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LICENSE TO BANK: EXAMINING THE LEGAL FRAMEWORK GOVERNING WHO CAN LEND AND PROCESS PAYMENTS IN THE FINTECH AGE

VIRTUAL HEARING

BEFORE THE

TASK FORCE ON FINANCIAL TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTEENTH CONGRESS

SECOND SESSION

SEPTEMBER 29, 2020

Printed for the use of the Committee on Financial Services

Serial No. 116–112

U.S. GOVERNMENT PUBLISHING OFFICE
43–526 PDF WASHINGTON : 2021

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CONTENTS

Page

Hearing held on:
September 29, 2020 1
Appendix:
September 29, 2020 25

WITNESSES

TUESDAY, SEPTEMBER 29, 2020

Carrillo, Raul, Policy Counsel, Demand Progress Education Fund; and Fellow, Americans for Financial Reform Education Fund 5
Knight, Brian, Director, Innovation and Governance Program, Mercatus Center 11
Sands, Everett K., Chief Executive Officer, Lendistry 7
Wilmarth, Arthur E., Jr., Professor Emeritus of Law, George Washington University Law School 9

APPENDIX

Prepared statements:
McHenry, Hon. Patrick 26
Carrillo, Raul, ... 28
Knight, Brian, ... 54
Sands, Everett K. 150
Wilmarth, Arthur E., Jr. 159

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Lynch, Hon. Steven:
Written statement of the American Bankers Association (ABA) 210
Joint written statement of ABA, BPI, and ICBA 217
Written statement of the Center for Responsible Lending (CRL) 220
Written statement of the Conference of State Banking Supervisors (CSBS) 272
Written statement of the Credit Union National Association (CUNA) 282
Written statement of the Department of Financial Institutions of the State of Utah 284
Written statement of the Electronic Transactions Association (ETA) 291
Written statement of the Independent Community Bankers of America (ICBA) 294
Written statement of the National Association of Federally-Insured Credit Unions (NAFCU) 298
Joint written statement of the National Association of Industrial Bankers and the Utah Bankers Association 302
Written statement of Varo Money, Inc. 306

LICENSE TO BANK: EXAMINING THE LEGAL FRAMEWORK GOVERNING WHO CAN LEND AND PROCESS PAYMENTS IN THE FINTECH AGE

Tuesday, September 29, 2020

U.S. HOUSE OF REPRESENTATIVES,
TASK FORCE ON FINANCIAL TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The task force met, pursuant to notice, at 12:15 p.m., via Webex, Hon. Stephen F. Lynch [chairman of the task force] presiding.

Members present: Representatives Lynch, Gottheimer, Axne, Tlaib; Emmer, Hill, Davidson, and Steil.

Chairman LYNCH. Welcome, everyone. It's great to have our witnesses with us, and also the Members. And thank you to our staff, Petrina and Clement and the rest of the staff, for setting this up. We really do appreciate it.

We have just a few housekeeping measures that I have to go through here for a minute before we get to the actual hearing.

The Task Force on Financial Technology will come to order.

Without objection, the Chair is authorized to declare a recess of the task force at any time.

Also, without objection, members of the full Financial Services Committee who are not members of this task force are authorized to participate in today's hearing.

Members are reminded to keep their video function on at all times, even when they are not being recognized by the Chair. Members are also reminded that they are responsible for muting and unmuting themselves, and to mute themselves after they have finished speaking.

Consistent with the regulations accompanying House Resolution 965, staff will only mute Members and witnesses as appropriate, when not being recognized by the Chair, to avoid inadvertent background noise.

Members are also reminded that all House rules relating to order and decorum apply to this remote hearing.

Today's hearing is entitled, "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age."

I now recognize myself for 5 minutes to give an opening statement.

In the past year-and-a-half, this task force has witnessed the many ways in which banking is changing. With just my cell phone,

I can deposit a check, apply for a loan, send money to a friend, and buy cryptocurrency. The financial services world, once dominated by brick-and-mortar institutions, is now filled with so-called disruptors who are responding to evolving consumer preference and revolutionizing the way that we interact with our own money.

The implications of these changes are clear. Banking is becoming less centralized. Consumers have access to a wider array of services than they once did. Technology and tech companies are playing an ever-increasing role in our finances, and our laws and regulations are struggling, to be kind, to keep the peace.

In an attempt to address these facts, regulators have been proposing new charters and reviving and re-imagining existing ones. In 2016, the Office of the Comptroller of the Currency (OCC) proposed a special purpose national bank charter for nondepository Fintech firms.

Earlier this year, Acting Comptroller Brian Brooks announced plans for another special purpose charter, this time for payment companies, amounting to what he has described as a national version of a State money transmitter license.

