MAXINE WATERS, CA
CHAIRWOMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

PATRICK MCHENRY, NC
RANKING MEMBER

June 20, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: June 25, 2019, "Overseeing the Fintech Revolution: Domestic and International Perspectives on Fintech Regulation"

The Task Force on Financial Technology will hold a hearing entitled "Overseeing the Fintech Revolution: Domestic and International Perspectives on Fintech Regulation" at 2:00 p.m. on Tuesday, June 25, 2019, in room 2128 of the Rayburn House Office Building. This single-panel hearing will have the following witnesses:

- **Paul Watkins**, Assistant Director, Office of Innovation, Consumer Financial Protection Bureau (CFPB)
- **Beth Knickerbocker**, Chief Innovation Officer, Office of the Comptroller of the Currency (OCC)
- **Valerie Szczepanik**, Associate Director of the Division of Corporation Finance and Senior Advisor for Digital Assets and Innovation, Securities and Exchange Commission (SEC)
- **Charles E. Clark**, Director, Department of Financial Institutions, State of Washington, on behalf of the Conference of State Bank Supervisors (CSBS)
- **Christopher Woolard**, Board Member and Director of Strategy and Competition, Financial Conduct Authority (FCA), United Kingdom

Overview

While there is no consensus definition of which technologies qualify as new or innovative enough to be "fintech," it is generally understood that the term refers to innovations to the way a financial activity is performed that are made possible by recent rapid advances in digital information technology.[1] Underlying, cross-cutting technological advancements that enable fintech include: increased capability in data collection, storage, and processing; development of algorithmic decision-making (and the related technological evolutions towards machine learning and artificial intelligence); and increasingly widespread, easy access to the internet and mobile technology. The complementary use of these technologies in the delivery of financial services could potentially create efficiencies,[2] possibly leading to reduced prices for and increased access to financial services, including for consumers and small businesses.[3]

---

[1] Patrick Schueffel, "Taming the Beast: A Scientific Definition of Fintech," *Journal of Innovation Management*, vol. 4, no. 4 (2016), pp. 32-33.
[2] Thomas Philippon, *The Fintech Opportunity*, National Bureau of Economic Research, Working paper 22476, Cambridge, MA, August 2016, pp. 2-9.
[3] Financial Stability Board, *FinTech and Market Structure In Financial Services: Market Developments and Potential Financial Stability Implications*, February 14, 2019, pp. 1-5, at https://www.fsb.org/wp-content/uploads/P140219.pdf.

New technologies can also generate risks. It may be difficult to predict how an innovation with little track record will perform, so there could be instances, for example, where certain technologies involving payments ultimately may not distribute funds as intended. In addition, fintech startups may be inexperienced in complying with applicable laws and regulations. Some studies[4] suggest that the use of fintech can result in disparate impact on protected groups,[5] and that the increasing use of high-speed internet and mobile devices in finance may be leaving behind groups that cannot afford those services and devices.[6] Given that most of the federal financial regulatory framework was created prior to the development and deployment of many recent technologies, regulators are grappling with how to regulate in a way that appropriately mitigates the risks these technologies may present while fostering the adoption of potentially beneficial technologies.

The remainder of this memo focuses on selected issues facing certain U.S. and international regulatory agencies and the approaches these agencies have adopted or considered to resolve those issues.[7]

Federal and State Bank Regulators

The federal bank[8] regulators—the Office of the Comptroller of the Currency, the Federal Reserve (Fed), and the Federal Deposit Insurance Corporation (FDIC)—face a number of issues presented by fintech and its deployment in the banking industry. While the Fed does not have an innovation office and the FDIC is in the process of standing up one, the OCC established an Office of Innovation in 2016 as part of a series of actions designed to promote responsible financial innovation.[9]

Certain fintech innovations, particularly in lending and payment processing, may make it possible for technology-focused, nonbank companies to efficiently perform certain activities that have traditionally been the core business of banks. This raises questions over whether certain fintechs should be regulated as banks. Currently, fintech firms are generally regulated by the states and the laws to which they are subject may vary in each state.[10] Furthermore, state banking regulators, organized through the Conference of State Bank Supervisors, are implementing "Vision 2020," an initiative to modernize state regulation of non-bank and fintech companies through several steps, including harmonizing multi-state supervision and improving third-party supervision.[11]

---

[4] For example, see Robert Bartlet, Adair Morse, Richard Stanton, et al., *Consumer Lending Discrimination in the Era of Fintech*, University of California-Berkley working paper, October 2018, at https://faculty.haas.berkeley.edu/morse/research/papers/discrim.pdf.

