Digital Disruption in Financial Services: FinTech

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By Bob Hayward | Principal, Management Consulting | KPMG Asia / Pacific
Digital Disruption: The Music Industry

What is Meant by ‘Digital Disruption’?

The music industry is a perfect example of continuous digital disruption going back 40 years:

- **1970s**: Vinyl LP
- **1980s**: Cassette
- **1990s**: Compact Disc
- **2002-2013**: ITUNES
- **2013+**: Spotify

Each disruption completely altered revenue flows, creating new winners and leaving behind those who could not adapt fast enough.

The disruptions shown are for LEGAL music sales. Starting with Napster in 1999, then Limewire/Kazaa and now BitTorrent P2P, illegal downloads have had a far bigger impact on the Music industry.

Citi research:

After first signs of digital disruption
- 1.6% pa shift in market share from incumbents to ‘born digital’
- Accelerates to 6% pa after year 4

After 10 years:
- a 44% shift in market share
- 30% average reduction in profits to incumbents
- Top 3 incumbent market share of 45% to Top 3 mixed share of 80%

Vinyl sales only category of physical music sales growing

Starting with Napster in 1999, then Limewire/Kazaa and now BitTorrent P2P, illegal downloads have had a far bigger impact on the Music industry.
Many Industries Have Already Been ‘Digitally Disrupted’

The world’s largest taxi company that owns no taxis?
The world’s largest accommodation provider that owns no rooms?
Two of the largest phone companies that own no Telco infrastructure?
The world’s most valuable retailer that has no inventory and owns no stores?
Two of the world’s most popular media firms that create no content?
The world’s largest movie house that owns no cinemas?
Two of the world’s largest software companies that do not write applications?
The largest providers of computer infrastructure that do not make servers?

>US$10b revenue, >US$250b payments, Market value greater than all listed Banks in Germany
330% larger than PayPal, 96% of online payments in China do not involve a Bank
Multiple Trends and Forces are Driving the Digital Disruption of Financial Services

Disintermediation          Blockchain/DLT          Digital Bank
Intermediation (Infomediary, Price Comparison)
Servitization               Rich Customer Experience
Gamification                Crowdsourcing & Crowdfunding
Peer To Peer (P2P)
eCommerce use data to move into adjacent FS
D2C Direct to Consumer

FinTech Models
Open Innovation (API economy)
Dynamic Pricing
Predictive analytics
Knowledge/Expert Automation (‘Robo-’)
Serving the Underserved
Financial Inclusion
Using IoT to offer Personalized Services
Cognitive/MI

The Financial Services sector is at an inflection point, spurred by dramatic changes in technology, social demands, economics, and regulation

Declining costs of technology
Availability of funding, low barriers to entry
Fast-paced technology innovations
Ubiquitous broadband and data
Evolving consumer behaviour and preferences
Gaps in market through regulatory constraints
Globally competitive markets
Erosion of Trust in Institutions post GFC
Attractive profit pools
Digital Disruption in Financial Services: FinTech Models applied across FS

Existing financial services firms, as well as corporates in areas such as software, internet, telecommunications or retail can exploit FinTech just as readily as Startups.
### A Taxonomy for FinTech: Categories of FinTech Innovation

<table>
<thead>
<tr>
<th>Marketplace Lending</th>
<th>Payments &amp; Billing</th>
<th>Wealth Tech</th>
<th>Insurance Tech</th>
<th>Institutional Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Peer to Peer (P2P) lending</td>
<td>— Mobile payments &amp; billing</td>
<td>— Robo-advice &amp; retail investments</td>
<td>— Underwriting</td>
<td>— Tools for banks, hedge</td>
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<td>— Crowdfunding</td>
<td>— Merchant acquiring</td>
<td>— Investment research</td>
<td>— Wearables</td>
<td>funds, mutual funds and</td>
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<tr>
<td>— Alternative lending</td>
<td>— Payments Service Providers</td>
<td>— Personal financial management &amp; planning</td>
<td>— Telematics</td>
<td>other institutional</td>
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<td>— Invoice trading</td>
<td>— APIs</td>
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<td>investors.</td>
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<td>and analysis</td>
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<thead>
<tr>
<th>Bank in a Box</th>
<th>Financial Inclusion</th>
<th>Security &amp; Biometrics</th>
<th>Blockchains &amp; DLTs</th>
<th>Regulatory Tech</th>
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<tr>
<td>— Online lending</td>
<td>— Account opening</td>
<td>— Cyber-security</td>
<td>— Distributed ledger</td>
<td>— Automate compliance,</td>
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<tr>
<td>— Credit analytics</td>
<td>— Under-banked/insured</td>
<td>— Biometric authentication</td>
<td>— Crypto-currencies</td>
<td>including AML/KYC/CFT</td>
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<td>— Back office efficiencies</td>
<td>— Remittances</td>
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<td>— Cross-border payments</td>
<td>— Reduce operational</td>
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<td>— Challenger Banks</td>
<td>— Micro-Finance</td>
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<td>— Smart contracts</td>
<td>risks through monitoring</td>
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<td>— Neobanks</td>
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<td>— Settlements, trades</td>
<td>and alerts</td>
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### FinTech Startups are focused on niche FS service areas, as broad FS services are ‘unbundled’ and attractive profit pools come under sustained attack. McKinsey report: 60% of 2015 global bank retail profits of US $650B at risk next 10 years

