

A Potentially Promising Approach to Regulation of FinTech

or Should the U.S. Adopt a Regulatory Sandbox?

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A Potentially Promising Approach to Regulation of FinTech

or Should the U.S. Adopt a Regulatory Sandbox?

By: Richard B. Levin and Bob Wenner

The Office of the Comptroller of the Currency (“OCC”) recently published a proposal to bring emerging financial technology (“FinTech”) companies within the scope of the agency’s jurisdiction. The proposal is useful as part of a greater discussion of how to properly regulate FinTech companies in a way that will protect the public without stifling innovation.

The OCC proposal appears to echo the sentiments of some lawmakers that FinTech should be regulated like banks. Critics of this approach believe the OCC’s proposal to register FinTech companies as special purpose national banks will more than likely prove unduly burdensome for the majority of early stage FinTech companies. Others believe such an approach may prove a useful option for well-established FinTech companies that can afford the costs associated with the application process and on-going compliance with applicable rules and regulations. As Congress considers how to regulate FinTech, lawmakers should consider the free market approaches being employed in other jurisdictions that are actively supporting the development of FinTech, including Singapore and the United Kingdom.

Background

“[FinTech] companies are changing financial services, and it is vital that the regulators and Congress understand all the impacts and take actions as appropriate.”¹ In July 2016, Senators Sherrod Brown (D-OH) and Jeffrey Merkley (D-OR) sent a letter to the leaders of Federal Reserve, the OCC, the Federal Deposit Insurance Corporation (“FDIC”), the National Credit Union Administration, and the Consumer Financial Protection Bureau (“CFPB”) asking them to outline the steps they are taking to ensure effective oversight of the emerging financial technology (“FinTech”).² The Senators noted:

[W]e must be mindful that some of these products, activities, and business models may be new and innovative, while others may largely resemble those of existing, federally regulated firms, . . . As Congress considers its role in overseeing FinTech and its impact on American consumers, we believe it is important that Congress better understand the way federal regulators oversee FinTech and their relationships with federally regulated financial institutions.³

¹ Letter from Senators Sherrod Brown and Jeffrey Merkley to the leaders of Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Consumer Financial Protection Bureau (July 21, 2016), available at: <https://www.brown.senate.gov/newsroom/press/release/brown-merkley-press-federal-agencies-on-oversight-of-financial-technology-> (the “Brown-Merkley Letter”).

² Senator Brown is the Ranking Member on the Banking, Housing, and Urban Affairs Committee. Senator Merkley previously served as the ranking Democrat on the Banking Committee’s Financial Institutions and Consumer Protection Subcommittee.

³ *Id.*



Senators Brown and Merkley believe:

If a FinTech company is neither directly regulated by [the federal] agencies nor a third party service provider, there are concerns that applicable federal consumer laws may not extend to consumers engaging with FinTech companies, and that consumers or small business owners may not understand that protections provided by federal financial institutions do not apply to the products and services offered by these companies. . .⁴

While members of Congress from both parties have expressed their support and concerns about FinTech, the response from the federal agencies has been less clear.⁵

OCC Whitepaper

The OCC recently published a proposal to bring FinTech companies within the scope of the agency's jurisdiction.⁶ The proposal offers an approach that would allow FinTech companies to receive charters as special purpose national banks.⁷ Comptroller of the Currency Thomas J. Curry stated in his announcement of the proposal that: [i]t will be much better for the health of the federal banking system and everyone



who relies on these institutions, if [FinTech] companies enter the system through a clearly marked front gate, rather than in some back door, where risks may not be as thoughtfully assessed and managed.

The proposal is an important step forward in acknowledging the growing importance of FinTech to the United States financial services industry and a move to address the fragmented approach to regulation of FinTech by the states. It remains to be seen whether the proposal will afford FinTech companies an approach that will obviate the need to register with one or more state regulators under state banking and securities laws.

The OCC's Proposed Regulatory Framework

The OCC has the authority to grant charters to national banks under the National Bank Act (the "Act").⁸ The Act has long been interpreted to allow

⁴ *Id.*

⁵ The General Counsel of the Federal Reserve recently stated the Federal Reserve would examine FinTech companies this year in conjunction with the OCC. Fed to Evaluate Large Bank 'Living Wills,' FinTech in 2017, ABA Banking Journal (Jan. 6, 2017), available at: <http://bankingjournal.aba.com/2017/01/fed-to-evaluate-large-bank-living-wills-FinTech-in-2017/>.