[5] The Equal Credit Opportunity Act (ECOA; 15 U.S.C. §§1691-1691f) generally prohibits discrimination in credit transactions based upon certain protected classes, including an applicant's sex, race, color, national origin, religion, marital status, age, and "because all or part of the applicant's income derives from any public assistance program." ECOA historically has been interpreted to prohibit both intentional discrimination and *disparate impact* discrimination, in which a facially neutral business decision has a discriminatory effect on a protected class. For background on disparate impact claims, see CRS Report R44203, *Disparate Impact Claims Under the Fair Housing Act*, by David H. Carpenter.

[6] Terri Friedline, *Unequal Fintech Landscapes*, New America, March 2018, https://newamerica.org/documents/2110/Unequal_Fintech_landscapes_FINAL.pdf.

[7] This memo was prepared with the assistance of David W. Perkins, Cheryl R. Cooper, and Eva Su with the Congressional Research Service (CRS). This memo is not exhaustive of all regulatory agencies and issues relating to financial technology. For more information from CRS, see https://www.crs.gov/Reports/IF10513 and https://www.crs.gov/Reports/IF11195.

[8] For brevity, this memorandum will focus on the banking industry and bank regulators. However, certain issues raised here are also concerns for credit unions and credit union regulators, including the National Credit Union Administration.

[9] Anthony Ponikvar, *OCC Announces Creation of New Office to Foster the Development of Fintech in Banks*, BakerHostetler, November 2016, https://www.finservblog.com/2016/11/occ-announces-creation-of-new-office-to-foster-the-development-of-fintech-in-banks/.

[10] To avoid certain state interest rate limits, some fintech firms have established relationships with banks wherein the bank originates the loan that the fintech funds and underwrites. Such arrangements have raised legal questions concerning federal preemption of state usury laws—specifically, whether federal laws that allow *banks* to "export" the maximum interest rates of their "home" states apply to loans that are originated by banks but later purchased by *non-bank* entities. For more information on this issue, including cases involving the "valid when made" and "true lender" doctrines, see CRS Report R45726, *Federal Preemption in the Dual Banking System: An Overview and Issues for the 116th Congress*, by Jay B. Sykes.

[11] https://www.csbs.org/vision2020

In contrast, the OCC announced in July 2018, that it would consider "applications for special purpose bank charters from [fintech] companies that are engaged in the business of banking but do not take deposits."[12] The OCC and proponents of the fintech charter argue that it would free a set of innovative companies from an ill-suited state-by-state regulatory regime and allow them to safely and efficiently provide beneficial financial services. Opponents generally assert both that the OCC does not have the authority to charter these types of companies and that doing so would inappropriately allow fintech companies that held the charter to circumvent important state-level consumer protections.[13] Subsequent to the OCC's July 2018 announcement, state regulators filed lawsuits challenging the OCC's assertion that it has the authority to grant such charters.[14] To date, the OCC has not granted a fintech charter. In addition, some commentators have speculated about whether the Fed should grant holders of these charters direct access to its payment systems as it generally does with traditional banks.[15]

Another possible option for fintech companies to operate a bank is to establish an industrial loan company (ILC). An ILC charter is a state-level charter that allows the holder to perform certain banking activities. The commercial parent holding company of the ILC is generally not subject to Fed supervision as a financial holding company would be. Opponents of ILCs argue that creating an avenue for a commercial firm (such as a large technology company) to own a depository would blur the line between commerce and banking and expose the U.S. economy to these types of risks.[16] Proponents of ILCs generally view these concerns as overstated, citing the potential benefits of a mixed arrangement (e.g., economies of scale, risk diversification, information efficiencies, customer convenience/savings).[17]

In addition, banks that lack the in-house expertise to set up and maintain fintech are increasingly relying upon third-party vendors, specifically technology service providers (TSPs), to provide software and technical support. In recent years, the bank regulators have issued new or updated guidance documents aimed at least in part at clarifying bankers' understanding of their responsibilities in managing their TSP and fintech company relationships.[18]

Consumer Financial Protection Bureau (CFPB)

In 2012, the Consumer Financial Protection Bureau established "Project Catalyst," which was later modified and renamed the Office of Innovation in 2018.[19] The office's mission is to promote innovation, competition, and consumer access within financial services through regulatory relief, engagement with

---

[12] OCC, "OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies," press release, July 31, 2018, https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html. The OCC had been considering taking this action for some time, and first announced its intention to study the issue in 2016.