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Global FinTech Startup Trends

- Global VC investment: 200% CAGR 2011-2015
- Over 700 FinTech VC deals in 2015
- Every part of the world involved
- Asia/Pacific: US$4.5b VC in FinTech in 2015, 400% increase from 2014
- Existing Banks have placed over US$5b in FinTech VC funds
- Over 20 ‘Unicorns’ in FinTech
- Leading locations:
  - London
  - New York
  - Silicon Valley
  - Nordics/Netherlands
  - Israel
- In Asia/Pacific:
  - Guangdong/Beijing/Shanghai
  - Sydney
  - Singapore
  - Hong Kong

Global FinTech Industry
15,000+ start-ups
Investments in FinTech in 2015: US$14 billion

- Personal finance planning & management
- Retail investments/robo-advisor
- Payments
- Institutional investments
- Remittances
- Marketplace Lending
- Digital Disruption in Financial Services: FinTech
Marketplace Lending in Asia-Pacific

Digital Disruption in Financial Services: FinTech

Total Marketplace Lending Volume per Capita vs GDP per Capita (2015, US$)

Why is Blockchain Considered so Potentially Disruptive?

The blockchain paradigm of decentralization is orthogonal to traditional banking as it introduces a near-real time distributed ledger with an almost instantaneous, cryptography based consensus between the counterparties.

**Transfers – Today**

The current traditional ledger structure relies on third custody parties owning transfer of an asset to handle counter-party risk:
- Legacy infrastructure
- Slow clearing and settlement T+n
- Manually intensive
- Prone to errors

**Transfers – with Blockchains**

The transfer of the asset ownership is carried out by the blockchain network:
- Shared infrastructure is transparent to all
- Decentralized ledger
- Automated processing
- Cryptographically secured
## Blockchain Use Cases To Consider in Financial Services

Blockchain/DLT technology has the potential to enhance Financial Services processes throughout consumer and institutional applications.

### Cryptocurrencies
- **Cryptocurrency** is expanding globally due to the benefits such as enhanced security as opposed to credit cards, more transparency in regards to its value and international use.

### Mortgages
- Financial institutions will have the ability to organize all relevant documentation to a specific mortgage into the “chain” assisting banks in avoiding fines and streamlining mortgage related processes.

### Collateral Management
- Utilizing blockchain technology collateral requirements would decrease and collateral could be moved around the system faster to meet new regulatory rules imposed after the financial crisis.

### Settlement and Clearing
- On the blockchain, the entire lifecycle of a trade – including its execution, clearing and settlement – can occur at trade level, lowering post-trade latency and reducing counterparty exposures.

### Regulatory Reporting
- The blockchain is fundamentally a record of transaction history, delivering a fully transparent, accessible transactional database for governing bodies.

### Consumer Payment System
- Consumers will be able to feel more confident and secure making payments over electronic mediums.

### Know-Your-Customer
- Customer identity can be stored on the blockchain, ensuring secure and rapid ID authentication without the warehousing of sensitive data at third-party repositories.

### Trade Surveillance
- Blockchain can enhance a firm’s ability to monitor trade activity across various asset classes and throughout the lifecycle of the trade.

### Smart Contracts
- Blockchain allows the use of smart contracts which will significantly increase the efficiency of various markets.

### Exchanges
- Blockchain has the potential to simplify the process of tracking ownership and accelerating the transfer of assets.

