TESTIMONY OF

AARON CUTLER
PARTNER, HOGAN LOVELLS US LLP

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OF THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

FOR A HEARING ENTITLED
"EXAMINING OPPORTUNITIES FOR FINANCIAL MARKETS IN THE DIGITAL ERA"

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Good morning, Chairman Luetkemeyer, Ranking Member Clay and distinguished Members of the Subcommittee. Thank you for inviting me to testify.

My name is Aaron Cutler and I am a Partner at the law firm of Hogan Lovells US LLP in the firm's Government Relations and Public Affairs Practice Group. My practice is focused on policy, regulatory and advocacy matters across a broad array of sectors including insurance and financial services; my firm also represents depository and non-depository financial institutions, retailers and technology companies in regulatory matters related to emerging financial technology ("FinTech") innovation. Prior to joining Hogan Lovells in October of 2014, I was a staffer in the U.S. House of Representatives for five and a half years, primarily at the House Committee on Energy and Commerce and the Office of House Majority Leader Eric Cantor. I had the privilege of working closely with this Committee in my role as Senior Advisor to the Leader, so I reiterate how much of a pleasure it is to be before you today. Any statements I make reflect only my opinions and do not necessarily reflect the opinions of my law firm, colleagues or clients.

I would like to thank Chairman Luetkemeyer and Ranking Member Clay for holding this hearing. At the outset, I would like to stress that I support agile and effective regulation that enables the creation, development and deployment of safe, sound, and innovative consumer financial products and services.

FinTech products and services, including peer-to-peer and consumer lending platforms, payment systems, and a myriad of other services are already in use and continue to be rapidly adopted by U.S. consumers. As noted by the Treasury's recent report entitled "A Financial

System that Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation,"[1] (Treasury Report) up to one-third of US consumers who are online use no less than two FinTech services.[2] Many of the FinTech products on the market provide consumers with greater access, choice, and empowerment for financial planning and decision making. The US will miss out on opportunities to realize the benefits from innovative FinTech development if it fails to take measures to improve its current regulatory structure.

As the Government Accountability Office (GAO) aptly reported in 2016,[3] the US financial services regulatory structure is complex and contains areas of fragmentation and overlap that lead to an inefficient regulatory structure. Several of the recommendations contained in the Treasury Report identify areas for improvement and increased efficiencies. Given the limited amount of time for my testimony, I will discuss only a few of the recommendations below. In light of my firm's experience in payments and open banking programs in particular, I will mainly focus on those areas.

Overall, the Treasury Report is a call to action. I appreciate and support the effort to identify related risks and also believe that the time to act is now. Taking action on many of the recommendations could, among other things, improve the regulatory framework by addressing uncertainties and inefficiencies and removing duplication. These improvements stand to benefit FinTech entities, and the industry at large, and consumers.

DATA ACCESS

Financial institutions are sitting on a goldmine of insightful data about each of their customer's spending habits and use of funds. In the right hands, this data can be used to

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[1]A Financial System that Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation, dated Jul. 2018, available at: https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation_0.pdf ("Treasury Report")

[2] Treasury Report p. 18.

[3] Financial Regulation, Complex and Fragmented Structure Could be Streamlined to Improve Effectiveness, dated Feb. 2016, *available at:* https://www.gao.gov/assets/680/675400.pdf

promote sound financial management, assess risk and support consumers. The information in a user's transactional accounts can, for example, be used to make highly accurate assessments of that user's credit risk (even if they have no credit history), and to help customers manage their money better, switch accounts to a more appropriate product or avoid incurring overdraft charges. It can also help with digital identity verification or even to make risk assessments for insurance products. In many cases, however, it is not the financial institutions themselves that are best able or motivated to carry out this analysis, but innovative third-parties with greater expertise in data analytics. Due to the convenience and perceived value of these services, the use by consumers of FinTech products that employ third-party data aggregation is increasing in popularity. However, financial institutions and data aggregators often find themselves at odds over data sharing and gaining efficient and reliable access to customer data continues to be a significant barrier to such services. This is part due to the prevailing regulatory regime.

Currently, financial institutions face uncertainty regarding their liability for sharing consumer account data. Section 1033 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[4] is the only express statutory provision relating to a consumer's access to his or her own financial account and transaction data. It requires covered financial institutions to make account transaction information in the financial institution's control "available to a consumer, upon request."[5] There are conflicting views about whether information shared with data aggregators, upon a consumer's request, are covered by Section 1033. The Treasury Report recommends that the Bureau of Consumer Financial Protection (Bureau) confirm that third parties given consumer-authorized access be covered under the definition of "consumer"[6] pursuant to Section 1002(4) of Dodd-Frank for the purpose of sharing financial account and transaction data, thereby requiring financial institutions to share the data with these third parties.

[4] Codified at 12 U.S.C. § 5533.
[5] 12 U.S.C. § 5533(a).
[6] The term "consumer" means an individual or an agent, trustee, or representative acting on behalf of an individual.

While this interpretation may help to remove current legal and regulatory uncertainties that cause reluctance on the part of financial institutions and data aggregators to enter into data sharing agreements, it will impose obligations on financial institutions to share certain customer data. Without guidance, these obligations could have unintended consequences or add other layers of uncertainty.

In my view, the overriding concern when setting a framework for open access to transactional information should be to ensure the security of the account and credentials, facilitate the customer's freedom of choice, and to allocate risk and liability appropriately to protect the customer. For many open banking projects, whether private or public, a key component of the framework is therefore enabling access via open application programming interfaces ("APIs"), rather than through use by the third party of the user's own security credentials (commonly known as 'screen-scraping'). In the case of a 'public' open banking project (i.e., one involving multiple banks and multiple third party providers), an additional consideration will be the creation of consistent standards determining how data is created, shared, and accessed – and by whom.

