VIEW TO THE NEWS

STATES COMPETE WITH OCC OVER FINTECH REGULATION

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The Office of the Comptroller of the Currency announced at the end of 2016 that it "will move forward with chartering financial technology companies that offer bank products and services."[1] Fintechs would have the option of becoming special purpose national banks under the OCC regime, joining other existing special purpose national banks, such as trust banks or credit card banks. A chartered fintech would be a nondepository financial institution that would not be insured by the Federal Deposit Insurance Corporation but would be expected to be a member of the Federal Reserve System.

The OCC provided more details on the fintech charter in March 2017 in the form of (i) a proposed licensing manual supplement and (ii) a white paper that includes general responses to comments on the OCC's December 2016 fintech charter white paper.[2]

State regulators, community banks and some members of the Congress have opposed the OCC fintech charter proposal or expressed serious reservations.[3] The Conference of State Bank Supervisors has publicly stated that a fintech charter is "fatally flawed" and "threatens to damage the U.S. financial system" by distorting the marketplace, unduly expanding the OCC's authority and threatening consumers.

The New York State Department of Financial Services has been a vocal opponent to the OCC's proposal to create a new national bank charter for any entity the OCC deems to fit within the undefined category of "fintech." The NYDFS called on state regulators, legislators, and other policymakers to oppose the OCC's proposed special charter and support the nation's strong state-based regulatory system.

The Independent Community Bankers of America has expressed its concerns with the OCC granting special-purpose bank charters to unregulated fintechs and called on the OCC to rescind the draft supplement and request specific congressional authorization to grant fintech charters.

Some states, in reaction to the OCC's proposal, have acknowledged that states could streamline licensing by creating a more unified system for companies that apply for and maintain multi-state licenses. CSBS is working with the National Multistate Licensing System to simplify multistate licensing for companies that are licensed or registered through NMLS, such as money-services businesses.

Under the new call report released in April through NMLS, MSBs will be allowed to fill out a single form when submitting their quarterly financial data to the 18 regulators that have adopted the new report. Several additional states are expected to adopt the new MSB Call Report in the near future, although most states have not moved their non-mortgage licensing to NMLS, so any standardization adopted through the NMLS will have minimum impact on the licensing burden that many fintechs face.

The new call report is the first step in a series of initiatives announced by CSBS on May 10th to modernize state fintech and nonbank regulation.[4] The initiatives include redesigning and expanding the NMLS, harmonizing multi-state supervision, establishing a fintech advisory panel to identify points of friction in multi-state regulation and assisting states to supervise banks and nonbanks effectively.

So, what is going on?

Are the states and the OCC in competition? The answer is yes. Regulatory competition between states and federal regulators is not a new phenomenon and can create value to regulated entities by encouraging regulators to achieve the appropriate level of regulation.

As states expressed back in the 1990s when national bank preemption was a contested issue, states do not believe that the OCC adequately protects consumers. Additionally, states are concerned that overreaching by the OCC will disrupt the balance of power between state and federal regulation, which the states view as bad for the marketplace and innovation. Specifically, the CSBS has identified the three primary concerns about a new OCC charter:

First, a federal fintech charter will distort the marketplace and institute command-and-control innovation.

State regulators are concerned that the OCC's subjective criteria for awarding charters, and its intent to not include the normal regulatory safeguards placed on national banks — such as deposit insurance — would result in the OCC choosing winners

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and losers within the fintech industry as well as the broader banking industry, a sharp departure from the role of a financial regulator.

Second, the OCC is expanding its mandate absent statutory authority.

The National Bank Act does not give the OCC authority to issue full-service bank charters to institutions that do not engage in deposit taking. The OCC is relying on its own regulations to get around this — and not on the NBA — to create a non-depository special purpose charter for fintech firms. However, CSBS argues that there is no historical precedent for such a charter in the national banking system. In fact, Congress for more than a century and a half has purposely limited the OCC's chartering authority.

Third, despite assurances to the contrary, CSBS believes consumers will be at risk.

The OCC has a history of pre-empting state consumer protection laws in ways that damage consumers. During the early 2000s, many states adopted laws and brought enforcement actions to stop predatory lending. The OCC's response was to preempt the application of state anti-predatory lending laws to national banks and their operating subsidiaries, thereby permitting unsafe and abusive lending practices to flourish in the lead up to the U.S. financial crisis.