### Reconciliation
- Manual reconciliation becomes redundant as a result of blockchain technology.

### Trade Finance
- Enhance trade finance by speeding up banking transactions, while cutting costs and boosting transparency.

### Institutional Payments
- Blockchain’s application for frictionless P2P & overseas transactions has the potential to reduce risk, transaction costs and to improve speed, efficiency and transparency.

### Digital Identities
- Blockchain technology can enhance the security of digital identities.

### Consumer Payment System
- Consumers will be able to feel more confident and secure making payments over electronic mediums.

### Privately Held Shares
- Blockchain allows for the automation of tracking private shares.

### Cross Currency Payments
- Blockchain allows counterparties seamlessly track ownership of cross currency transactions.

### Insurance
- Records can be stored in a decentralized manner reducing friction and costs throughout organizations.

### Reconciliation
- Manual reconciliation becomes redundant as a result of blockchain technology.

### Syndicated Loans
- Reduce back office processing time and expenses of syndicated loan transactions.

### Digital Disruption in Financial Services: FinTech

Blockchain/DLT technology has the potential to enhance Financial Services processes throughout consumer and institutional applications.
How are Incumbent Banks Responding?

They are becoming ‘Digital Banks’……

— A completely new entity operating primarily through online channels (a Neobank)?
— Or resetting the existing Bank brand to one that is renowned for performing continuous technology-based innovation?
— Or both of the above?

A ‘Digital’ Bank continuously excels through the use of the very latest technologies such as:

Mobile, Cloud, IoT/IoE, Smart Machines/Cognitive Computing, Analytics, Blockchains/DLTs, Social Media and more

<table>
<thead>
<tr>
<th>Customer engagement</th>
<th>Straight through processing/automation</th>
<th>Agility, Speed, Efficiency</th>
<th>Data &amp; Decisions</th>
<th>New Types of Services</th>
</tr>
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<tbody>
<tr>
<td>All possible customer touchpoints can be made online through mobile devices with a rich, intuitive and engaging interface that is highly personalized and delivers services in context to situation and location.</td>
<td>Market-leading reductions in the time taken by various core banking processes through automation (e.g. new account opening from days/hours to minutes).</td>
<td>Uses technology to keep pace with market and consumer velocity, such as the introduction of new features, marketing campaigns, and even entirely new services in dramatically less time than peers.</td>
<td>Embeds sophisticated analytics into all aspects of the business to deliver quotes, approvals, advice and highly personalized services that deliver value to the customer in context and sometimes in predictive modes (know who you are, what you want, where you are, what you are about to need, etc.).</td>
<td>A digital bank will also adopt a digital operating model to provide a range of newer types of financial product, such as innovative mobile payments, marketplace lending, peer-to-peer offerings, micro-credit, robo-advisor options, Blockchain-based money transfers and many more, often with new types of partnerships.</td>
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Incumbent FS Firms are Building Innovation Eco-Systems

**Build**

- **Capability**
  - Build & protect innovation capabilities

**Procure**

- **Procurement**
  - Accessing a broader range of external partners/providers

**Partner**

- **Business Model**
  - New products and business model opportunities

**Sell to/through**

- **Alliance**
  - Selling to or through tech-based or disruptive companies

**Acquire/Invest**

- **Venturing**
  - Equity stakes in high growth businesses and acquisitions

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**1. Innovate rapidly and deliberately**

- Experiment, pilot, and early rapid revision (‘Lean’ concepts).
- Create open APIs and use external APIs
- Ask staff to mentor startups, participate in ideations
- Protect innovation teams from the rest of the firm

**2. Adopt a Portfolio Approach**

- Vary innovation types
- Match pace to business needs
- Nurture best bets
- Be prepared for failures

**3. Co-ordinate new growth**

- Cash flow from mature business to invest in new growth
- Build alternative teams tasked with putting your own firm out of business (the ‘Kodak moment’)

**4. Analyze growth non-traditionally**

- Develop new methods of analyzing business opportunities
- Prepared to cannibalize revenue streams
- A generational paradigm shift, not granular project based business cases

**5. Right people with the right technologies**

- Focus responsibilities with small and nimble teams
- Experiment with and learn from emerging technologies
- Put your best people into innovation teams
- Embrace SMAC