Any open banking system will therefore have to make decisions about means of access, liability, banking secrecy, and data protection, as well as the nature of the rights and obligations between participants. Therefore, I propose a few key considerations for the Bureau and Congress:

1. *Acceptable methods for data transmission.* As noted in the Treasury Report, the two main methods by which FinTech applications access and aggregate consumer data are "screen-scraping" and APIs.[7] Screen-scraping requires consumers to provide account login credentials for third parties to acquire financial and transaction data, process data requests or

[7] Treasury Report p. 25.

execute transactions.[8] This is the most flexible method for third-parties, but means that the consumer is unable to reliably control access, or grant access only to certain types of data, that the FinTech provider is required to store user credentials, and that the financial institution is unable to conclusively identify the third party and may block access, suspecting that the account is being hacked. By contrast, data aggregation through an API is based on explicit consumer consent given directly to the account provider rather than requiring login credentials. Importantly, this consent can be easily revoked by the consumer, without having to change the login credentials. Data sharing via API also generally means that the participating financial institutions are knowingly sharing data through an agreement or protocol; access is enabled through consumer consent provided to the financial institution or at the API access point.[9] Unlike screen-scraping, APIs give companies the ability to address specific issues critical to data sharing such as enhanced consumer access controls, robust security features, and transparency. They also allow the consumer to control access at a very granular level, supporting the principle of data minimization. However, account providers must voluntarily participate in the APIs, and the quality, reliability and performance of the API interface is within each provider's control. The type of data transmission that is allowable, or whether there will be one mandatory standard, will need to be determined. For access via APIs, it may be necessary to set minimum standards in terms of access, performance and reliability.

2. *Liability.* Financial institutions would benefit from guidance about whether they are expected to treat a data aggregator operating under a data sharing agreement as it would treat itself when it employs a data aggregator. Likewise, clarifications are needed about which parties are responsible for the failure to adequately protect data should be specifically dealt with in the data sharing agreements.

[8] Treasury Report p. 25-26.
[9] Treasury Report p. 26.

3. *Prescriptiveness.* The Treasury Report encourages the US to use the UK's Open Banking initiative as a potential comparison point in further developing its data aggregation regime. Under Open Banking, the UK's nine largest banks have been required to adopt open API banking standards and to make such data available. For legislators and regulators, Open Banking has underscored the importance of identifying whether – in the long term – the aims of a data aggregation regime are better achieved through enabling legislation, regulation, or simply through guidance. Such guidance might cover removing obstacles and relying upon competitive forces to achieve success. Mandatory requirements may result in more activity sooner, but may also result in a narrower and more restricted end product. Being overly prescriptive runs the risk of stifling the very innovation that it seeks to promote; on the other hand, being too general merely creates ambiguity and uneven implementation.

LICENSING AND REGULATORY FRAMEWORK

Many FinTech companies, including payments companies and platform lenders, are subject to the authority and supervision of state banking departments and other financial services regulatory agencies. Under the state regulatory regimes, FinTech companies are often required to obtain some form of state licensing and registration, depending on the product or service being offered. For FinTechs operating across multiple states that require licensing or registration, the company must conduct an expensive and time-intensive national licensing campaign, taking several months or even years.

License and registration application redundancies between the states contribute to the cost and time involved in the licensing process. For example, state applications may ask for detailed information about the company, key employees, executives and owners. Questionnaires for individuals often request detailed personal information, including background financial, residential, employment, and family history that may not be readily accessible to that

individual, adding complication to the process. The information requested may also slightly vary between states, even though the objective is substantially similar. When multiplied by the number of states in which the entity is seeking licensure, these requirements quickly become time and resource intensive.

The Treasury Report identifies the state oversight and harmonization challenges faced by entities offering financial services products across multiple states in the US. Thus, it recommends creating uniformity to streamline state supervision and licensing for non-bank financial institutions, such as adopting reciprocity-type measures to help reduce redundancies in the licensing and registration process. I fully support this recommendation.

As the Treasury Report notes, ongoing efforts are underway to build efficiencies into state licensing and registration processes. The Conference of State Bank Supervisors ("CSBS") and state regulators have made meaningful developments in this regard. One ongoing effort is the expansion of financial services industries that fall within the framework of the Nationwide Multistate Licensing System ("NMLS").[10] The NMLS is a technology platform that promotes information sharing and coordination between state regulators in state license activities (applications, updates, renewals, and surrenders). From a practical standpoint, the NMLS centralizes licensing and registration processes that would otherwise be scattered amongst numerous state regulators' systems. Expansion of the NMLS will help streamline and reduce the burden of the licensing processes.

The CSBS has also launched Vision 2020, its commitment to further harmonize the state-based regulatory regime.[11] Under Vision 2020, the CSBS and state regulators are exploring passporting-like efforts among the states. Earlier this year, seven states agreed to recognize the review and acceptance by other participating states of certain application

[10] States Expand Use of NMLS to New Industries updated Jan. 1, 2018, *available at:* https://mortgage.nationwidelicensingsystem.org/news/Pages/ExpandedUse.aspx
[11] Vision 2020 for Fintech and Non-Bank Regulation, dated June 7, 2018, *available at:* https://www.csbs.org/vision2020

materials for money services businesses.[12] Further passporting or reciprocity efforts between state regulators would be welcomed by the industry.

ALTERNATIVE CREDIT RISK MODELS

As the Treasury Report identifies, lenders are finding innovative ways to evaluate the credit risk for consumer and small business credit applicants by using alternative data in their risk analysis. This type of credit risk analysis often depends on results generated from the abundance of consumer data available online, coupled with machine learning. These models vary from traditional credit risk analyses; systems not only use alternative data but employ machine-based learning to determine outcomes for future credit risk decisions. Use of alternative data and machine learning for credit risk analyses puts to use a broader range of data, including data that may be less obviously associated with creditworthiness. These systems have been recognized as potentially helping lenders make sound credit risk decisions while increasing inclusion for applicants that are often excluded from other credit models.[13] For individuals who could be a decent credit risk, but have relatively thin credit histories, alternative data modelling may open credit access.