The OCC's preemption stance later required Congressional action to reset the balance between state and federal regulation in consumer protection. State regulators believe that, when it comes to preemption, the past is a prologue.

Some critical commentary

The NYDFS provided the following critical comments of the OCC's proposal in its comment letter:

- Unlike state regulators, the OCC has never regulated nonbank financial institutions.
- The NBA does not provide the OCC with authority to create the new proposed charter.
- The creation of a national charter is likely to stifle rather than encourage innovation.
- A national charter would encourage large "too big to fail" institutions.
- The recent financial crisis demonstrated that lax regulation on the federal level is devastating for the U.S. financial system and consumers.
- The proposal could permit companies to engage in regulatory arbitrage and avoid important state consumer protection laws, such as strong usury protections.
- State regulators like the NYDFS are experienced and therefore better equipped to regulate cash-intensive nonbank financial service companies, which require strict oversight and enforcement of anti-money laundering, consumer identification, and transaction monitoring statutes and regulations.

Despite such concerns, the OCC appears to be moving forward with its fintech charter. In response to the over 100 comment letters submitted on the OCC's December white paper, the OCC addressed states' consumer protection concerns by asserting that chartered fintechs would be subject to consistent federal consumer protection standards, federal supervision and regulation and a variety of non-preempted states laws. Chartered Fintechs will be expected to meet the same high standards of safety, soundness and fairness that all federally chartered banks must meet.

The OCC touted the benefits of a robust dual bank system and argued that denying Fintechs a federal charter option could make the federal banking system less capable of adapting to evolving business and consumer needs. The OCC also identified three threshold principles in its March white paper that informed the drafting of the proposed licensing manual supplement by stating that the OCC will not allow:

- The inappropriate commingling of banking and commerce.
- Products or services that have predatory, unfair or deceptive features.
- "Light-touch" supervision of chartered fintechs.

The proposed supplement mainly adopts existing licensing procedures and expectations for full-service national banks with some modest variation for fintech applicants. The more notable variations:

- The OCC leaves it to fintechs to identify and explain their methods for defining their relevant markets and communities and the needs of such markets or communities. If the OCC grants a charter, a chartered Fintech is expected to implement and update its financial inclusion plan periodically and obtain public input.
- Although fintechs will be subject to the minimum capital requirements for national banks, the OCC indicated that limited on-balance-sheet assets or nontraditional strategies will be considered when setting a fintech's particular capital requirements (which could be higher).
- As with other types of special purpose banks, the OCC may place additional requirements on fintech charters to ensure adequate liquidity. As the

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OCC acknowledged in its March white paper, many fintechs have yet to operate in stressed conditions.

The supervisory framework for chartered fintechs will incorporate many of the core supervisory elements used with other national banks, including an assigned portfolio manager, on-site and off-site supervisory activities, a risk-based approach to supervision and the CAMELS rating system. Newly chartered fintechs will be subject to more frequent and intensive supervision in the early years of operation.

The OCC has done little to show the benefits of obtaining a fintech charter, except for the recognized benefits of federal bank preemption. Banking restrictions and requirements are onerous individually and in the aggregate. Many of the banking restrictions and requirements (*e.g.*, financial inclusion, restrictive capital requirements, intrusive business plan approvals, public input into business plans, regulatory interference into proposed innovative products and services, regulatory oversight into the qualifications of organizers, management and directors, liquidity requirements, alternative business strategies requirements and regular examinations by a paternalistic regulator) were intended to make *depository* banks safer and thus, protect the public's money.

Whether these banking regulations are appropriate for nondepository banks remains an open question. The OCC has also reserved the right to apply other banking law requirements to fintechs, such as affiliate transaction restrictions, loans to a single borrower restrictions, interlocking directorate restrictions, anti-tying restrictions and community reinvestment requirements.

Thus, while chartered fintechs would enjoy many of the advantages of federal preemption under the NBA, obtaining a charter could subject fintechs to many of the laws and regulations that can burden national banks, such as regular examinations, reporting requirements and supervision by the OCC. It is not clear how many fintechs would, in fact, pursue a national charter under the OCC's current proposal.

The state-side view

It is not clear that state regulators are equipped to deal with the variety of fintech models and with the pace of innovation. State regulators have limited resources and the sophistication of regulators can vary from state to state. although Fintechs have been operating for several years, states did not begin surveying and studying marketplace lenders until December 2015.

