

Fintech Regulatory Update

September 5, 2018

Financial Services

The sharp focus by the financial services industry on new and emerging technologies has created a new opportunity for regulators to foster innovation while protecting consumers. In the last three months alone, a host of federal agencies, Congress, and state Attorneys General have taken action designed to advance—and regulate—the use of financial technology (“fintech”).

This client alert summarizes recent regulatory developments relating to fintech and discusses the implications of these developments.

* * *

Table of Contents

OCC Begins Accepting Applications for Fintech Bank Charter.....	2
Arizona Attorney General Begins Accepting Applications for Fintech Regulatory Sandbox	3
BCFP Continues Moving Toward Opening a Fintech Regulatory Sandbox.....	3
BCFP Announces Participation in Global Financial Innovation Network.....	4
Treasury Releases Report on Nonbank Institutions, Fintech, and Innovation.....	4
Early Consideration of Charters.....	7
Covington Contacts.....	8

* * *

OCC Begins Accepting Applications for Fintech Bank Charter

On July 31, 2018, the Office of the Comptroller of the Currency (“OCC”) announced that it would begin accepting applications from nondepository fintech companies that engage in one or more core banking activities, such as paying checks or lending money, for a special purpose national bank (“SPNB”) charter.

Comptroller of the Currency Joseph M. Otting explained that the new charter “helps provide more choices to consumers and businesses, and creates greater opportunity for companies that want to provide banking services in America.” Comptroller Otting added that “companies that provide banking services in innovative ways deserve the opportunity to pursue that business on a national scale as a federally chartered, regulated bank.”

The SPNB fintech charter is poised to provide key benefits to certain fintech companies. In particular, a SPNB charter could make a fintech company’s regulatory framework more uniform and less dependent on the current patchwork of state licensing and rate cap regulation. The charter also may enable a fintech company to gain direct access to the payment system, subject to the Board of Governors of the Federal Reserve’s (“Federal Reserve’s”) willingness to grant such access. A company that obtains a SPNB charter may have less of a need to enter into a partnership with a bank depending on the company’s business.

There also are limits to the SPNB charter. The OCC has made clear that a company with a SPNB charter will not be authorized to accept FDIC-insured deposits. The OCC also emphasized that every application for a SPNB charter will be evaluated on the basis of its specific facts and circumstances, and that fintech companies that become special purpose national banks initially will be subject to heightened supervision, similar to other *de novo* banks.

An application for a SNPB charter generally will be processed like other *de novo* national bank applications in four phases. A potential applicant will first engage with the OCC in formal and informal meetings to discuss the proposal in the prefiling phase. After the prefiling phase, the fintech company will submit a complete application. The application will be subject to a comment period, during which the OCC will accept and consider comments from the public regarding the fintech company’s application and proposed business plan. The application will include, among other information and documents, the applicant’s business plan, capital and liquidity analysis, financial inclusion plan, and contingency plan.

During the subsequent review phase, the OCC will review and analyze the application to assess whether the proposed bank satisfies the criteria for approval, namely: (i) whether the proposed bank will have a reasonable chance of success; (ii) whether the proposed bank will be operated in a safe and sound manner; (iii) whether the proposed bank will provide fair access to financial services; (iv) whether the proposed bank will treat customers fairly; (v) whether the proposed bank will comply with applicable laws and regulations; and (vi) whether the proposed bank will foster healthy competition. Finally, the application will enter the decision phase. The OCC will decide first whether to grant a preliminary conditional approval for the proposed bank to begin organizing. After conditional approval, the OCC will subsequently decide whether to grant a final approval for the bank to open for business to the public.

The OCC’s decision to move forward with the SPNB fintech charter had been highly anticipated and publicly debated since the OCC published white papers in 2016 indicating that the agency was exploring whether to offer an SNPB charter for fintech companies. The OCC was sued by

the New York State Department of Financial Services and Conference of State Bank Supervisors with respect to the OCC's authority under the National Bank Act to offer the SPNB charter shortly after the OCC indicated it was considering the charter. While these suits initially were dismissed on ripeness grounds, it is expected that new suits will be filed when a company submits an application for the SPNB charter.