With the potential to render more accurate and reliable indicators of credit risks than traditional models, lenders, investors, and the larger economy could benefit significantly from exploring the use of these alternative credit models. Despite the benefits, however, lenders may be reticent to develop and utilize alternative credit models because of the unknown regulatory compliance risks. In particular, they often face concerns that the use of these models will expose them to liability under anti-discrimination statutes and regulations, including the Equal

[12] State Regulators Take First Step to Standardize Licensing Practices for Fintech Payments, dated Feb. 6, 2018, *available at:* https://www.csbs.org/state-regulators-take-first-step-standardize-licensing-practices-fintech-payments

[13] In February of 2017, the Bureau issued a Request for Information Regarding Use of Alternative Data and Modeling Techniques in the Credit Process. In its request, the Bureau acknowledged the "gaps in access to mainstream credit for certain consumer groups and segments" and the possibility that "alternative data modeling techniques" could help close these gaps and improve credit risk decisions. *See* https://files.consumerfinance.gov/f/documents/20170214_cfpb_Alt-Data-RFI.pdf.

Credit Opportunity Act and its implementing regulation, Regulation B ("ECOA").[14] ECOA liability may arise under several theories, some of which have not been tested with respect to Big Data and machine learning. Understanding more about how alternative credit models will be assessed under the current anti-discrimination prohibitions is critical for regulators to provide guidance that allows the careful development of this innovative technology.

REGULATORY SANDBOXES

Regulators and industry participants, alike, will benefit from the information obtained by testing new innovative technologies.

The purpose of a regulatory sandbox is essentially, to create an environment for firms to try out new ideas without threat of regulatory penalty. By providing this environment, regulators expect to create a range of beneficial outcomes for firms and consumers, such as:

a) reduced time to market for new products and services due to firms having greater certainty as to the regulatory treatment of those products and services;

b) better access to finance for firms seeking to raise funding for their new products and services, due to investors having greater comfort that the business will be viable from an operational and regulatory perspective;

c) the development of more innovative products, due to firms having the ability to test ideas in a supportive regulatory environment; and

d) better outcomes for consumers, due to the better quality of testing that can be applied within a sandbox environment. Also, the use of a sandbox enables the regulators to provide input on consumer protection features at an earlier stage of the product development process.

[14] 15 U.S.C. §§ 1691 et seq.; 12 C.F.R. § 1002.4(a).

In the United Kingdom, for example, the lead financial services regulator, the Financial Conduct Authority (FCA), has established a domestic regulatory sandbox which has been used as a model for other sandboxes around the world. The FCA is able to deploy the following tools to facilitate the operation of its regulatory sandbox:

a) Restricted Authorization

Where a firm wishes to conduct a regulated activity in the UK, it must be authorized by the FCA, unless its activities fall within the scope of an applicable exemption. Consequently, where a sandbox applicant's activities would involve the performance of regulated activities, it will need to apply for authorization from the FCA to perform those activities.

In order to streamline this process for firms that have been accepted into the sandbox, the FCA has developed a tailored authorization process. The authorization granted by the FCA for the sandbox applicant will be restricted so that firms may only test their ideas as agreed with the FCA. At the end of the sandbox testing period, the firm may either apply for full authorization, or its authorization will expire.

It should be noted that the restricted authorization option is not available for firms seeking a banking licence.

(b) Individual Guidance

The FCA is able, under its existing powers, to issue individual guidance to firms on the interpretation of the FCA rules applicable to the activities that the firm wishes to carry out. The FCA may use this power to issue individual guidance to help firms participating in the regulatory sandbox to understand the regulatory treatment of their proposed activities. If a firm acts in accordance with the guidance, it provides the firm with certainty that the FCA will not take action against it.

(c) **Waivers or modifications to the FCA's Rules**

The FCA has the statutory power to issue waivers or modifications to its rules where it is satisfied that:

(i) compliance by the person with the rules, or with the rules as unmodified, would be unduly burdensome or would not achieve the purpose for which the rules were made; and

(ii) the waiver or modification would not adversely affect the advancement of the FCA's objectives.

Consequently, where it is clear that proposed testing activities within the regulatory sandbox do not meet the FCA's rules, but the firm can meet the waiver test and the rules are within the FCA's power to waive, the FCA can waive or modify particular rules for sandbox firms. A waiver or modification allows what would otherwise be a temporary breach of the FCA's rules.

(d) "**No Enforcement Action" Letters**

In cases where the FCA is unable to issue individual guidance or waivers, but believes it is justified in the particular circumstances and characteristics of the sandbox test, the FCA can issue "no enforcement action" letters.

Such letters would state that the FCA will take no enforcement action against testing activities where they are reasonably satisfied that the activities do not breach the FCA's requirements or harm its objectives. The letter would apply only for the duration of the sandbox test.

Provided that the firm deals openly with the FCA, keeps to the agreed testing parameters and treats customers fairly, the FCA accepts that unexpected issues may arise and would not expect to take disciplinary action.

TRUE LENDER/VALID WHEN MADE

In my opinion, a handful of court decisions have wrongly called into question whether the bank is the "true lender" in a bank-fintech company partnership even if the bank extends the credit according to underwriting criteria it has approved, is included as the lender in the loan agreement, and holds the loan for some time after the loan is made. These court decisions are based on a "predominant economic interest" test that is subjective and that can be cited to conclude that the fintech company is the true lender in these circumstances. Whether the bank or fintech company is the true lender may be the difference in determining whether the loan is void or uncollectible, meaning that the lender may not be able to recover its principal, much less its costs and profit, depending on the court's "true lender" analysis. This uncertainty is having a chilling effect on innovation in the United States. To address this uncertainty, Congress should consider legislative language making clear that the bank is the "true lender" in these partnerships when it is extending credit.

