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Fintech: A New M&A Frontier

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On September 26, the parent company of the Chicago Board Options Exchange announced the $3.2 billion acquisition of Bats Global Markets, a high-tech stock exchange founded 11 years ago. Of course, a multi-billion dollar merger transaction is little news to the New York legal market these days. Still, the CBOE-Bats deal is a timely reminder of the existence of a vibrant financial technology ("fintech") sector largely based in New York.

The fintech industry has gone through several waves of M&A activity over the last two decades. Internet-enabled consumer services, online banks, stock exchanges and trading platforms have all seen sector consolidation—and also fragmentation. These transactions have remade important components of the financial services sector. To put the Bats transaction in context, a global wave of stock exchange consolidation at the end of the last decade was partly due to a new wave of competitors—including Bats—coming into the market since 2000.

There is every reason to believe that the pending wave of fintech development and investment

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activity will, if anything, eclipse all prior M&A cycles in the sector. The technologies that propelled the first generations of fintech were complementary to the existing business models of financial institutions. The next generation, focusing on distributed ledger technologies and big data analytics, could entirely disrupt the financial services business. Indeed, the very nature of a "bank" could well be up for grabs.

The relationship between big data and financial institutions is fairly straightforward. Actually, "big data" itself is a bit of a misnomer; the data is already there. What is only beginning to emerge are technologies to observe and exploit trends and patterns that would be meaningless to human observation. As those technologies mature, significant elements of the financial services business—risk analytics, market making, investment allocations—will be remade in their entirety.

That disruption, however, pales in comparison to the potential changes to result from distributed ledger technology (DLT). DLT is still a foreign concept to most; the term refers to a dataset that is shared and constantly synchronized across multiple systems. Blockchain software, which underlies cryptocurrencies such as Bitcoin, is the most common DLT now in common use. However, DLT by its nature promises to supplant the most basic function of a bank: the storing of wealth and the recordation of its transfer. A robust development of DLT, combined with the expected deployment of ever more sophisticated big data systems, would upend the entire financial services sector.

New York in the Center

Technological innovation has long been a driver of economic growth and M&A activity, and both Silicon Valley and the venture capital community remain firmly entrenched. However, fintech is shaking up the tech world through a shift in geography toward New York and other financial centers and through an expansion of the players, including a vast range of financial institutions not historically known for innovation.

Fintech is shaking up the tech world through **a shift in geography toward New York** and other financial centers and through an **expansion of the players,** including a vast range of financial institutions not historically known for innovation.

New York has quickly become the place to be for fintech. The city sits at the intersection of finance and technology and offers entrepreneurs and innovators direct access to leading banks and other financial firms for collaboration and fundraising. According to a report published by Accenture Strategy and the Partnership Fund for New York City, New York surpassed Silicon Valley in fintech venture financing for the first time when $690 million in funding flowed into New York while $511 million went to Silicon Valley in the first quarter of 2016.

Innovations labs, accelerators and incubators have sprung up throughout the boroughs and seek to capitalize on the deep investor pool and access to leaders in the financial services industry. Barclays Rise and the Fintech Innovation Lab are just two examples. NYC fintech success stories abound. Betterment, an online investment manager that has been called "the Apple of finance," has raised more than $200 million to date. ConsenSys, operating out of a former industrial warehouse in Brooklyn, is churning out new use cases for DLT. The list goes on and on.

In New York, fintech deals are not just limited to venture capital and the ubiquitous tech behemoths. Instead, large financial institutions are major players and are committing billions of dollars on investment in fintech. Some of this investment is funneled into internal incubation units, but much of it is destined to M&A activity, be it in control transactions, consortium deals or minority stakes. We have seen that the vast New York financial community is quickly embracing technology as a way to spur profitability growth during what has been a challenging period of performance for the industry. As we have observed, this balancing of supply and demand has resulted in an ideal environment for M&A activity.

We expect the breadth of activity to widen going forward. For example, investment in the DLT is accelerating rapidly, and we expect significant activity in this sector going forward. A KPMG/CB Insights report from March 2016 showed that investment in Bitcoin and DLT rose from just $3 million in 2011 to $474 million in 2015. Major U.S. and non-U.S. banks are particularly interested in the potential of DLT to transform their businesses and are exploring the technology with immense interest. In September 2015, several of the world's largest banks—including J.P. Morgan, Barclays, Credit Suisse and UBS—partnered with start-up firm R3 to spur the creation of common platforms and protocols for using DLT in their businesses. More than 60 financial firms have now joined the R3 partnership.

Impact of Regulatory Landscape

Technologies like DLT and big data analytics have the potential to revolutionize the financial services industry, but regulatory issues make it challenging for startups to succeed independently. The United States has a particularly complex financial regulatory system with a web of regulators at both the federal and state levels. Looking at the banking sector alone, regulators include the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, the Department of the Treasury, and the Consumer Financial Protection Bureau. In addition, there are banking and financial regulators in each of the states. Similarly, the securities industry is regulated by the U.S. Securities and Exchange Commission, FINRA and state securities commissions, just to name a few. This has caused many fintech ventures to partner with deep-pocketed financial firms instead of competing with them head-on. Indeed, the KPMG/CB Insights report indicated that in New York in 2015, 83 percent of fintech funding went to ventures that collaborated with financial institutions, up from 37 percent in 2010.

To date, the fintech industry has for the most part escaped the heavy burden of regulation and oversight. However, financial regulators are certainly paying notice and are moving quickly to catch up with the industry. As an example, in March 2016 the OCC issued a white paper on its vision for innovation in fintech and the principles that it plans to use to guide the development of an appropriate regulatory framework. We expect that regulators will continue to probe the fintech industry, and ventures that do not pay heed to the potential regulatory implications of their businesses could run into trouble. This should lead to further consolidation within the fintech industry and partnering with established financial institutions. It will simply be too costly to go it alone.

These are exciting times for fintech. The big banks, insurance companies, investment management firms and other financial players are all watching developments in fintech intently—and investing their strategic capital accordingly. We expect that technological breakthroughs will likely continue to unleash a tidal wave of M&A activity.