⁶ Office of the Comptroller of the Currency, Exploring Special Purpose National Bank Charters for FinTech Companies (Dec. 2016) ("white paper"), available at: <https://www.occ.treas.gov/topics/bank-operations/innovation/special-purpose-national-bank-charters-for-FinTech.pdf>

⁷ Brown-Merkley Letter.

⁸ 12 U.S.C. § 38 et. seq., available at: <https://www.gpo.gov/fdsys/granule/USCODE-2011-title12/USCODE-2011-title12-chap2-subchapI-sec38>.



the OCC to grant charters for special purpose national banks, traditionally covering trust banks as well as credit card banks. In the proposal, the OCC seeks to expand special purpose charters beyond these two types of banks and into FinTech, subject to the restrictions provided in the Act. For a bank or other entity to be chartered as a special purpose national bank it must engage in fiduciary activities or provide at least one of the following banking services:

- receiving deposits
- paying checks,
- lending money

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...the OCC seeks to reduce the complexity of FinTech regulation and shift away from the existing state-by-state supervisory framework through preemption by federal law.
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The OCC believes the innovative services provided by many FinTech companies are equivalent to these traditional activities in their utilization of modern technology. For instance, the OCC noted in its proposal that issuing debit cards or engaging in other means of facilitating electronic payments are the “modern equivalent” of paying checks.

While this approach may have some merit considering the diversity of products and services offered by FinTech companies, the OCC intends to determine an entity’s eligibility for the special purpose charter on a case-by-case basis. The OCC acknowledges that it will not be the sole source of oversight for FinTech, noting that other agencies such as the Federal Reserve, the FDIC, and the CFPB will likely have additional supervisory roles.

State Regulation of FinTech

The OCC proposes to establish a uniform supervisory framework for FinTech companies. The proposal would bring qualifying FinTech entities into the scope of the same laws that cover national banks, thus limiting state regulation to laws “that only incidentally affect” the authorized powers of a national bank.⁹ In doing this, the OCC seeks to reduce the complexity of FinTech regulation and shift away from the existing state-by-state supervisory framework through preemption by federal law. Currently many FinTech companies face the challenge of attempting to determine the state and federal regulations that apply to their business. The proposed framework seeks to address these challenges by allowing FinTech companies to register at the federal level and eliminating state licensing requirements. The OCC believes the public interest will be served by ensuring that FinTech companies operating “in a safe and sound manner,” promoting “consistency” in governing law, and making “the federal banking system stronger.”¹⁰

⁹ OCC white paper at 5.

¹⁰ *Id.*



Special Purpose National Banks

The proposed framework will bring FinTech companies within the OCC's jurisdiction under the Act as special purpose national banks that are subject to the same forms of regulation as other national banks. This means that special purpose national banks are subject to the same laws, regulations, examination, reporting requirements and ongoing supervision as national banks. The OCC intends to apply the safety and soundness, fair access, and fair treatment of customer rules to FinTech companies while tailoring the rules to address the size and associated risks of FinTech companies.¹¹ Although the system means there will be no licensure requirement at the state level, state law will continue to apply in complimentary areas including anti-discrimination, fair lending, debt collection, taxation, and unfair or deceptive treatment of customers, with the goal of achieving a high level of supervision similar to that of national banks.¹²

Supervisory Expectations

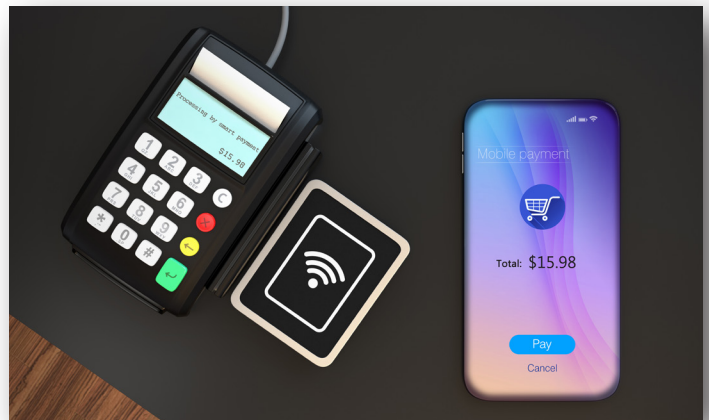
In the proposal the OCC set forth a list of guiding supervisory expectations for FinTech companies seeking a special purpose charter. These expectations include:

- a well-developed business plan,
- a corporate governance structure,
- capital,
- liquidity,
- compliance risk management,
- financial inclusion, and
- recovery and resolution planning.