A related but separate issue is the "valid when made" doctrine, which is a bedrock principle of lending in this country that was eroded by the court's decision in *Madden v. Midland Funding*[15]. In Madden, a loan originated by a bank was charged off and sold by the bank to a debt buyer. The debt buyer argued that because the loan was valid when it was made by the bank, any fees that could be charged by the bank under its governing statute also could be charged by the debt buyer. The court disagreed and held that the terms of the loan were now governed by the relevant laws applicable to the debt buyer and therefore invalid in the hands of the debt buyer. The court's decision is a problem not just for bank-fintech partnerships but for the U.S. credit markets more generally. To restrict the transferability of loans in this way is to prevent fintech companies from purchasing and attempting to collect on, sell, or securitize loans made by banks in these states because of the risk of litigation asserting violations of state usury

[15] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

laws. Congress should consider legislative language restoring the “valid when made” doctrine so that loans are freely transferable and the terms and conditions that applied when the loan was made remain intact, thereby preserving active credit markets in the US and facilitating the innovation that results from banks and fintech companies partnering together.

CONCLUSION

The Treasury Report is a very good start and I commend the Treasury Department on its publication. I would urge Congress to work together in a bipartisan fashion to address the recommendations that fall within Congress’ purview. The US cannot fall behind other countries and so we must ensure we have clear rules of the road and right now that is not the case.

Appendix

Fintech in the U.S.: The state of the union is questionable

Written by Aaron Cutler and published by FinTech Futures

05 Apr 2017

This is the first in a series of three articles by *Hogan Lovells' partner Aaron Cutler* and *associate Loyal Horsley* discussing the regulation of the fintech industry in the US.

This first article provides an overview of the current fintech regulation by the prudential regulators: the OCC, the FDIC, and the Federal Reserve.

The second instalment addresses the views of the Department of Treasury, the CFPB, and the SEC on the regulation of the fintech industry. The third one looks at state-level fintech regulation, proposed legislative solutions, and provide a brief overview of international regulation.

With President Donald J. Trump, it is difficult to predict how the legislative and regulatory landscape will change, but we expect a lighter regulatory environment. On 3 February 2017, President Trump issued an executive order laying out his core principles on financial regulation and mandating a review of current and proposed regulations with a view to their compatibility with those principles. Secretary Mnuchin will provide a report to President Trump in June providing his and the agency heads' analysis. Fintech has been an area of exciting innovation and regulatory interest, it remains to be seen how it will evolve under this new administration.

"Fintech" is a portmanteau of financial and technology and refers to the vast swath of emerging financial products and services relying on new technology. These include, but are not limited to, marketplace lending (like Prosper or Lending Club), online banking, Bitcoin and blockchain technology (also known as distributed ledger technology or DLT), money management apps (like Mint), and money transmitters/digital wallets (like Venmo and Paypal). Because of their increased availability and utility, state and federal financial regulatory agencies and state and federal legislatures have taken notice of fintech products, services, and

companies. There is discussion of whether fintech should be integrated into current laws and regulations or should be specifically addressed in new laws and/or regulations.

The federal regulatory landscape

Because it is new technology, there is not a defined regulator for fintech. At the federal level, there are many agencies that deal with financial regulation, these include the Department of the Treasury, the Office of the Comptroller of the Currency (OCC), the Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (FRB or the Fed), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission, the National Credit Union Administration, and the Federal Trade Commission.

The OCC, FRB and FDIC are considered prudential regulators because they focus on the safety and soundness of an institution, as well as the entire financial system. Because many fintech companies are partnering with banks in order to avoid expensive regulatory compliance costs, usually on the state level, the prudential regulators want to ensure they understand the marketplace and the risks posed by these new entrants. This article will focus on the prudential regulators' roles in regulating the fintech industry.

A growing role for the OCC

The OCC is the primary regulator for all national banks and federal savings and loan associations and it has been among the most proactive in addressing the concern of regulating a growing fintech industry. In December 2016, the OCC announced it was moving forward with its rather audacious plan to use its chartering authority to provide special purpose charters to fintech companies engaged in the "business of banking." The proposal sets out the OCC's chartering authority and provides a general outline of the initial and ongoing requirements for receipt of this charter. These requirements include capital, liquidity, and "financial inclusion" (which is the OCC's term for Community Reinvestment Act – CRA – type requirements).

While capital and liquidity requirements may deter some fintech companies from pursuing a charter, the most potentially burdensome requirements are those related to financial inclusion. As the CRA is only applicable to FDIC-insured institutions, it would likely not cover most OCC-chartered fintech companies. CRA compliance and applicability is already an issue for banks that do not have any brick and mortar branches (digital-only banks) – the CRA is enforced by looking at the bank's lending, investments, and services in the communities where they have branches.

The CRA requires banks to be examined and graded by their prudential regulator to monitor the bank's activity in low- and moderate-income neighborhoods that are traditionally underserved by lenders. Regulators adjust their examination based on the bank's size, with those institutions with more than $1 billion in assets receiving the most rigorous exams; intermediate banks (between $250 million and $1 billion in assets) and small banks (less than $250 million in assets) have successively less robust exams. The examiner reviews the bank's lending portfolio and determines the percentage and number of loans made to low- and moderate-income borrowers; examiners also review the percentage and number of accounts at the bank belonging to low- and moderate-income customers.

Importantly in this context, one of the guideposts for showing service to low- and moderate-income communities is the number and location of a bank's branches in those communities. If a bank has no branches, how can examiners measure whether it discriminates

against those areas it serves? If a branch is no longer a requirement to be a bank, the CRA will have to be retooled to continue being effective. Currently, some banks are partnering with marketplace lenders to help with their CRA statistics because online lenders are able to reach a wider swath of borrowers. These partnerships are potentially at risk, depending on the OCC's determination of what CRA-like requirements will apply to its chartered fintech companies.