**6. Encourage intersections**

- Exchange talent throughout the organization
- Engage outside innovators
- Get involved with incubators, accelerators
- Host developer days for local startups and entrepreneurs

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### Digital Disruption in Financial Services: FinTech

**What does FinTech mean for Consumers?**

<table>
<thead>
<tr>
<th>Category</th>
<th>Details</th>
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</thead>
</table>
| An explosion of new services and new providers     | - Large numbers of new services in areas such as payments (eCommerce, mobile devices, NFC, messaging apps), micro-finance, alternative loans, personal credit, remittances, investment management, finance advice, aggregated comparisons, pay-as-you-need insurance and many more.  
  - Many new service providers from niche payments through to comprehensive online banks, including new brands from incumbent providers. |
| Potential large savings versus traditional offerings | - Already, it is estimated global consumers have saved US$60b through increased competition in Financial Services enabled by digital innovations since 2010.  
  - More convenience, more productivity, more financial inclusion, less cost, more options. |
| New types of investment opportunities               | - Especially with P2P platforms and Crowd-funding services.  
  - Rise of Robo-Advisors |
| Even more confusion                                 | - Financial Services were already complex, daunting and intimidating to many.  
  - FinTech adds to the challenges of consumer education and protection. |
| Need help with education and assessment of risks    | - Weak appreciation for protections and risks associated with many new FinTech offerings and providers.  
  - Chinese problems with >4,000 P2P providers, many of which are nothing more than Ponzi schemes (leading to ‘boss run away’ phenomenon) is salient lesson.  
  - Prior focus on ‘sophisticated’ versus ‘non-sophisticated’ investors is being challenged  
  - Nothing to stop novice investor putting US$500 into equity of a new startup (like a VC) or helping to fund a small business (like a Bank) without any understanding of risks |
What does FinTech mean for Regulators?

Most regulators are supportive, but have not formally finalized rules for FinTech or Blockchain.

**US Securities Exchange Commission**

The SEC has reportedly approved Overstock’s plans to issue stock via the blockchain through its subsidiary platform. According to Wired, the company was granted an amended Form S-3—a requirement solely for companies that report under the Securities Exchange Act of 1934—meaning that it could now issue public securities leveraging blockchain technology.

**New York Reveals BitLicense Framework for Bitcoin Businesses**

The New York Department of Financial Services (NYDFS) has released its long-anticipated list of proposed rules and regulations that will be required for New York-based bitcoin businesses.

**Blockchain is ‘no panacea’, says UK regulator**

Blockchain, the technology behind the bitcoin virtual currency that is now widely touted as a transformational technology for the financial services industry, may not be “the panacea of all ills” in the sector, according to the UK’s industry regulator, which says that it has “yet to take a stance until its application is clearer”.

**I don’t know who to even call,” said Charlie Cooper, managing director at R3 CEV**

To illustrate the challenges, Cooper pointed to the question of “settlement finality” in financial transactions, and how agencies differ in terms of how they define the concept. For example, both the Securities Exchange Commission and Commodity Futures Trading Commission have different rules on what constitutes final settlement of transactions.

**CFTC Ruling Defines Bitcoin and Digital Currencies as Commodities**

The US Commodity Futures Trading Commission (CFTC) has issued its first action against an unregistered bitcoin options trading platform, ordering the startup to cease operations and simultaneously settling the case.
## Digital Disruption in Financial Services: FinTech

### Financial Services Regulatory Positions (1/2)

<table>
<thead>
<tr>
<th>Encourage innovation while protecting consumers and the integrity of the FS system</th>
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</thead>
<tbody>
<tr>
<td>FCA in UK, a digital sandbox free of most regulatory reprisals and constraints</td>
</tr>
<tr>
<td>PSD2 in Europe to open up banking systems through APIs</td>
</tr>
<tr>
<td>Fast-track approvals to firms offering niche and innovative FS service (‘light’ licenses, payments banks, small finance banks…)</td>
</tr>
<tr>
<td>Scans to ensure regulations are not unnecessarily impeding emerging technology</td>
</tr>
<tr>
<td>Ensure regulatory neutrality: Avoid decisions that favor one part of the FS eco-system over another (it could be argued China has favored new over old)</td>
</tr>
<tr>
<td>Provide clarity over regulations, avoiding ambiguity</td>
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<tr>
<td>Try to accommodate new approaches within existing frameworks, avoiding overly prescriptive rules</td>
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<tr>
<td>Regulations should not front-run innovation, needs to be alongside and quickly determine if innovation is something to promote, or something to restrain (‘materiality test’)</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>Consider social obligations</th>
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<tbody>
<tr>
<td>Digital disruption should NOT result in the exclusion, marginalization or higher fees for less technical-savvy consumers, vulnerable citizens or people who face cost/location challenges to access digital channels. But this will be very hard to ensure.</td>
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<tr>
<th>Keep focus on larger goals</th>
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<tbody>
<tr>
<td>Economic growth and prosperity in a competitive world</td>
</tr>
<tr>
<td>Poverty reduction and increased financial inclusion</td>
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<tr>
<td>The relevance and competitiveness of local FS sector (avoiding tech obsolescence)</td>
</tr>
<tr>
<td>Real cost savings for consumers through digital innovation</td>
</tr>
</tbody>
</table>
Digital Disruption in Financial Services: FinTech