¹¹ *Id.* at 2.

¹² *Id.* at 5.

These requirements are substantially similar to those imposed on national banks and are intended to help demonstrate a company's reasonable chances for success while operating in a safe manner, with adequate capital to support its risk profile. By creating these baseline requirements, the OCC will be able to evaluate FinTech companies on a case-by-case basis to determine their eligibility for a special purpose charter.



Application Process

In addition to the above expectations, the OCC proposed an application process for FinTech companies that mirrors its standard policies and procedures for charter applications. This process generally includes:

- the **pre-filing stage**, consisting of formal and informal planning meetings allowing applicants to engage with the OCC,
- the **filing stage**, where a formal application is filed,
- the **review and evaluation stage**, in which the OCC conducts an individualized investigation,
- the **decision stage**, consisting of a conditional and final approval phases.



These steps will help the OCC make individual determinations for each entity. The OCC intends to impose several standard conditions at the decision stage when it grants conditional approval, including the establishment of appropriate policies and procedures and adoption of an internal audit system appropriate to size, nature and scope of the company's activities. These standard conditions may be expanded depending on the individual circumstances and risk associated with each entity.

Implications and Risks

While some members of Congress believe a centralized regulatory model for FinTech may be necessary, using an existing, traditional supervisory framework to regulate these innovative firms does have some risks. For many early stage companies, the regulatory and supervisory burdens of the special purpose national bank charter may outweigh the benefits. FinTech has been driven largely by the development of innovative technologies by small, agile start-up companies that have taken advantage of a lack of regulatory clarity. Excess regulation has the potential to slow the development of these technologies.

If the OCC is able to develop an approach to the regulation of FinTech that is tailored to these innovative technologies, federal regulation of FinTech companies could benefit the industry by preempting

state regulation of these companies. However, it remains to be seen whether FinTech companies will not be subject to regulation by some statutes that would otherwise be inapplicable. The OCC noted in its white paper that it may work with FinTech companies to “achieve the goals of a particular statute or regulation through the OCC’s authority to impose conditions on its approval of a charter” in situations where a law would not necessarily directly apply to a company.¹³ The OCC would do this “if it deems the conditions appropriate based on the risks and business model of the institution.”¹⁴

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FinTech companies will need to weigh the risks associated with additional regulation against the benefits of a more uniform supervisory framework. The proposed plan may be of limited value to businesses that engage in deposit-taking activities because the FDIC has not published its proposal for regulation of FinTech companies in this space, and the Federal Reserve has only released an exploratory research paper with no statement of its regulatory intentions or any proposed supervisory frameworks.¹⁵

¹³ *Id.* at 2.

¹⁴ *Id.* at 6.

¹⁵ Federal Reserve Board, *Distributed ledger technology in payments, clearing, and settlement* (Dec. 2016), available at: <https://www.federalreserve.gov/econresdata/feds/2016/files/2016095pap.pdf>.



Alternative Approach – Regulatory Sandbox

While the OCC has proposed an approach for regulating FinTech companies that may be appealing to some members of Congress, the approach has been criticized by some members of both parties. Senators Brown and Merkley



recently raised their concerns about the OCC proposal.¹⁶ The Senators believe “new federal charter for financial technology firms could weaken consumer protections, limit competition,

and threaten financial stability.”¹⁷ The Senators stated: “Offering a new charter to non-bank companies seems at odds with the goals of financial stability, financial inclusion, consumer protection, and separation of banking and commerce . . .”¹⁸

Republican members of Congress have also raised concerns with the OCC proposal. Congressman McHenry (R-NC) has noted “[i]n Washington, we continue to force FinTech companies into regulatory categories that do not fit and burden them with regulations that make no sense . . .”¹⁹ Republicans armed with new majorities in both houses of Congress and a Republican President, may follow through on their plans to pass their innovation initiative to promote the growth of FinTech companies.²⁰ As Congress considers how to regulate FinTech, the members should consider the free market approaches being employed in other jurisdictions that are actively supporting the development of FinTech, including Singapore and the United Kingdom.