The California Department of Business Oversight initiated an inquiry into online consumer loan and small business financing programs to determine whether market participants comply with California lending and securities laws and to assess how California's regulatory regime is working, and should work, with respect to the online lending industry. The survey found that financing provided to California consumers and small businesses by 13 major online lenders increased by 936 percent from 2010-2014.

These marketplace loan programs are providing needed access to financing according to the CDBO, but the state must ensure that it regulatory structure adequately protects the interests of consumers and small businesses, and works effectively for industry. It remains to be seen in what direction California will head with the information obtained from the survey.

Similarly, in June 2016, NYDFS requested information from online marketplace loan programs. Despite the timing of this inquiry, the NYDFS argued in its comment letter on the OCC's fintech proposal that state regulators are more experienced, and therefore, better equipped to regulate cash-intensive nonbank financial service companies. Comparatively, the OCC has asserted that it has technical expertise in a number of areas that likely are relevant to chartered fintechs and has established the Office of Innovation to be the primary point of contact for fintechs and provide resources for banks and nonbanks on regulatory expectations.

Fintechs can be subject to a patchwork of state regulation that was written without fintechs in mind. Recent developments indicate that states are taking divergent approaches to regulation of Fintechs. While the states seem to agree that the fintech charter is a bad idea, the states are not in agreement on the proper regulation of fintechs.

Some states want to increase regulation of fintechs and other states want to streamline regulation of fintech for consistency between states. For example:

- An Illinois Senator in 2016 proposed an amendment that would enact the Illinois Small Business Lending Act. The proposed Act would regulate small business loans and merchant cash advances not exceeding $250,000 by establishing requirements and restrictions including licensing.
- The New York State Legislature proposed in early 2017 to expand the Licensed Lender Law to regulate (i) persons making commercial loans of $50,000 or less to business entities and not just individuals, and (ii) persons who solicit and purchase or otherwise acquire from others loans or other forms of financing, or arrange or facilitate the funding of loans to individuals residing in New York or to businesses located or doing business in New York. These provisions were ultimately removed from the New York budget

bill, but this is likely not the end of legislative efforts by the NYDFS to expand the scope of the Licensed Lender Law.

- Vermont recently passed amendments to its Licensed Lender statute that could reach fintechs marketing loans. Other states have similarly followed suit by amending their lending laws to reach certain Fintechs or taking an expansive interpretation of the applicability of existing state laws.
- The Colorado Attorney General in April 2017 filed substantially similar complaints in Colorado state court against non-bank service providers alleging that the service providers are the "true creditors" in the online lending programs and violated Colorado's Consumer Credit Code.[5]

Although not named in the Colorado AG's complaints, the bank-lenders in the online lending programs filed complaints requesting declaratory judgments and injunctive relief against the Colorado Administrator of the Code.[6]

Will the courts decide?

The fate of the OCC's fintech charter, absent specific Congressional action, could ultimately be decided by the courts.

The CSBS recently filed a complaint against the OCC that challenged (i) the OCC's authority under the NBA to create a special purposes national bank charter for Fintechs and (ii) the OCC's process for proposing the Fintech charter, which did not follow the notice and comment procedure for agency rulemaking.[7] The OCC has yet to file a substantive response although the ability of CSBS to bring the suit can be expected to be challenged.

Shortly after the CSBS filed its complaint, now-former Comptroller Thomas J. Curry acknowledged in a speech that the fintech charter has "sparked some opposition" and indicated that "the heart of the issue is the fundamental nature of the business of banking." [8] Curry argued that the "the business of banking is dynamic" and warned that defining the business of banking as a static state could choke off growth and innovation.

The NYDFS superintendent filed a separate lawsuit on May 12, 2017 in U.S. District Court, Southern District of New York, challenging the fintech charter.[9] This complaint has a notably more pointed tone than the CSBS' complaint. Superintendent Maria T. Vullo argues that the "business of banking" under the NBA requires that OCC-chartered banks receive deposits unless Congress expressly authorizes otherwise.

The OCC, according to the NYDFS, has exceeded its statutory authority by impermissibly redefining the "business of banking" through regulation "to empower itself to charter non-depository institutions." Vullo encouraged the court to look at the fintech charter with a "measure of skepticism" insofar as states have had nearly exclusive jurisdiction to regulate non-depository, non-bank institutions for over 150 years.