Additionally, in March of this year, the FDIC approved Nelnet and Square for FDIC deposit insurance, the first time they have approved a new industrial loan charter (ILC) applicant since 2008. These actions have been met with significant controversy. The OCC's Fintech Charter is the subject of litigation right now over their authority to grant banking charters to nondepository institutions.

The Southern District of New York has sided with the New York Department of Financial Services in that case. Meanwhile, the planned payment charter is expected to face similar legal challenges. And both banking industry associations and consumer groups have signed a letter to the FDIC in opposition to the approval of the new ILC applications.

Supporters of these new charters argue that they promote financial innovation and access to capital while eliminating redundant licensing requirements across the States. Opponents, however, worry about firms using these charters as a way to skirt important consumer protection laws and to avoid additional regulatory oversight at both the State and Federal level.

Both the charters and the ILC approval raise questions about the traditional separation of banking and commerce and the entry of technology firms with their move-fast-and-break-things approach into the financial services arena, which has become rule-bound as a result of congressional responses to a series of major national financial crises over the past century.

The current legal questions and regulatory conflicts should be addressed by Congress. Our regulators and the courts mediating these disputes have been forced to resort to 19th Century books to interpret the intentions of Congress from a time when these issues were far less apparent.

Banking has changed. We can't afford to allow outdated laws to create opportunities for regulatory arbitrage and additional consumer harm.

We need to update our regulatory framework to provide clarity, opportunity for innovation, and, most importantly, safeguard the consumer and the American taxpayer.

Chartering authority is the cornerstone of this system. Our charters determine which firms can engage in banking and which regulators will ensure their safety and soundness. This conversation is as important as any in financial services could be right now, and this discussion could not be more timely.

This morning, we will hear from a distinguished panel of experts on what these proposed changes might mean for regulating the business of banking and the implications of changing the process for granting special purpose national bank charters. I look forward to today's discussion.

The Chair now recognizes the ranking member of the task force, my friend from Minnesota, Mr. Emmer, for 4 minutes for an opening statement.

Mr. EMMER. Thank you, Mr. Chairman.

Thank you for convening this important hearing today.

Before I go into the content of the hearing, I want to acknowledge what is likely our last Fintech Task Force hearing of this Congress.

I would like to thank the Chair, and the past leadership of former Ranking Member French Hill on this task force, for producing thoughtful, nonpartisan conversations about the emerging technologies with which regulators and Congress are grappling.

No matter the outcome of November's election, I hope it has become apparent on both sides, the multitude of policy questions and topics in the area of Fintech. The growth of these technologies and the considerations for Congress and regulators will only continue to grow. That is why next Congress, this committee should create a financial technology subcommittee in order to provide proper attention to this expanding and exciting area. A subcommittee would allow for greater focus on the details of many of the topics we discussed as a task force.

The consequences of Congress' action or inaction on these topics stand to greatly influence the economy as well as the location of the next great technological innovation like the internet.

As a body, we have already fallen behind on our knowledge and understanding of technology issues. If we don't catch up on Fintech, these innovations will pass us by.

Today, we close out our hearings with our attention toward the regulator that has likely been the most forward-leaning and supportive of new technologies that could build a more open and free financial system and equip millions of Americans previously excluded with the tools to build a credit and prosperous financial future: the Office of the Comptroller of the Currency.

The OCC, under the leadership of Acting Comptroller Brian Brooks, has undertaken tremendous efforts to clearly spell out the regulatory environment for emerging technologies and ensure their domestic development rather than allowing for more departures to countries that have provided more clear rules of the road. Many have weighed in after the prospect of a payments charter became news.

As Congress and regulators tackle issues with our changing financial system, it is important and prudent to consider the implications involved and to make sure consumers are protected and our financial institutions remain strong and secure.

At the same time, a charter under the OCC is by no means a license to operate free from regulation. It is not even regulation, as some of the testimony today will portray. It, in fact, imposes many responsibilities and duties to adhere to safe business practices and disclose information in an effort to ensure market stability.

The OCC has long held and will continue to ensure that their regulated institutions operate in a safe and sound manner, provide fair access to financial services, and treat customers fairly.

I am certain that as details begin to emerge and payment charters are granted, the OCC will continue to fulfill their mission. In addition, regulatory certainty is a goal that Acting Comptroller Brooks and I share. That is why, last week, I introduced the Securities Clarity Act, which will clarify securities law in a technologically agnostic way and allow for the distribution of an underlying asset that is, in fact, a commodity.

With regard to blockchain technologies, the Securities Clarity Act would allow for the distribution of a token following the registered securities offer. So long as actors play by the rules of the road, they deserve assurances that regulators will not continue to cause uncertainty and will, in fact, support innovation in America.