Arizona Attorney General Begins Accepting Applications for Fintech Regulatory Sandbox

On August 3, 2018, Arizona became the first state in the nation to accept applications for a fintech regulatory "sandbox" program to facilitate the development of innovative financial products and services. These programs typically allow participant companies to test innovative financial products and services while exempted from certain regulations and while under regulator supervision. Several foreign jurisdictions, including the United Kingdom, Canada, and Singapore, have already begun experimenting with regulatory sandbox programs.

The Arizona sandbox is the result of a March 2018 state law that authorizes the Arizona Attorney General to create and administer the program. The Attorney General may allow approved fintech companies to engage in the testing of products and services on up to 10,000 state residents (and as many as 17,500 residents in some instances) and for up to two years (with the possibility of an additional one-year extension) without additional licensing. The program would exempt participants from certain state financial regulations but not federal requirements.

According to the Attorney General, eligible products or services may include "most types of credit extending services, such as peer-to-peer lending and online marketplace lending," "innovative products and services for money transmission and investment management," and certain blockchain or cryptocurrency products or services. Ineligible products or services include securities trading, insurance products, and services that provide "solely deposit-taking functions." Applicants must submit to Arizona's jurisdiction but are not required to be Arizona residents or businesses.

The state's enabling statute contains trade secret protection for participants, including a provision stating that records obtained by the attorney general's office as part of administering the sandbox are not public records nor open for inspection by the public.

Although the sandbox is a first among U.S. states, the Arizona statute notably includes a reciprocity feature that would allow sandbox participants to participate simultaneously in similar programs in other jurisdictions, with the Arizona Attorney General's permission.

BCFP Continues Moving Toward Opening a Fintech Regulatory Sandbox

In May 2018, Acting Director of the BCFP Mick Mulvaney [announced](#) that the Bureau of Consumer Financial Protection ("BCFP" or "Bureau") is developing a fintech regulatory sandbox in coordination with the U.S. Commodity Futures Trading Commission ("CFTC").

As part of Acting Director Mulvaney's efforts, the BCFP announced the creation of a new Office of Innovation to replace the agency's previous "Project Catalyst" innovation initiative. According

to the Bureau, the new office will “focus on creating policies to facilitate innovation, engaging with entrepreneurs and regulators, and reviewing outdated or unnecessary regulations.”

On July 18, 2018, Acting Director Mulvaney announced his selection of Paul Watkins to lead the Office of Innovation. Watkins previously served as Chief Counsel for the Civil Litigation Division of the Office of the Arizona Attorney General. Moreover, Watkins led the Arizona Attorney General office’s fintech initiatives, including the creation of the state’s newly opened fintech regulatory sandbox described above.

BCFP Announces Participation in Global Financial Innovation Network

On August 7, 2018, the BCFP announced that it would join ten non-U.S. financial regulators in an alliance called the Global Financial Innovation Network (“GFIN”) to encourage the growth of fintech—and, potentially, create a “global sandbox” for financial innovation.

The alliance was initially proposed in February 2018 by the UK’s Financial Conduct Authority (“FCA”). The Bureau’s announcement revealed that, in addition to the FCA and the Bureau, nine other regulators have signed onto the initiative—including financial regulators in Singapore, Hong Kong, Dubai, and Canada. Notably, no EU regulators are participating and none of the other U.S. federal bank regulators appear to be involved.

The functions of the alliance are still under development, but are expected to include:

- acting as a network of regulators to collaborate in facilitating innovation in respective markets, including emerging technologies and business models;
- providing a forum for joint policy work and discussions; and
- providing firms with an environment in which to trial cross-border innovative solutions.

The alliance released a [Consultation Document](#) outlining these functions in more detail and soliciting comments and reactions from financial services firms and other stakeholders. Comments must be provided by October 14, 2018, and comments from U.S. stakeholders may be submitted to officeofinnovation@cfpb.gov.