The complaint also claims that the fintech charter will be "destructive" and poses an "insidious threat" to the New York regulatory environment that protects New York markets and consumers. The NYDFS argues that the OCC has set the bar for fintech-charter eligibility so low by permitting institutions that merely pay checks or lend money to apply for a charter that the scope of regulatory disruption is difficult to ascertain. Vullo proffered two examples of concrete harm in her complaint.

First, the fintech charter will strip New York money transmitter customers of critical financial protections under New York law, including bonding requirements, liquidity and capitalization standards and payment obligations to the state-run money transmitter insurance fund. Second, chartered fintechs will "gouge New York borrowers" by preempting New York's strict interest rate limitations, which will lead to the proliferation of payday lending.

The complaint positions the NYDFS as the expert regulator of non-depository institutions, and then asserts that the fintech charter will deprive the NYDFS of crucial resources by reducing the assessments that the NYDFS can levy on regulated entities.

Vullo's complaint seems to assume that:

- All non-depository institutions will seek a fintech charter.
- The OCC will approve all fintech charter applications.
- The OCC will place no standard or special conditions on chartered fintechs.

Continuing competition

As lending and other financial activities are increasingly conducted online, whatever regulator has authority over the fintech industry will generate revenue and enjoy job security. Indeed, potential lost revenue may be an underlying part of the current regulatory battle. Whether federal regulation or state regulation "wins" the power struggle depends on future developments, including the ultimate scope and nature of the fintech charter.

Currently, the OCC's fintech charter does not appear sufficiently flexible to be an attractive option

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for fintechs, many of which must adapt quickly to market developments, raise capital from diverse sources and are unaccustomed to handling the level of regulation imposed by the OCC. If the fintech charter becomes more flexible and thus, a more attractive option, states' opposition can be expected to increase.

Another development that could affect the power struggle between the OCC and states is a unified effort by states to standardize and simplify state regulation, as illustrated by the new NMLS call reports for MSBs. Streamlined state regulation could make the fintech charter less appealing insofar as bank-level regulation and supervision could be more burdensome than streamlined state regulation. Whether states could achieve the degree of standardization and simplification required to tip the scale remains to be seen.

State regulators and AGs could be more interested in flexing their regulatory muscles than collaborating on a uniformed approach to regulation. The key for fintechs is to be a part of the dialogue and use the competition between the OCC and the state regulators to achieve appropriate regulation of new business models.

Notes

[1] Thomas J. Curry, Comptroller of the Currency, Remarks at the Georgetown Law Center (Dec. 2, 2016); see *also* OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE NATIONAL BANKS FOR FINTECH COMPANIES (Dec. 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf.

[2] OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC Summary of Comments and Explanatory Statement: Special Purpose National Bank Charters for Financial Technology Companies (Mar. 2017), https://www.occ.treas.gov/topics/responsible-innovation/summary-explanatory-statement-fintech-charters.pdf.

[3] To access the comment letters on the OCC's December 2016 white paper, visit https://www.occ.treas.gov/topics/responsible-innovation/fintech-charter-comments.html.

[4] Media Release, CSBS Announces Vision 2020 for Fintech and Nonbank Regulation (May 10, 2017), https://www.csbs.org/news/press-releases/pr2017/Pages/051017.aspx.

[5] *Meade v. Marlette Funding, LLC,* No. 1:17-CV-00575 (D. Colo. 03/09/17); *Meade v. Avant of Colorado LLC,* No. 1:17-CV-00620 (D. Colo. 03/09/17) (removed to federal court).

[6] *WebBank v. Meade,* No. 1:17-cv-00786 (D. Colo., *complaint filed* 03/28/17); *Cross River Bank v. Meade,* No. 1:17-cv-00832-PAB (D. Colo., *complaint filed* 04/03/17).

[7] *Conference of State Bank Supervisors v. the Office of the Comptroller of the Currency,* No. 17-00763 (D.D.C., *complaint filed* 04/26/17).

[8] Thomas J. Curry, Comptroller of the Currency, Remarks at the Fintech and the Future of Finance Conference, Kellogg School of Management, Northwestern University (Apr. 28, 2017), https://www.occ.gov/news-issuances/speeches/2017/pub-speech-2017-48.pdf.

[9] *Vullo v. Office of the Comptroller of the Currency,* No. 17-cv-03574 (S.D.N.Y., *complaint filed* 05/12/17).

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