[13] Conference of State Bank Supervisors (CSBS), "CSBS Responds to Treasury, OCC Fintech Announcements," press release, July 31, 2018, at https://www.csbs.org/csbs-responds-treasury-occ-fintech-announcements. For more information on this issue, see CRS Report R44614, *Marketplace Lending: Fintech in Consumer and Small-Business Lending*, by David W. Perkins; and CRS Report R45726, *Federal Preemption in the Dual Banking System: An Overview and Issues for the 116th Congress*, by Jay B. Sykes.

[14] CSBS, "CSBS Sues OCC Over Fintech Charter," press release, October 25, 2018, at https://www.csbs.org/csbs-sues-occ-over-fintech-charter, and Jonathan Stempel, "New York Sues U.S. to Stop Fintech Bank Charters," *Reuters*, September 17, 2018, at https://www.reuters.com/article/us-usa-treasury-fintech-lawsuit/new-york-sues-u-s-to-stop-fintech-bank-charters-idUSKCN1LU21O.

[15] Pete Schroeder, "Fintech Firms Want to Shake Up Banking, and That Worries the Fed," *Reuters*, January 14, 2019, at https://www.reuters.com/article/us-usa-fintech-fed/fintech-firms-want-to-shake-up-banking-and-that-worries-the-fed-idUSKCN1P80C0.

[16] Independent Community Bankers of America, *Industrial Loan Companies: Closing the Loophole to Avert Consumer and Systemic Harm*, March 2019.

[17] James R. Barth, Tong Li, et al., *Industrial Loan Companies: Supporting America's Financial System*, Milken Institute, April 2011, pp. 1-6, 62-67.

[18] For example, see Office of the Comptroller of the Currency (OCC), *Description: Frequently Asked Questions to Supplement OCC Bulletin 2013-29*, OCC Bulletin 2017-21, June 7, 2017, questions 6-14, https://www.occ.gov/news-issuances/bulletins/2017/bulletin-2017-21.html; and FDIC, *Technology Service Provider Contracts*, Financial Institution Letter-19-2019, April 2, 2019, https://www.fdic.gov/news/news/financial/2019/fil19019.html.

[19] For more information about this office, see https://www.consumerfinance.gov/about-us/innovation/.

the fintech community, and collaboration with other regulators. CFPB recently proposed three policies to reduce regulatory requirements for new financial technologies. First, the CFPB proposed revisions to a 2016 *No Action letter* policy, relaxing the criteria for companies to apply for a enforcement relief. Second, the CFPB proposed a new policy, called a *product sandbox*, to grant statutory and regulatory safe harbors and exemptions to certain companies, for limited periods of time, generally 1 or 2 years.[20] Lastly, the CFPB proposed revisions to its trial disclosure program, which allows companies to waive requirements to test and improve consumer disclosures for financial products.[21] These proposals have garnered support from industry and opposition from consumer groups and some state attorneys general.[22]

Securities and Exchange Commission (SEC)

Recently, financial innovation in capital markets has created new forms of fundraising for firms, such as crowdfunding and initial coin offerings (ICOs).[23] Innovation has also led to the emergence of a new asset class, referred to as digital assets.[24] In addition, fintech has been applied in investment management, most notably in robo-advising (essentially, an automated digital investment advisory program offering asset management services to clients through online algorithmic-based platforms).[25] The SEC oversees the capital markets, and it faces a number of issues related to how to apply regulation when new technologies are used.[26]

Specific policy issues raised include whether applying federal securities regulations to certain innovative activities based on the current definition of a "security" results in adequate investor protections while at the same time not hindering potentially beneficial innovation. In addition, aspects of general SEC regulations related to asset valuation, trading, and safekeeping present challenges when applied to digital assets. The SEC has generally applied the existing regulatory framework to fintech, without tailored rulemaking. One rationale for this approach is that many industry experts believe that, given the speed at which innovations evolve, more prescriptive fintech rules may quickly become obsolete.[27] However, some fintech advocates have advocated for more tailored regulation.[28]

Apart from rulemaking, the SEC has broadly increased enforcement activities and allocated resources towards building fintech-related capacities, including by establishing a new Cyber Unit to increase monitoring of and enforcement against illicit digital asset transactions.[29] In October 2018, the SEC launched a program called the Strategic Hub for Innovation and Financial Technology—or "FinHub"—to engage with the fintech industry, consolidate and clarify communications, and inform

---

[20] CFPB, "Policy on No-Action Letters and the BCFP Product Sandbox," 83 *Federal Register* 239, December 13, 2018.

[21] CFPB, "Policy to Encourage Trial Disclosure Programs," 83 *Federal Register* 175, September 10, 2018.

