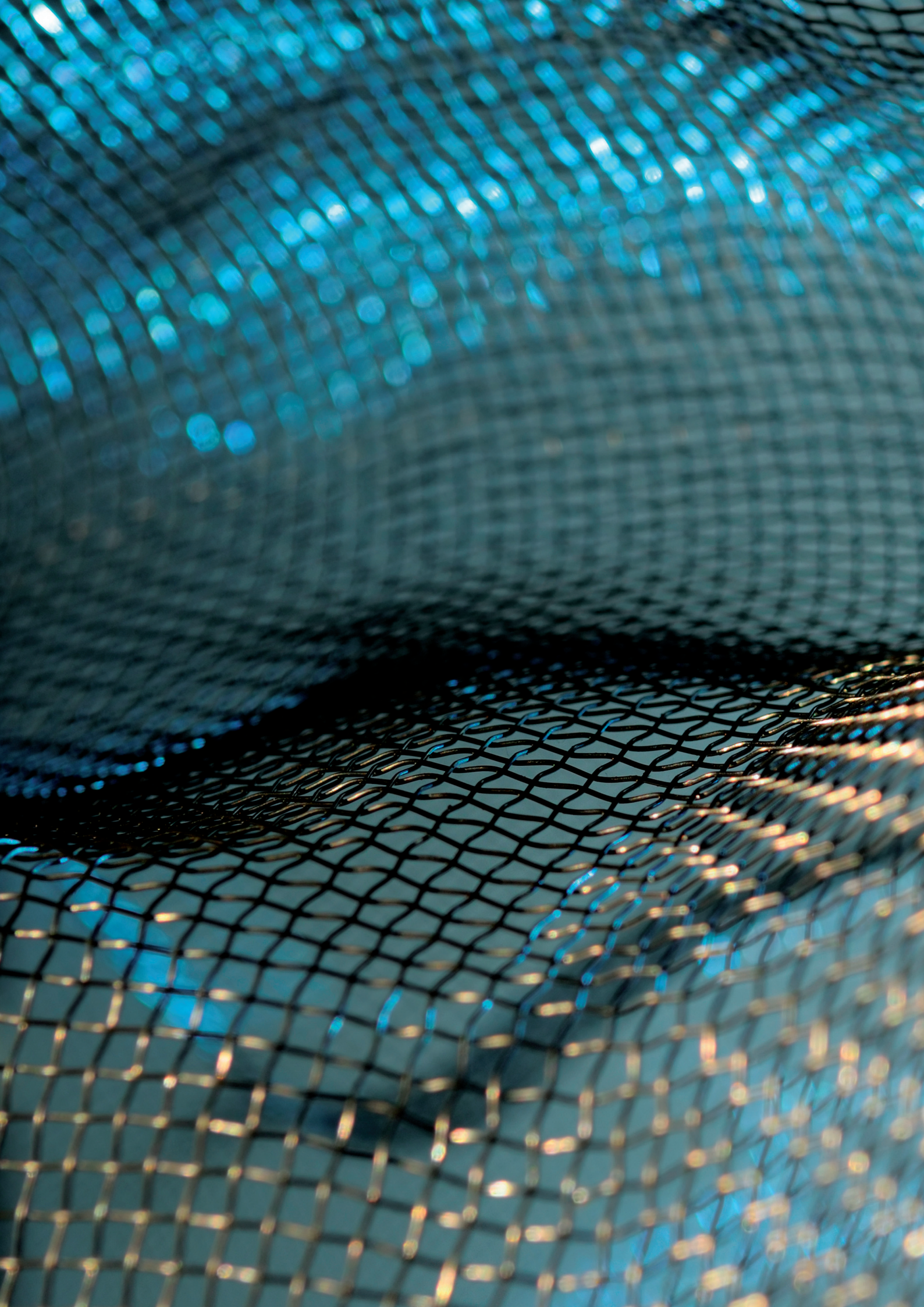


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Bitcoins, Smart Contracts and Payment Services – The Legal Framework for Fintech Companies



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Introduction

Many fintech companies have developed innovative business models in recent years with the aim of shaking up or enriching the banking and insurance sectors. As is the case with most start-ups, fintechs are young enterprises that focus on technical development of their product. Less attention is paid to the legal issues involved in successfully establishing the business model.