While the comment period on the special purpose charter just ended on 15 January 2017, the OCC has approved the creation of "Offices of Innovation" in Washington, DC, New York and San Francisco. The hope is that fintech companies will reach out to these offices and discuss their products and services with the OCC prior to launching them, so that the regulator can assess potential consumer harm and help the fintech company understand the laws and regulations that may be applicable to the proposed product or service. If the fintech company is able to integrate the OCC's advice into their business model, including a mutual understanding of its compliance obligations, it will hopefully allow for a better consumer experience and provide both the business and the regulator with a robust understanding of how the company fits into the larger financial services landscape.

The Federal Reserve (FRB, the Fed)

The Fed does not directly regulate any of the entities currently involved in fintech, but it does control the US payment systems. As such, the FRB has a special interest in DLT and its potentially transformative presence in payment and settlement systems. In October 2016, the it announced its two task forces (one focused on faster payments capabilities, the other on payment system security) had begun review of proposals and assessments submitted by interested parties throughout the payments industry.

Their findings will be issued in a two-part report with the initial report published on 26 January 2017. The first report provided an overview of the task force's background, its processes, the benefits of faster payments, and the current US payments landscape.

In December 2016, the FRB released its long awaited report, "Distributed ledger technology in payments, clearing, and settlement" (FRB Report). The report reviewed the current payment, clearing, and settlement systems and provided its view of the potential opportunities and potential pitfalls for the integration of DLT into these systems. To compile the FRB Report, the team worked with industry leaders, in both banking and DLT to better understand both the "frictions" present in the current systems and the potential of DLT.

The report allows that DLT "could reduce or even eliminate operational and financial inefficiencies", but stresses the technology is in its infancy. Theoretically, DLT has the capability to seriously cut down the threat of large scale hacking and theft of information because it lacks a centralized database with the stored information. In addition, if DLT is going to be useful and transformative, it will have to adopted on a large scale rather than in a piecemeal fashion. Overall, the report agrees that DLT has exciting promise, but it is unlikely to revolutionise payments, clearing, and settlement systems in the very near future.

The FDIC protects, defends and burdens the banks

The FDIC has only has oversight over FDIC-insured institutions and is the primary federal regulator for all state-chartered insured depository institutions. Therefore, it does not regulate most of those industry participants typically included under the fintech umbrella. Banks, themselves, are entering the fintech "playground" and their activities would be covered

by the FDIC, but most fintech activities at banks is happening through their relationships with third parties.

With that in mind, the FDIC released its proposed Third Party Lending guidance in July 2016 (Proposed Guidance). It focuses on bank relationships with third party lenders, which mainly consists of online marketplace lenders. FDIC-insured institutions are incentivized to enter into relationships with marketplace lenders because it allows them to reach a wider potential audience and can pad the bank's portfolio with regard to its obligations under the CRA.

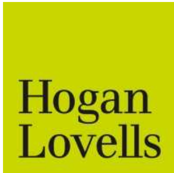
The FDIC warns, however, that the bank's board of directors and management are ultimately responsible for the activities of any third party with which it has a relationship. Therefore, the Proposed Guidance details the sort of risk assessments and ongoing compliance oversight a bank must conduct prior to entering, and throughout, a relationship with a third party lender.

In addition, the FDIC has stated it will evaluate the third party's activities as if they were being conducted by the bank, itself. That means the bank must have enough capital and liquidity to properly safeguard against the increased risk of third party loans. The bottom line is, banks are allowed to enter into third party lending relationships, but they will be subjected to increased scrutiny from the FDIC. Because the Proposed Guidance is from the FDIC, it would only be applicable to state-chartered banks that are not members of the FRB. The OCC and FRB, however, may well take cues from the FDIC.

The comment period on the Proposed Guidance ended in October 2016. While one would usually expect a final rule by probably mid-2017, the new administration has staked out a distinctly anti-regulation point of view. While the Proposed Guidance does not really create additional regulations, it does strengthen the FDIC's oversight of any bank with third party lending relationships, which the Trump administration may view as inappropriate and overly burdensome.

What's next?

While a light regulatory touch is usually the preferred system for start-ups and innovation, in financial services that often breeds more confusion than capital. It has long been understood that banks are special – deposits are backed by the full faith and credit of the United States Treasury and banks provide the lubrication for our entire financial system, and therefore the safety and soundness of the U.S. and global economy. This responsibility can make people wary to enter the financial services sector without proper direction from regulators. At the moment, the prudential regulators are poised to offer guidance and new opportunities to fintech businesses, but the future is uncertain.



U.S. fintech regulation: A divided picture at the federal level

Written by Aaron Cutler and published by FinTech Futures

12 Apr 2017

Hogan Lovells' partner Aaron Cutler **and** ***associate Loyal Horsley*** **address the views of the Department of Treasury, the CFPB, and the SEC on the regulation of the fintech industry in the US.**

This is the second in a series of three articles discussing the regulation of the fintech industry in the US.Click here to read the first article, which provides an overview of the current fintech regulation by the prudential regulators: the OCC, the FDIC, and the Federal Reserve.

While the prudential regulators are testing the waters in fintech regulation, other federal agencies have also focused on fintech's potential, both as a disruptor and as a potential market infrastructure tool. Marketplace lending has been a topic of regulatory and industry conversation for the last several years.

Currently, marketplace lending is attempting to fill gaps still left in credit availability after the financial crisis, especially in small dollar small business loans. In this case, small dollar means $250,000 or less. Community banks have generally provided the lion's share of small business and agriculture loans in the US, but the financial crisis and the response to it both eliminated many community banks and created a credit crunch. Marketplace lenders have stepped up to fill in the resulting gaps for both small business and personal loans. While the first generation of marketplace lenders tended to be distinct, separate entities, many are now partnering with banks. Marketplace lenders are not the only ones: money transmitters are exploring bank partnerships in order to avoid costly and time consuming fifty state licensing solutions.

