service bank, but will still need to comply with the rigorous oversight and regulation. There is also a risk that the charter will fail down the line as several organizations, including the Conference of State Bank Supervisors, are attempting to block the charter. In addition, consumer advocates are opposing the charter noting that it will expose new risks including failed fintech companies and predatory lenders. These parties want to protect consumers from being deceived or treated unfairly during the loan origination process and want to promote responsible lending practices. For these reasons, the charter has not been gaining as much traction as initially expected and the OCC has only received a handful of applications.

The federal charter is a unique opportunity for fintech companies, but it is not the only option available nor the perfect solution. Each company needs to evaluate their strategic goals and objectives to determine if this charter is the correct fit. Overall, the charter is encouraging and a step in the right direction attempting to create opportunity and growth to innovative companies in a changing environment.

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