A comprehensive review of these issues is crucial at the financing stage and also fundamental to ensuring a fintech's long-term success. This brochure provides an overview of the most important legal issues that arise in association with founding and running fintech companies in Germany.

A. Banking Supervisory Law

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| 1. Is a regulatory license required in order to implement a fintech business model – e.g. due to providing banking transactions, financial services or payment services? | Typically, yes! A fintech company needs a license before it can provide financial services or payment services or can engage in banking transactions on a commercial basis. A license is also required in all cases where one of the more than 30 business activities defined in the German Banking Act or Payment Services Supervision Act is involved. |
| 2. When should the regulatory constraints on the business model be assessed? | The authorisation process takes time and money. It is important to be aware of this right from the start, because if a license is required the fintech will only be able to commence its business activity after obtaining the license. The regulatory environment also frequently dictates the contractual structure of the business model. Engaging with regulatory aspects at an early stage thus avoids wasted effort and additional costs. |
| 3. Do start-ups also need a license? | Start-ups don't get a free pass! Obtaining a license should therefore be an early priority in most cases (see above). |
| 4. Can I ask the German Federal Financial Supervisory Authority (BaFin) to review my business model to see if a license is required? | This service is available, but BaFin only reviews actual business models and will not assist in designing them. BaFin can also charge an administrative fee for any such review. Any request to BaFin should therefore be carefully considered, and proper preparation is essential. |
| 5. Do I also need a license if I am working in partnership with a bank or payment service provider? | In some circumstances, this kind of alliance may obviate the need for a license. Working with a bank or payment service provider is common practice, particularly at the early stage of a start-up. Fintech companies should be aware in such cases that the partner needs to be compatible – and will be looking to make money. Before entering into an alliance, the fintech should consider whether it wants a long-term relationship or just a temporary one. The fintech company then needs to take account of this in the legal structure of the alliance, particularly with regard to aspects that impact the fintech's customers. |
| 6. Can I try out my business model first and apply for a license at a later date? | No. If a business model calls for a license, this requirement applies from the moment the company commences its business activity. |

7. What will happen if I operate without the required license?

BaFin has the power to impose substantial fines and order the cessation and winding-up of the business if a fintech company engages in business activities that require a license without holding such a license. The fintech's management may also be liable to prosecution. A corresponding conviction generally excludes any future role as a director or partner in a company requiring a banking license, as the relevant individuals are considered to be not fit and proper.

8. What conditions need to be met when obtaining a license under banking law?

The conditions for obtaining a license can vary widely depending on the chosen business model and the associated statutory treatment. Evidence must always be provided of a certain amount of equity capital when carrying on an authorised activity. There are also organisational requirements (e.g. fit and proper managing director, anti-money laundering officer, compliance officer, putting internal control mechanisms in place). Supplementary insurance may also be required (e.g. after implementation of the PSD 2 directive).

A comprehensive application must also be submitted to BaFin. The fintech must describe the company and its business model and also demonstrate that the conditions required for issuing a license are met.

9. Can I avoid the requirement to obtain a license, e.g. by modifying the business model?

In some cases, a fintech can avoid the need for a license by modifying its business model. However, BaFin now explicitly regards many of the strategies used in the past as inadmissible. A careful assessment is therefore required. It is also important to analyse whether the modified business model will still work.

10. Can I invoke the "commercial agent" exemption when using a marketplace model?

The new Payment Services Directive (PSD 2) explicitly aims to make it more difficult for marketplace models to invoke the "commercial agent" exemption. These business models are not normally based on fintechs entering into and/or negotiating contracts, as required for the commercial agent exemption. Contracts are frequently automated in the case of marketplace models and entered into with no "real involvement" of the marketplace. As such, the marketplace is not a genuine commercial agent. BaFin has therefore taken a very restrictive stance on applicability of the commercial agent exemption in recent years, and also influenced European legislation accordingly. Nonetheless, there may be cases where the commercial agent exemption does apply. Careful scrutiny is necessary here.