Financial Services Regulatory Positions (2/2)

Adopt cultural change just as the FS sector is doing

- Be informal, approachable, consultative, flexible and collaborative
- Engage with all the participants in the FS ecosystem, including Startups, Incubators, Accelerators, Investors, eCommerce Providers, Messaging App Providers, Incumbent Firms, Device Manufacturers, Software Providers, Social Media Providers, etc.

Encourage certain FS technology innovations at early stages, especially APIs, Blockchains/DLTs and Regulatory Tech

- Use Government purchasing power to understand, encourage and use FinTech
- Encourage, promote and enable cross-industry inter-operability and new payers of common industry standards or API layers on top of which everyone can innovate (e.g. payments, merchant terminals, KYC utility, digital identity, authentication, consent, etc.)
- Ultimately, the role of FS regulators (and Auditors!) may be considerably reduced in a self-policing, transparent, social-sharing, blockchain/DLT-using FS world
- Potential for this technology to reduce risk in FS (e.g. counterparty risk, distributed ledger more secure then centralized)

Learn from other regulators globally, this is a fast-moving space

- US regulators of Bitcoin focus on ‘chokepoints’, the on- and off-ramps such as exchanges, digital wallets, merchant payment systems rather than try to regulate the blockchain itself
- Some countries experimenting with BitLicense to authorize businesses using public encryption for virtual currencies
- China and India are moving very fast into new territory – e.g. J-A-M (Jan Dhan Yojana for financial inclusion, Aadhaar as biometric digital identity and Mobile)
- Apply modular, customized regulations as FinTech is broken down into categories and materiality test is applied
The Race to be the Future of Financial Services

Digital Disruption in Financial Services: FinTech

Existing FS Firms (Banks, Insurance)

- **Positives**
  - Capital
  - Customers
  - FS Experience
  - Compliance
  - Risk Mgmt.
  - Data
  - Holistic

- **Negatives**
  - Legacy
  - Culture
  - Processes
  - Protect existing
  - Distracted

- **Trust?**
- **Brand?**
- **UX?**
- **Scale?**

Almost asymmetrical capabilities
Industrialists need Innovators,
Innovators need Industrialists

SolrBanks? 31% threat
Insurance? 10% threat

“FinTech” Startups

- **Positives**
  - Urgency
  - Culture/Mindset
  - Ideas, Skills
  - Niche focus
  - Customer-centric
  - Cleansheet
  - UX

- **Negatives**
  - Capital
  - Customers
  - Compliance
  - Risk Mgmt.
  - Data
  - Crowded
  - Confusing
  - FS Experience

- **Trust?**
- **Brand?**

Startups? 41% threat

The Future FS Firm

Battleground fought on
Trust, Data and Customer Experience

Pathways of Collaboration, Alliances,
Joint-Ventures, Distribution,
Investment, Acquisition

Established eCommerce Retailers

- **Positives**
  - Capital
  - Customers
  - Culture
  - Data
  - Trust
  - Brand
  - UX

- **Negatives**
  - FS Experience
  - Compliance
  - Risk Mgmt.

Retailers? 18% threat

Technology Firms (Software, Telco)

- **Positives**
  - Capital
  - Customers
  - Compliance
  - Culture
  - Data
  - Brand
  - UX

- **Negatives**
  - Focus/Priority
  - FS Experience
  - Compliance
  - Risk Mgmt.

Tech Firms? 45% threat
Telcos? 27% threat

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17

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