The Department of Treasury oversees the entire US financial system and economy and is a guiding force when it comes to regulatory scrutiny.

The Securities and Exchange Commission (SEC) regulates the primary and secondary markets of the US and safeguards consumers in that space. A recent expansion of the rules on raising capital online, as well as the entry of new players, such as online marketplace lenders,

in the mortgage securitisation space has implicated the SEC's involvement in fintech, which will likely only grow as fintech expands its footprint.

The Consumer Financial Protection Bureau (CFPB) regulates consumer financial products and services, which covers most of fintech's new and exciting tools. The CFPB has direct supervision over financial institutions with $10 billion or more in total assets. Each agency has taken an interest in the growing role fintech is playing in the U.S. and international financial systems.

Treasury takes notice

In May 2016, Treasury released a white paper entitled "Opportunities and Challenges in Online Marketplace Lending" and has sent representatives to speak at several conferences on the topic of marketplace lending. The white paper was drafted as a follow-up to Treasury's request for information (RFI), "Public Input on Expanding Access to Credit through Online Marketplace Lending", which was issued in July 2015.

Treasury received about 100 responses to its RFI and the white paper is generally positive about the potential for online marketplace lending to expand access to credit. Treasury offers its view of the RFI responses and provides some advice and recommendations for moving forward in this space. It found that online marketplace lending has expanded access to credit, especially small businesses, though the majority of the loans originated were for consolidating debt. The expansion of data used for underwriting was one of the more exciting innovations by online lenders and is being adopted by a larger segment of the financial services industry. However, these "data-driven algorithms" do not provide the borrower the opportunity to correct information and they may result in fair lending violations and disparate impacts. It's really too early to determine the impact, but the expansion of data and modeling are an area on which Treasury will continue to focus. In addition, online marketplace lending has emerged in the low cost of credit environment during the Obama years; these lenders have not been properly tested during a higher cost of capital environment.

Small business' access to credit has been a big focus in the last few years. Many RFI responders drew attention to the relative lack of financial protection for small businesses. The Obama years have seen an immense focus (at both legislative and regulatory levels) on consumer protection, exemplified by the creation and expansive authority of the CFPB (which will likely be narrowed by Congress and the Trump Administration).

However, small businesses do not enjoy the same level of oversight and protection. Clearly, small businesses do not uniformly want increased regulatory oversight, but offering enhanced protections for small businesses in terms of consumer-like disclosure and reporting obligations were generally favored by the commenters. Some consumer advocates argued that small businesses should be treated as consumers for lending purposes. Considering people often have different definitions for what constitutes a small business, this treatment seems rife with potential misuse and unlikely to survive legislative or regulatory muster.

Finally, the white paper reviews the secondary market for loans originated by online marketplace lenders. Securitization of these loans is not well developed at the moment and will require further regulatory guidance. The SEC is reviewing the implications of online marketplace lenders selling loans into the secondary market.

Fintech in the markets

The SEC is also getting into the game on fintech. It has established a Distributed Ledger Technology (DLT) Working Group to investigate the new technology and its potential uses and abuses. Further, the SEC is looking at the growing field of crowdfunding, both its Regulation Crowdfunding equity crowdfunding model and others, including debt crowdfunding. In addition, the marketplace lending market, especially securitisation of loans, is of particular interest to the SEC.

Acting Chairman Piwowar is especially interested in promoting fintech and the SEC's role as regulator and ally to the growing industry; he championed the SEC's Fintech Forum, which was held in November 2016. The Fintech Forum reviewed robo-advisors, DLT, new paths for capital formation, and investor protection. Robo (or digital) advisors are increasingly common and are often used by individuals with smaller investments who either cannot afford an investment advisor or would like to supplement that advice. Digital advisors' assets under management are projected to reach $2.2 trillion by 2020.

The panel participants stated their view of the future is that this becomes just "investment advice" rather than "digital investment advice" as humans would lean on algorithms and computing power to give investment advice anyway. The future of investment advice does not appear to be solely computer-based, but will certainly be an intricate blend of algorithmic and experienced-based advice, which would likely trigger the Investment Advisers Act of 1940's provisions requiring registration (Section 203) and compliance with a fiduciary standard (Section 206, as understood by the Supreme Court in *S*EC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)).

Capital formation for small(er) businesses was an ongoing preoccupation for the Obama administration and the Republican Congress, which signed the bipartisan JOBS Act in 2012. One of the most exciting provisions of the JOBS Act was the advent of SEC-regulated equity crowdfunding, which allows businesses to offer securities over the internet. Its main utility is for small businesses, since it limits offerors to raising $1 million per year. This is an example of simple fintech: a tool providing a new route to capital for small businesses that would not be able to conduct an IPO or have access to venture capital. Regulation Crowdfunding, 17 C.F.R. § 227.100 et seq., became effective 16 May 2016 and has so far been a great success, according to the SEC.

Blockchain/DLT is one of the only truly new innovations and its use for traditional financial services, as well as other industries, is still being discussed. However, some organisations are forging ahead with its use. For instance, Sydney Stock Exchange has revamped its settlement system, and so has its larger competitor Australian Securities Exchange (ASX), which is expected to start using blockchain later this year. Both stock exchanges believe the new technology will drive down costs, increase efficiency and transparency, and decrease risk.

One of Switzerland's largest market infrastructure providers, SIX Securities Services is currently working on a proof-of-concept (PoC) to integrate blockchain into the Swiss financial system.

In the US, Cook County, Illinois, is currently running a pilot program to use blockchain to transfer and track property titles and other public records. The Cook County Recorder's Office is the second largest in the US, so the adoption and success of a DLT system there would likely encourage other states and counties to use the technology.

On top of DLT, the advent of "smart contracts" has the ability to change payments drastically. A smart contract is an autonomous program that directs money without human interference according to an algorithm. An example: if an investor is willing to provide funding to a start-up, but only if they reach a certain capital threshold; they can execute a smart contract that will automatically go into effect upon the start-up reaching that threshold. The parties will not need to discuss it further or provide any instructions after the original agreement.