11. What do I need to consider if I intend to operate across borders?

Any institution with a German license can operate either as a cross-border service provider or via a branch in another EU or EEA country. The structures required for these variants differ, but in both cases a notification process is involved. The supervisory authorities are well used to handling such notifications and the process generally works without any problems. It should be noted that commercial registration may be required when setting up a branch and obtaining this can sometimes prove difficult in practice. Foreign legal systems sometimes require documentation which is not known to German law (and vice versa).

Anyone who does not require a license in Germany due to an exemption is unable to invoke the same exemption in another country.

12. Can I apply to BaFin for an exemption?

An exemption may be approved if BaFin does not see any need for supervision. In such a case, BaFin can exempt a company from the need to obtain a license. However, this is extremely rare in practice. A distinction must be made between an exemption and negative clearance; BaFin uses the latter to certify that an activity is not subject to authorisation.

13. Can I test my business model without a license in a friends and family phase?

German law makes no provision for a friends and family phase without a license. The sole criterion is whether a commercial enterprise with a commercially organised business operation is involved. BaFin has defined when these conditions are met in a "test phase" with regard to a number of specific cases.

14. I know a competitor with the same business model who doesn't have a license. What does that mean for me?

Nothing. Just because a competitor may be breaking the law doesn't mean that you can too. It is also often difficult for outsiders to identify how a competitor's business is actually structured and whether a competitor might have found a way of avoiding the need for a license, and if so how they have done this.

15. Can I operate as a tied agent without having a license of my own?

It is possible to provide certain financial services as a tied agent, with a regulated institution taking liability. This activity is characterised by the fact that the tied agent operates exclusively on behalf and for account of the regulated institution and is thus subject to its instructions and dependent on its strategy, product range and market branding, as well as other conditions imposed by the institution. Tied agents are listed in a register kept by BaFin.

16. What do I need to be aware of with regard to bitcoins, barter clubs and other digital currencies?

Virtual currencies are digital representations of value that are not created by a central bank or public authority and also not linked to legal tender. Bitcoins and litecoins are examples of virtual currencies. They can be used as a means of exchange and can be transferred, stored and traded electronically.

Distinctions must be made depending on the mode of operation. First of all, there are virtual currencies that are created by a mathematical process within a computer network (mining), with all users having equal rights. There is no central entity that controls or manages the transactions or balances. BaFin categorises this type of virtual currency, which also includes bitcoins, as financial instruments pursuant to section 1 subsection 1 sentence 1 of the German Banking Act. No license is required merely to use these virtual currencies or for mining or for the selling of virtual currencies that the user has mined or acquired. However, if certain circumstances arise when using these virtual currencies commercially, a requirement to obtain a license may be triggered.

The situation is different with regard to virtual currencies issued by a central authority. This central authority will generally be operating an e-money business pursuant to section 1a of the German Payment Services Supervisory Act (ZAG).

17. Do the requirements of the German Anti-Money Laundering Act (GwG) also apply to fintech companies?

Yes. There are no special rules in place for fintech companies. The requirements of the GwG apply equally to fintech companies and are dependent on the services that a fintech provides to its customers. Credit institutions, financial services providers and payment institutions are generally under an obligation to identify their customers. This also applies to fintech companies providing services in this arena. These requirements still apply when working with a cooperation partner. In certain cases, however, the cooperation partner may assume responsibility for these requirements on behalf of the fintech.

Additional organisational obligations aimed at preventing money laundering and funding terrorism which may affect fintech companies are included in the Fourth EU Anti-Money Laundering Directive, which must be implemented into national German law by mid-2017.

B. Data protection

1. Why do data protection and data security play such an important role for fintechs?

Account details and financial data provide deep insights into people's financial situation and social contacts. Apart from involving the risk of administrative fines, data leaks and data protection breaches can also cause lasting damage to a fintech's reputation due to the associated media exposure. It is almost impossible to overcome the resulting loss of customer confidence after the event. Fintech companies thus need to strive for high standards of IT security and compliance with data protection laws.