Singapore

The Monetary Authority of Singapore (“MAS”) is currently developing a more flexible framework for the regulation of FinTech companies than what has been proposed by the OCC.²¹ Rather than expanding existing regulatory systems to cover FinTech companies, the MAS has proposed a regulatory

¹⁶ Letter from Senators Sherrod Brown and Jeffrey Merkley to the Office of the Comptroller of the Currency (January 9, 2017), available at: <http://brown.senate.gov/download/occ-FinTech>.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Congressional Republicans Preparing Fintech Promotion Legislation, Wall Street Journal (March 18, 2016), available at: <http://www.wsj.com/articles/congressional-republicans-preparing-fintech-promotion-legislation-1458333389>

²⁰ *Id.*

²¹ MSA FinTech Regulatory Sandbox Guidelines (June 6, 2016), available at: <http://www.mas.gov.sg/~/-/media/MAS/News%20and%20Publications/Consultation%20Papers/Consultation%20Paper%20on%20FinTech%20Regulatory%20Sandbox%20Guidelines.pdf>.



sandbox tailored to specific forms of FinTech innovation. In this system, FinTech companies will be able to experiment and grow without being subject to excessively burdensome regulation. The MAS will develop a supervisory framework as the technology progresses. Rather than have a single sandbox with a general set of relaxed rules, the MAS envisions a system in which the sandboxes have rules that are relaxed based on the specific technology in use. Actual regulation of FinTech companies under this system will only commence once they grow to a size that would pose risks to consumers and the wider financial system. This framework recognizes that the existing regulatory frameworks may be ill-suited for new FinTech products and services. In developing this system, the MAS acknowledges that FinTech companies may not fit neatly into a regulatory framework, and that some innovators may not want to approach the regulatory agency in order to avoid scrutiny and the potentially costly compliance actions where regulation is uncertain or oppressive. This is a significant recognition that uncertainty may stifle creation of new products and services in an industry that has been experiencing rapid growth. The sandbox model creates a platform for interaction between the regulator and FinTech innovators. This model also promotes the development of innovative regulatory solutions that will be critical in driving FinTech innovation.

United Kingdom

The United Kingdom's Financial Conduct Authority (FCA) has taken a similarly progressive approach to the regulation of FinTech.¹⁸ The FCA has

acknowledged the small, agile nature of many FinTech startups and seeks to limit barriers to innovation by providing direct support throughout the development of compliance procedures. Like the proposed system in Singapore, the FCA has developed a regulatory sandbox in order to provide a safe space for businesses to test new products and services with customers for a limited period without be subject all of the regulatory requirements. The goal of such a system is to reduce the overall cost and time of bringing these new technologies to market by enabling FinTech companies to refine their business models before being subjected to regulation.

Conclusion

The OCC's proposal is useful as part of a greater discussion of how to properly regulate FinTech companies in a way that will protect the public without stifling innovation. While the concerns of Senators Brown and Merkley are well founded, the OCC's proposal to register FinTech companies as special purpose national banks will more than likely prove unduly burdensome for the majority of early stage FinTech companies. Such an approach may prove a useful option for well-established FinTech companies that can afford the costs associated with the application process and on-going compliance with applicable rules and regulations. The authors encourage members of Congress to look to the adoption of a regulatory sandbox similar to those used in other jurisdictions because it will protect the public, and promote innovation and compliance with applicable laws by fostering a constructive dialogue between the regulators and FinTech companies.

²² Speech by Christopher Woolard, FCA Director of Strategy and Competition, delivered at the Innovate Finance Global Summit (April 11, 2016), available at: <https://www.fca.org.uk/news/speeches/innovate-finance-global-summit>; also, FCA FinTech Regulatory Sandbox, available at: <https://www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox>



Members of Congress should look to the adoption of a regulatory sandbox similar to those used in other jurisdictions because it will protect the public, and promote innovation and compliance with applicable laws by fostering a constructive dialogue between the regulators and FinTech companies.

Any firm that is planning to develop a FinTech platform that may be subject to regulation by state and federal regulators including the OCC, the CFPB, the Federal Reserve, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, should proceed with caution. Similarly, anyone looking to invest in a FinTech company should make sure the company is properly structured to comply with state and federal laws. Due to the lack of clearly defined guidance with respect to the authority of the state and federal regulators, it is important that you engage experienced counsel to assist you in navigating the regulatory requirements that may apply to any FinTech company that you are building or in which you are investing.

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