This sort of tool could simplify complex payment agreements in many spheres. For example, in a farmer's drought insurance agreement, the parties could agree that after 15 days of zero rain, as recorded by the National Weather Service in the farmer's zip code, the insurance company would make a certain payout without the farmer having to make a claim.

DLT and smart contracts are also being discussed in the healthcare industry, as a way to keep up with patient records. In both the health care and financial services sector, the biggest potential issues are privacy and security, which must be adequately addressed before DLT can be used for mass market record-keeping.

The CFPB, fintech and the future

The CFPB has been among the most active agencies in engaging the fintech industry. Because so much of financial innovation does not fit within the bailiwick of "banking" or even the broader "business of banking", but is certainly a consumer financial product or service, the CFPB is the relevant federal agency. In this role, it has undertaken "Project Catalyst," which encourages "consumer-friendly innovation in markets for consumer financial products and services".

One of its major "outreach" efforts is the new no-action letter policy, which encourages fintech companies to reach out to the CFPB by providing information regarding their product or service and their understanding of the compliance requirements. By providing a no-action letter, the CFPB is indicating it believes the company is in compliance with the relevant laws and regulations and the CFPB is not going to file an enforcement action so long as the company does not make material changes.

While the CFPB's policy is quite friendly, its no-action letters are not binding on other agencies, so that leaves a fintech company vulnerable to the determination, by another regulator, that it is not in compliance with all relevant laws and regulations. This is obviously true of any agency's no-action letter, but considering most of the federal financial regulators are having trouble deciding what to do with fintech, many companies may decide not to take the chance of relying on the CFPB's say-so. Again though, regulating by No-Action Letter is much less desirable than actually going through the Administrative Procedure Act-mandated rulemaking process.

The CFPB did recently release its long awaited Prepaid Card Rule, which provides a very broad definition of "prepaid card" that encompasses mobile wallets, like Google Wallet and Paypal, where you can not only send money, but also store it. Money transmission is moving money from one place/person to another, and while Paypal and Venmo provide that service, they also allow users to keep money in the app rather than transfer it to their bank account. This service places them within the scope of the CFPB's new rule.

Mobile wallets are one of the more exciting and popular recent innovations, splitting the bill at dinner or having multiple friends purchase a present has never been easier now that

everyone can transfer funds quickly and for free. Considering their popularity, the CFPB likely felt compelled to provide consumer protections where there may be a need, but this sort of rule could cut down on start-ups entering this space as they would have to hire experts and attorneys to ensure compliance and avoid potential enforcement actions.

The CFPB is likely the most vulnerable agency in a Trump government. Its broad mandate and limited congressional oversight has made it a target of Trump and Congressional Republicans. While it is incredibly unlikely the CFPB would actually be dismantled, its structure and leadership will almost certainly change, likely relatively early in President Trump's term. The Court of Appeals for the D.C. Circuit's recent decision in PHH Corporation, et al. v. Consumer Financial Protection Bureau found the current structure of the CFPB is unconstitutional.

However, the court provided a simple fix: the president can now remove the Director of the CFPB at will, rather than only for cause. The D.C. Circuit granted an en banc rehearing on 26 February 2017 and oral arguments began in March. Due to the rehearing, the previous order is on hold pending the rehearing. A rollback of current regulations and policies will be difficult to enforce, but the uncertainty may further discourage fintech innovators from working with the CFPB.

States are also involved in regulating fintech and their role may grow if President Trump follows through on his early moves to cut down on federal regulation. Several states, including New York, which is very influential in financial services regulation, have stated their goal of stepping into any federal void created by regulatory rollback. In addition, Congress is focused on both financial regulatory reform, in general, and fintech-specific legislation. The new Congress and President Trump's terms have barely begun, so their effect on the fintech industry remains to be seen.

Hogan Lovells

Fintech in the U.S.: Where is regulation headed

Written by Aaron Cutler and published by FinTech Futures

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***Aaron Cutler, partner, and Loyal Horsley, associate at Hogan Lovells*, examine the state-level fintech regulation, proposed legislative solutions, and provides a brief overview of international regulation.**

This is the third in a series of three articles discussing the regulation of the fintech industry in the US. Click here to read the first instalment (an overview of the current fintech regulation by the prudential regulators: the OCC, the FDIC and the Fed). Click here to read the second article, which addresses the views of the Department of Treasury, the CFPB, and the SEC on the regulation of the fintech industry.

As discussed in earlier articles, fintech regulation is unsettled at the moment. Federal financial regulators are all addressing fintech issues in different ways and the efficacy of some approaches remains to be seen. In order to ensure consumer protection, while also encouraging innovation and, hopefully, spurring economic growth, both state regulators and the federal legislature have also stepped into fintech oversight.

State rules and regulations

While federal regulators and legislators have spent many months working to find solutions to address this growing industry, states have also been working hard to encourage "responsible innovation" in the fintech industry. Much of the innovation in fintech is really in the delivery system, rather than the product itself. More often than not, fintech is just speeding up the process for services, such as transferring funds. Because of that, the state-level money transmitter licensing schemes are well-positioned to regulate much of the burgeoning fintech industry.

While it's a point of contention, and some states are working on separate frameworks to address it, even the most "exciting" fintech innovation – virtual currency and blockchain technology – often falls under this regulatory regime. Money transmission is defined by each state, but the general idea is that a company transmits or converts money. This definition captures many of the fintech businesses making waves at the moment and simplifying/speeding up this process is the focus of many of the innovators.