2. When does (German) data protection law apply to fintech companies?

Data protection law is applicable whenever personal data is collected, processed or stored, i.e. these provisions apply if data can be linked to an individual. However, the supervisory authorities in particular take a very broad view of what constitutes personal data. IP addresses, cookies, mobile identifiers and hash values can all be considered personal data. Data protection law thus generally applies to fintech companies in the B2C sector that process financial, account-related or transaction data for their customers or track user behaviour on a website or in an app. It is not possible to rule out personal data being involved in the B2B domain either, since in all cases individuals act for the companies concerned.

3. Is financial data subject to special rules on confidentiality under data protection law?

Financial data does not represent a "special category" of data that is subject to stricter regulations. There are therefore only a few isolated instances of special rules on financial data and its confidentiality in data protection law. Particularly relevant is the duty to notify the supervisory authorities and data subjects without delay if third parties unlawfully obtain knowledge of personal data related to bank or credit card accounts with the threat of serious harm to the data subjects' rights or legitimate interests.

4. What needs to be considered when carrying out credit checks?

As a result of the prohibition enshrined in German data protection law, (statutory) authority is required if data is transferred to a credit agency (e.g. Schufa or Creditreform) in order to carry out a credit check. As such, any data transfer for this purpose without the consent of the data subject is not allowed. Transfer is permitted by way of exception if the company transferring the data has a particular interest in transferring this data which outweighs the interests of the data subject. This type of interest includes inter alia cases where a fintech company needs to make a decision on granting credit.

5. Which data protection law applies to international business models?

International business models regularly involve data being exchanged between the relevant parties across borders. Personal data is often exchanged or collected by companies that operate in, or have branches in, different countries. For each data processing operation it is necessary to consider which national data protection law applies, because data protection law is not harmonised either globally or across Europe. It is important to note here that the applicable data protection law cannot be determined through choice of law by the actors involved.

This will change at European level in future due to the General Data Protection Regulation (GDPR).

6. When does the GDPR take effect?

The GDPR will become directly applicable in the EU Member States with effect from 25 May 2018. It stipulates heavy fines of up to EUR 20 million or 4% of annual turnover in an attempt to enforce data protection law more rigorously than has previously been the case. The Regulation supersedes conflicting national provisions of the Federal German Data Protection Act (BDSG), but does give Member States some leeway for divergent regulations through various escape clauses. The GDPR introduces far-reaching changes and reforms to data protection and is aimed in particular at significantly reinforcing the rights of data subjects.

C. E-commerce/Competition law

1. What needs to be taken into account when choosing a company name and domain for a fintech?

There are limits on the scope for originality here, particularly under trademark law. Company names and domains must be chosen such that they do not infringe third-party rights, particularly trademarks or rights to a name.

2. What is the minimum amount of information that must be provided on the website?

The duty to provide certain legal information also applies to fintechs: this information must be easily discernible, directly accessible and permanently available on all websites that serve a commercial purpose. This information includes inter alia the company name complete with the legal form, the name of an authorised representative of the company, the postal address, e-mail address, telephone number, commercial register details and VAT identification number. The relevant information must be accessible from every page of the website without any significant intermediate steps being required, e.g. via a link labelled "Legal notice" or "Provider ID".

Since a platform is also generally offered via the website, T&Cs and a data protection policy should also be provided.

3. What do fintech companies need to consider when drafting their T&Cs?

In addition to general principles such as compliance with transparency requirements, clear and understandable wording and a ban on surprising provisions, there are also some special features for fintech companies with respect to drafting their T&Cs. Depending on the actual structure of the business model, these include the civil law provisions of payment services legislation (sections 675a et seq. of the German Civil Code (BGB)) and contractual constructions that are required under supervisory law.

Caution is urged against creating T&Cs by simply copying and pasting text from other providers, since T&Cs must always match the specific business model. Also, T&Cs may enjoy copyright protection as literary works, meaning that simply copying them without permission could represent a breach of copyright and incur corresponding penalties.

4. What is important with regard to the language in which the T&Cs are provided?

Although everyday English is widespread in Germany, legal, contract and commercial English are not. It may therefore be regarded as unacceptable to provide German consumers with T&Cs exclusively in English, with the result that none of the clauses would count as transparent and would therefore be void. Providing the T&Cs in both German and English is advisable in order to avoid this problem while still reaching as many customers as possible. It should be made clear that only one language version is definitive, however, with the German version being the most appropriate option.