While still very much under development, the GFIN could in the future help address the balkanized nature of local financial innovation sandbox arrangements by allowing, for example, the easier testing of innovative solutions for cross-border consumer financial services (such as remittances).

Treasury Releases Report on Nonbank Institutions, Fintech, and Innovation

On July 31, 2018, the U.S. Department of the Treasury released a [report on nonbank financials, fintech, and innovation](#) (the “Report”).

The Report is the fourth and final report issued by Treasury pursuant to [Executive Order 13772](#), which established certain “Core Principles” designed to inform the manner in which the Trump Administration regulates the U.S. financial system. The Core Principles call for policies that: (i) empower Americans to make independent financial decisions and informed choices; (ii) prevent taxpayer-funded bailouts; (iii) foster economic growth and vibrant financial markets through

more rigorous regulatory impact analysis; (iv) make regulation efficient, effective, and appropriately tailored; and (v) restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

Treasury's report contains over 80 recommendations, which are summarized in an appendix to the report. The recommendations generally fall into four categories: (i) adapting regulatory approaches to promote the efficient and responsible aggregation, sharing, and use of consumer financial data and the development of key competitive technologies; (ii) aligning the regulatory environment to combat unnecessary regulatory fragmentation and account for new fintech business models; (iii) updating a range of activity-specific regulations to accommodate technological advances and products and services offered by nonbank firms; and (iv) facilitating experimentation in the financial sector.

Some notable recommendations include:

Embracing Digitization, Data, and Technology

- TCPA Revisions: Recommending that Congress and the Federal Communications Commission ("FCC") amend or provide guidance on the Telephone Consumer Protection Act to address unwanted calls and the revocation of consent.
- Consumer Access to Financial Data: Recommending that the BCFP develop best practices or principles-based rules to promote consumer access to financial data through data aggregators and other third parties.
- Data Aggregation: Recommending that various agencies eliminate legal and regulatory uncertainties so that data aggregators can move away from screen scraping to more secure and efficient methods of access.
- Data Security and Breach Notification: Recommending that Congress enact a federal data security and breach notification law to protect consumer financial data and notify consumers of a breach in a timely manner, with uniform national standards that preempt state laws.
- Digital Legal Identity: Recommending efforts by financial regulators and the Office of Management and Budget ("OMB") to enhance public-private partnerships that facilitate the adoption of trustworthy digital legal identity products and services and support full implementation of a U.S. government federated digital identity system.
- Cloud Technologies, Artificial Intelligence, and Financial Services: Recommending that regulators modernize regulations and guidance to avoid imposing obstacles on the use of cloud computing, artificial intelligence, and machine learning technologies in financial services, and to provide greater regulatory clarity that would enable further testing and responsible deployment of these technologies by financial services firms as these technologies evolve.

Aligning the Regulatory Framework to Promote Innovation

- Harmonization of State Licensing Laws: Encouraging efforts by state regulators to develop a more unified licensing regime, particularly for money transmission and lending, and to coordinate supervisory processes across the states, and recommending Congressional action if meaningful harmonization is not achieved within three years.
- OCC Fintech Charter: Recommending that the OCC move forward with the SPNB charter for fintech companies described above.

- Bank-Nonbank Partnerships: Recommending banking regulators clarify regulatory guidance regarding bank partnerships with nonbank firms.

Updating Activity-Specific Regulations

- Codification of “Valid When Made” and True Lender Doctrines: Recommending that Congress codify the “valid when made” doctrine and the legal status of a bank as the “true lender” of loans it originates but then places with a nonbank partner, and that federal banking regulators use their authorities to affirm these doctrines.
- Encouraging Small-Dollar Lending: Recommending that the BCFP rescind its Small-Dollar Lending Rule and that federal and state financial regulators encourage sustainable and responsible short-term, small-dollar installment lending by banks.
- Adoption of Debt Collection Rules: Recommending that the BCFP promulgate regulations under the Fair Debt Collection Practices Act to establish federal standards governing third-party debt collection, including standards that address the reasonable use of digital communications in debt collection activities.
- Promote Experimentation with New Credit Models and Data: Recommending that regulators support and provide clarity to enable the testing and experimentation of newer credit models and data sources by banks and nonbank financial firms.
- Regulation of Credit Bureaus: Recommending that the Federal Trade Commission (“FTC”) and other relevant regulators take necessary actions to protect consumer data held by credit reporting agencies and that Congress assess whether further authority is needed in this area.
- Regulation of Payments: Recommending that the Federal Reserve act to facilitate a faster payments system, as well as changes to the BCFP’s remittance transfer rule.