Money transmitters, or money services businesses, operating across state lines (which is almost impossible not to do in the age of the internet/smartphone) must be licensed in each state in which they operate (except Montana, which does not currently have a licensing requirement), which is an expensive proposition. New York, Connecticut, North Carolina, and Washington have drafted licensing requirements specific to virtual or digital currency, just to name a few. The Uniform Law Commission is finalizing the Regulation of Virtual Currency Businesses Act, in the hopes of streamlining states' virtual currency regulation. The drafting committee met in March 2017 to review and revise the current proposal.

Banks, of course, provide money transmission services and are not required to be separately licensed to do business in this space, which leads to many partnerships between banks and fintech companies – and to the reason the banking agencies are desperately trying to address this industry.

Proposed legislative solutions

The most comprehensive legislative proposal addressing this industry currently on the table is Rep. Patrick McHenry's (R-NC) Financial Services Innovation Act of 2016. The bill was introduced as part of the House Republicans Innovation Initiative, led by Majority Leader McCarthy (R-CA) and Rep. McHenry, which has the stated goals of "fostering innovation to spur greater economic growth and to bring our government into the 21st century".

The Financial Services Innovation Act proposes to create a Financial Services Innovation Office (FSIO) within the CFPB, CFTC, FCA, FDIC, FHFA, FRB, FTC, HUD, OCC, NCUA, SEC, and Department of Treasury. Recognising that fintech and financial innovation may not touch all of those administrative agencies, it has a sunset provision, meaning that if the FSIO in an agency has not received a petition in five years, it will be eliminated.

To coordinate between the various agency FSIOs, there will be the FSIO Liaison Committee to ensure uniformity of standards and advice throughout the FSIO system.

The main point of the FSIO (and the Financial Services Innovation Act more generally) is, similar to the OCC's Offices of Innovation, chiefly to encourage those with interesting and innovative ideas to come to the regulators to try to ensure a compliant product or service.

A fintech provider files a petition with the relevant agency in which the petitioner provides an "alternative compliance strategy" for its product or service and shows the regulator that this strategy would serve the public interest, increase access to financial products and services, promotes consumer protection, and does not present a systemic risk to the financial system. Upon receipt of a petition, the chosen agency must review it and provide for public comment. If the petition is approved, the agency and fintech provider can enter into an "enforceable compliance agreement," in which the agency may waive certain of its regulatory requirements and prohibits other federal agencies and states from commencing enforcement actions against the protected fintech provider. This proposal echoes the "fintech sandbox" approach of some other governments, discussed below.

This bill is still in its infancy, legislatively speaking, and will likely be heavily modified, especially the enforceable compliance agreement's moratorium on enforcement actions. However, with a Republican president and Republican Congress, it may have a chance of passing. While President Trump has railed against increased regulation, the McHenry bill provides for the elimination of any offices that aren't used, increases public interaction with regulators, and essentially forces the regulators to embrace and encourage new and innovative fintech products and services, so the new administration may view it favourably.

While the proposed legislation and regulations address the current state of fintech and will likely be helpful in the near future, there are several unaddressed potential issues.

First and foremost would be the potential of a non-bank fintech company to become a non-bank systemically important financial institution (a non-bank SIFI) under the Dodd-Frank Act, as determined by the Financial Stability Oversight Council. While currently that may seem sort of silly, if, for example, Google or Apple or Facebook became an active player in the financial services sector, they could easily overwhelm the competition and become an essential player in the market. The non-bank SIFI designation is required for those non-bank financial service providers whose failure could potentially trigger a financial collapse. Because of some tech companies' ubiquity in our daily lives, their collapse could absolutely have a contagion effect on the financial services industry. Currently, the regulatory burden of entering into the financial services industry (likely along with other considerations) has kept these technology giants out of it, but the basic tenets of capitalism suggest that if they had the right product or service, they would enter the fray. Chairman Jeb Hensarling (R-TX) and other Congressional Republicans have introduced legislation to take away FSOC's authority to designate non-bank SIFIs. The removal of that authority could lessen the potential pitfalls of a big tech company entering this space.

A global perspective on US fintech regulation

Perhaps surprisingly, the U.S. is not the leader in addressing fintech's place in regulated financial services. In the UK, the Financial Conduct Authority (FCA) has authorised a "fintech sandbox", which allows companies, both start-ups and current players, to provide the product or service to a limited consumer audience before requiring regulatory compliance/ licensing, as applicable. On the one hand, this encourages innovation and allows beta testing of new products and services; consumers can be exposed to the cutting edge of fintech and decide whether or not products and services are useful to them. It does, however, increase the chance of consumer harm. This programme only went live in May 2016, so we have yet to get to see how well it works.

Both Singapore and Hong Kong have also decided to adopt the "sandbox" approach.

The Bank of Canada, Canada's central bank, recently experimented with digital currency, creating the CAD-Coin and running a pilot programme with several large financial institutions. While the Bank of Canada has stated it has no plans to actually issue a digital Canadian dollar, its experimentation with virtual currency and its report issued in August 2016 shows the momentum and increased acceptance of virtual currency. Similarly, the Bank of England is reviewing the possibilities of digital currency and blockchain technology.

Onward!

As it stands, a start-up with an innovative proposal for a financial product or service could easily be completely lost in the current quagmire of federal and state laws, regulations,

and proposed solutions. Some either forge ahead without an understanding of current and potential compliance responsibilities, which could be harmful, both to consumers and to the company. Others try to gain an understanding of what rules are applicable to their product or service and lose momentum or faith due to the overlapping regulations and the large gaps facing the fintech industry.

On the one hand, the general proposals for deregulation may allow fintech companies to go to market earlier in their lifecycle, but it may also increase the potential for consumer harm, not to mention potential enforcement actions. The US is full of people with innovative ideas that may change banking and financial services entirely and the regulators are trying to have an open mind and a ready ear.

It remains to be seen if the “disruptive” politics of President Trump will hasten or stall this tenuous march toward acceptance. His “America First” worldview may lend itself to the US becoming the leader in fintech by establishing clear rules of the road, so fintech companies can prosper while ensuring the safety and soundness of the US financial system.