5. What differences between B2C and B2B business models need to be considered?

Business models that are (also) aimed at consumers must take numerous special aspects of consumer protection law into account. These include inter alia far-reaching duties to provide information. The options for structuring T&Cs are limited in the B2C arena due to the greater protection afforded to consumers.

In the B2B domain, on the other hand, there is more freedom because business customers require less protection due to their experience of the commercial world.

6. Are there any special features that apply to fintech companies with regard to the right to cancel?

Yes. Because the contract is generally entered into over the Internet, via an app or by e-mail, the rules on distance selling apply, meaning that consumers have a statutory right to cancel. There may also be special features that apply to contracts for financial services.

7. Are there any special statutory requirements in connection with advertisements for financial products?

In some specific cases, yes. The Securities Trading Act (WpHG) and the EU Market Abuse Regulation must be observed when advertising certain financial instruments or issuers of financial instruments, e.g. the associated marketing communications must be clearly identified as such pursuant to section 34b of the Securities Trading Act.

However, this only affects very specific fintech companies, i.e. those that provide investment recommendations or financial analysis (thus the previous legal term), which must in particular meet a range of minimum quality requirements and are subject to special identification requirements.

8. What is the situation with regard to e-mail marketing?

Sending marketing material by e-mail is especially popular on account of the low costs involved and the ability to measure and manage activity. However, care should be taken to avoid breaches of competition law and to ensure compliance with the principles of data protection law. The prior express consent of the addressee is required by way of a double-opt-in procedure. This applies equally to consumers and business customers.

If no such prior permission is obtained, e-mail marketing is only possible within narrowly defined limits as part of an existing customer relationship.

9. What are the consequences of any breaches of statutory regulations?

Competitors in particular tend to scrutinize new offerings very closely. If such offerings are freely accessible online by anyone, it is possible to review various legal aspects of their structure without undue effort and challenge them accordingly. Breaches of consumer protection law and competition law, as discussed above, are particularly relevant, as are potential infringements of copyrights and trademarks.

These types of infringements normally attract a cease-and-desist warning initially. The competitor will demand a corresponding undertaking, subject to a penalty for non-compliance. If the fintech fails to comply, court proceedings may follow. The demand to desist may also be enforced by way of an interim injunction.

But that is not the end of the matter – there may be claims for compensation and demands for information as well. It should also be noted that in some cases consumer groups or other bodies issue cease-and-desist warnings or take court action in response to infringements of the law. Penalties can also be imposed by the relevant supervisory authorities, e.g. BaFin, or by the relevant data protection authority in the event of breaches of data protection law.

D. IT/IP

1. What legal status does a blockchain have?

A blockchain can be regarded as a digital bank statement for communication between computers that is saved in different databases without being managed centrally. These databases can be used anonymously if required. Public blockchains can be viewed by anyone at any time, thereby enabling verification of payment transactions and other actions with legal effect. A transaction (for instance the transfer of digital goods) is only written to the blocks of a blockchain (i.e. validated) when it has been established that the sender was entitled to carry out the specific transaction. This condition is checked by the computers participating in the P2P network (the nodes).

Building on this kind of system, it is possible to make execution of a transaction dependent on the occurrence of various conditions. The resulting structures are known as smart contracts.

2. What is the legal relevance of smart contracts?

Smart contracts are not typically contracts in the legal sense, being more like a vending machine in terms of function. Using software instead of a traditional contract means that performance is governed and determined by the underlying programme code. This includes replicating the conditions that must be met. The exchange is fully automated and takes place when the conditions laid down in the programme code are met. This reduces transaction costs because execution of the contract does not require human involvement. Despite the fact that the phrase "code is law" is widely used when discussing smart contracts, such contracts are still subject to the law of the land in the same way as standard contracts. Nor do smart contracts provide any additional freedom or structuring options as compared with those permissible under existing laws.

There are many possible uses in the fintech arena. With stock exchange trading in particular, smart contracts could enable fintech companies to trade without using intermediaries such as banks or brokers.