[22] https://www.covfinancialservices.com/2019/02/consumer-groups-and-some-states-oppose-cfpb-policies-aimed-at-promoting-fintech-innovation/

[23] For more information on crowdfunding, initial coin offering, and other securities offerings, see CRS Report R45221, *Capital Markets, Securities Offerings, and Related Policy Issues*, by Eva Su.

[24] Digital assets are digital representations of value made possible by cryptography and blockchain technology. They include digital representations of currencies, tokens, securities, commodities, or commodity derivatives. For more details, see CRS In Focus IF11004, *Financial Innovation: Digital Assets and Initial Coin Offerings*, by Eva Su.

[25] SEC, *Investment Management Guidance Update: Robo-Advisers*, February 2017, at https://www.sec.gov/investment/im-guidance-2017-02.pdf.

[26] As noted earlier, this memorandum is not an exhaustive examination of all regulatory issues related to fintech. For brevity, this memorandum examines the SEC only. However, the Commodities Futures Trading Commission and state-level regulators also face issues related to innovative fintech in securities and derivatives trading.

[27] Bloomberg Government, *Securities and Exchange Commission Fintech Forum: Distributed Ledger Technology and Digital Assets*, Transcript, May 31, 2019, p. 39.

[28] For example, see Richard B. Levin, "Should the SEC Allow Fintech Firms to Play in a Sandbox," *Polsinelli Financial Technology (Fintech) eAlert*, March 2017, and Letter from Vincent Molinari, CEO and President of Ouisa Capital, LLC, to Securities and Exchange Commission, March 13, 2017, at https://www.sec.gov/rules/petitions/2017/petn4-710.pdf.

[29] SEC, *2018 Annual Report: Division of Enforcement*, November 2, 2018, pp. 3-4, 7-8, at https://www.sec.gov/files/enforcement-annual-report-2018.pdf.

policy.[30] SEC staff also have issued *No Action* letters to individual fintech businesses and to signal its regulatory intentions. They recently issued a *No Action letter* to TurnKey Jet, which advised the business-travel startup that the SEC would not take an enforcement action against the company if it offered and sold tokens without registration based on certain representations by its counsel.[31]

In addition, the SEC has invited industry representatives to provide information prior to potential rulemaking. For example, it sent a letter in March 2019 to an investment management association for input regarding the custody of the digital assets of their clients.[32] The SEC's Custody Rule requires asset managers to use custodians to "have possession and control of assets."[33] This rule is intended to protect investors and mitigate operational risks. However, it was developed for the traditional asset management industry that dealt in equity and debt instruments, and so could pose unique challenges when assets are digital and have no tangible representation.

International Perspective: The Financial Conduct Authority (FCA)

The FCA regulates the conduct of financial services in the United Kingdom by protecting consumers, safeguarding financial market integrity, and promoting competition. In 2014, the FCA started an initiative called "Project Innovate," to encourage financial innovation in the interest of consumers.[34] The initiative engages with fintech firms to learn about new technology developments, provide consultative advice, and facilitate conversations around improving regulation for such firms. The FCA also launched a "regulatory sandbox" program in 2016, in which companies apply for tailored regulatory support as they test new products. The FCA's regulatory sandbox program stands out internationally due to its success with firms participating (over 100 so far) and its focus on testing innovative technologies with a limited number of consumers, over a short period (often less than a year), in order to learn and later develop an evidence-based regulatory structure.[35] In addition, FCA has helped organized the Global Financial Innovation Network (GFIN), which the CFPB is a member of, which is an international group of 35 financial regulators and related organizations exploring ways to promote cross-border coordination on various financial technology innovations.[36]

---

[30] SEC, "SEC Launches New Strategic Hub for Innovation and Financial Technology," press release, October 18, 2018, at https://www.sec.gov/news/press-release/2018-240.
[31] SEC, *Response of the Division of Corporate Finance,* April 3, 2019, at https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.
[32] SEC, "Engaging on Non-DVP Custodial Practices and Digital Assets," March 12, 2019, at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.
The SEC's custody rule—17 CFR § 275.206(4)-2—was designed for asset safekeeping and investor protection and predates digital assets. Certain requirements of the rule, such as the demonstration of "possession and control" of assets, are challenging for a holder of a digital asset to comply with, due to its lack of tangible representation.
[33] Rule 206(4)-2 of the Investment Advisers Act of 1940.
[34] For more information, see https://www.fca.org.uk/firms/fca-innovate.
[35] FCA, *Regulatory Sandbox Lessons Learned Report,* October 2017, https://www.fca.org.uk/publication/research-and-data/regulatory-sandbox-lessons-learned-report.pdf.
[36] https://www.fca.org.uk/firms/global-financial-innovation-network