Enabling the Policy Environment

- Regulatory Sandboxes: Recommending that federal and state regulators design a unified system to provide expedited regulatory relief and permit meaningful experimentation for innovative financial products, services, and processes, essentially creating a regulatory sandbox.
- Technology Research Projects: Recommending that Congress authorize financial regulators to undertake research and development and proof-of-concept technology partnerships with the private sector.
- Cybersecurity and Operational Risks: Recommending that financial regulators consider cybersecurity and other operational risks as new technologies are implemented, firms become increasingly interconnected, and consumer data are shared among a growing number of third parties.

The Report followed a March 2018 report by the U.S. Government Accountability Office (“GAO”) that similarly concluded that agencies that regulate fintech companies should coordinate with each other more closely, develop offices of innovation, and consider adopting approaches to fintech used in foreign jurisdictions, such as the regulatory sandbox approach.

Early Consideration of Charters

This summer also included movement on various charter applications, and we expect the pace of such action to increase in the months ahead.

On July 5, 2018, Square, Inc. (“Square”) announced that it had temporarily withdrawn a pending application with the Federal Deposit Insurance Corporation (“FDIC”) to obtain deposit insurance for a proposed industrial loan company (“ILC”) to strengthen the application before reapplying. The company stated that a parallel application with the Utah Department of Financial Institutions for the ILC charter was still pending.

Although obtaining a federal regulator’s approval on a major bank application is nearly always an iterative process, the announcement was noteworthy in that it came at a time when numerous fintechs are weighing whether to seek bank charters—and if so, what kind. There is action on multiple fronts:

- Student loan servicer Nelnet, for example, has an active application to charter an ILC.
- Other industry participants have expressed a keen interest in the OCC’s new SNPB charter, described above.
- In addition, Varo Money submitted an application to charter a full-service national bank in July 2017. On September 4, 2018, the OCC issued a preliminary conditional approval order so that Varo Money may proceed to an organization phase as a de novo full-service national bank.

Eventually, a fintech company such as Varo Money will succeed in chartering an ILC or a national bank. Such a precedent may set off a domino effect in the industry, as an approval would create a template for other companies to follow and eliminate a set of associated “first-mover” costs.

As a result, developments in efforts by companies like Square and Varo Money may provide valuable insight for how the OCC and FDIC will, in the future, assess fintech applications related to full-service ILC charters and national bank charters.

* * *

Covington Contacts

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Services practice:

<u>Eric Mogilnicki</u>	+1 202 662 5584	emogilnicki@cov.com
<u>Michael Nonaka</u>	+1 202 662 5727	mnonaka@cov.com
<u>Luis Urbina</u>	+1 202 662 5088	lurbina@cov.com
<u>David Stein</u>	+1 202 662 5074	dstein@cov.com
<u>Randy Benjenk</u>	+1 202 662 5041	rbenjenk@cov.com
<u>Mark Plotkin</u>	+1 202 662 5656	mplotkin@cov.com
<u>Nikhil Gore</u>	+1 202 662 5918	ngore@cov.com
<u>Weiss Nusraty</u>	+1 202 662 5703	wnusraty@cov.com
<u>Lucille Bartholomew</u>	+1 202 662 5079	lbartholomew@cov.com
<u>Christopher DeCresce</u>	+1 212 841 1017	cdecresce@cov.com
<u>Ingrid Rehtin</u>	+1 415 591 7080	irehtin@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.