3. Can individual fintech business models be given special protection?	The development of innovative software and technologies by fintech companies is driving the rapid expansion of this sector. In order to succeed, however, these innovations need to be protected in law. It is important to note here that the protection available varies from jurisdiction to jurisdiction. While fintech business models were initially regarded as patentable in the US, this has now been cast into doubt by recent court rulings. These business models are not patentable per se in Europe, with the exception of cases where their purpose is “to solve a technical problem”.
4. What needs to be considered when using existing proprietary software and open-source software?	Existing proprietary software may only be used with the consent of the owner of the corresponding rights. In the case of open-source software, the terms and conditions of the relevant licence must be observed. Some open-source licences stipulate that the associated software may not be used for proprietary purposes.
5. What issues are there around placing work with programmers?	Programmers should be advised that they must not breach any third-party rights when programming and may only use open-source software that does not prohibit proprietary use of the work results.
6. Why do IP clauses and non-disclosure clauses play an important role in contracts with employees and service providers?	IP and knowledge are important assets. Carefully drafted non-disclosure agreements (NDAs) can minimise the risk of knowledge being shared without authorisation. IP clauses can strengthen the company’s position by including an agreement that the company should be entitled to work results in their entirety. Careful drafting of such clauses is important because both copyright law and employee invention law impose certain limits in this regard. If these limits are not taken into account in the contract, the fintech runs the risk of the provisions being ineffective.
7. What needs to be considered when uploading content and linking to other websites?	All uploaded content must comply with legal requirements. That means it cannot be copied from third parties without their consent, for instance. Linked content must also comply with the law, since according to the latest ruling by the ECJ there is an assumption that a person who links content in pursuit of financial gain is aware of any unlawful aspects of such content.
8. What do fintech companies need to be aware of in terms of IT security?	Fintech companies may face hazards such as hacking attacks, software manipulation, loss of data and stolen user identities. As such, some fintechs may need to meet minimum requirements with regard to their technical and organisational arrangements which guarantee that IT systems and associated IT processes ensure the availability, authenticity and confidentiality of data.

E. Tax

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| 1. Are there any special VAT issues when it comes to services provided by fintech companies? | Yes. Many fintech companies provide standard services that are subject to VAT and must be treated in the same way for VAT purposes as other e-commerce services. Given the proximity of the fintech sector to financial services, some services may be exempt from VAT, though, depending on the specific business model (e.g. brokerage services for certain bank and insurance products). Each specific business model and each service must therefore be assessed individually to establish whether it is subject to VAT or exempt. |
| 2. Aren't all services provided by fintech companies in connection with banking or insurance products exempt from VAT? | No. Services provided by fintech companies are only exempt from VAT if they relate to certain typical banking or insurance products and/or services or the fintech acts as an intermediary in this regard (e.g. credit or securities transactions, as well as payment transactions, and acting as an intermediary in such cases). Services that merely consist of technical support (e.g. providing IT services not related to transactions) are not generally covered by the VAT exemption for banking transactions. The boundary can be difficult to draw, particularly in the case of alliances between fintechs and banks, financial services providers or payment service providers. |
| 3. Isn't it irrelevant whether a fintech company also provides VAT-exempt services, provided that it at least charges and pays VAT "voluntarily" on all its services? | Absolutely not! If VAT-exempt services are provided (perhaps unknowingly), a fintech company cannot reclaim in whole or in part the VAT incurred on services supplied by third parties (e.g. services provided by an external programmer) as input tax. This can result in a significant cost burden. Customers can also subsequently demand repayment of VAT wrongfully paid to the fintech. It should also be noted that many office leases contain an obligation on the tenant only to provide services subject to VAT. If the tenant (e.g. a fintech company) breaches this provision, this may lead to a claim for compensation. It is therefore vital to establish upfront how the services provided by the fintech should be treated for VAT purposes. |
| 4. Does it make any difference whether services are provided in the B2B or B2C domain? | Yes. Particularly with customers in other countries, there is a fundamental difference between the VAT treatment of services for business customers and of services provided to private individuals. If a fintech company operates in both segments and has customers in other countries, it must put separate routines and processes in place for the two customer groups to ensure proper recording of VAT. |



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