I am grateful for the support of Darren Soto, a co-Chair of the Blockchain Caucus like myself, and Ro Khanna, a member of the Caucus, as well as a Member of Congress from the State of California, whose district has directly seen the benefits of these new technologies.

It is through practical, nonpartisan solutions like this that this task force could be most effective during this Congress, and continuing into the next Congress.

Again, I would like to thank Chairman Lynch for convening this hearing and leading the task force, and I hope we will continue to work together to better understand financial technologies and the ways Congress can support and foster innovation in America.

I yield back.

Chairman LYNCH. The gentleman yields back. Thank you, Mr. Emmer.

I understood that Mr. McHenry was going to be afforded an opportunity for an opening statement. Is he on board, because I did not see him in the grid?

Okay. We don't see Mr. McHenry. Mr. Emmer, would you like to reassign that minute remaining on the Minority side to any of your Members or consume it yourself?

Mr. EMMER. No. At this point, Mr. Lynch, I will yield back.

Chairman LYNCH. Okay. I thank the gentleman.

At this point, I would like to welcome our witnesses. Today, we will hear from several distinguished witnesses who are great authorities in this area.

First, Raul Carrillo is the Policy Counsel for the Demand Progress Education Fund, and also a Fellow for the Americans for Financial Reform Education Fund, where he helped develop a regu-

latory response to the Facebook Libra project and other emerging financial technologies.

Raul has also served as Special Counsel to the Enforcement Director of the Consumer Financial Protection Bureau, and worked in the executive office of then-California Attorney General Kamala Harris. Welcome.

Second, Everett K. Sands is the Chief Executive Officer at Lendistry, a Fintech community development financial institution (CDFI), and small business and commercial real estate lender. Mr. Sands has more than 20 years of experience in lending at national and community banks.

He is also a board member of the Penn Institute for Urban Research, which informs urban decision-making and public policy on issues of sustainable urban growth and development.

Thank you, also, for being here.

Third, Arthur E. Wilmarth, Jr., is Professor Emeritus of Law at George Washington University Law School. Professor Wilmarth is the author of the forthcoming book, "Taming the Megabanks: Why We Need a New Glass-Steagall Act," and co-editor of, "The Panic of 2008: Causes, Consequences, and Implications for Reform."

In 2010, he was a consultant to the Financial Crisis Inquiry Commission and is a member of the International Advisory Board of General Banking.

Welcome, Professor Wilmarth.

And finally, Brian Knight is director of the Innovation and Governance Program at the Mercatus Center. Mr. Knight's research focuses on financial regulation, including the role of federalism in Fintech regulation and the use of digital assets for financial transactions.

Prior to joining Mercatus, Mr. Knight worked for the Milken Institute, where he was in charge of the Fintech and capital access programs. Thank you as well for being here.

Our witnesses are reminded that your oral testimony will be limited to 5 minutes. A chime will go off at the end of your time, and I would ask that you respect the Members' and other witnesses' time by wrapping up your oral testimony at that point.

And, without objection, your written statements will be made a part of the record.

Mr. Carrillo, you are now recognized for 5 minutes to give an oral presentation of your testimony.

STATEMENT OF RAUL CARRILLO, POLICY COUNSEL, DEMAND PROGRESS EDUCATION FUND; AND FELLOW, AMERICANS FOR FINANCIAL REFORM EDUCATION FUND

Mr. CARRILLO. Thank you, Chairman Lynch, Ranking Member Emmer, and distinguished members of the task force for inviting me to testify today. My name is Raul Carrillo, and I am policy counsel to Demand Progress Education Fund, and a fellow at the Americans for Financial Reform (AFR) Education Fund.

Demand Progress is more than 2 million affiliated activists fighting to keep the democratic character of the internet, contest concentrated corporate power, and hold government accountable. AFR is a coalition of more than 200 consumer, civil rights, investor, retiree, labor, business, and faith-based groups.

While assessing new bank-like technologies, policymakers should look at possible benefits to individual users but also to risk to the integrity of the financial system, consumer protections, and our civil rights. They should also guard against developments that will entrench the power of Big Tech and further erode our democracy. We urge Congress to adopt a bright-line precautionary approach to digital bank-like activities.

What industry calls "innovation" is often easily mapped onto an existing product or service. In some cases, there is something new. In those cases, policymakers should ask why a technological development is being proposed. Treating innovation as an unqualified good not only leads us to ignore equity but sustainable innovation. Precaution should be the norm, just as it is, and just as it should be, in food and drug regulation.

The OCC and FDIC's current approach encourages rent-a-bank predatory lending. In *Madden,* the court followed a tradition dating back to the American Revolution, that States may limit the interest rates charged by non-bank companies as well as the general rule that consumer protections are not preempted unless they significantly interfere with the banks partnering on the loan.

Together, the so-called, "Madden fixed rules", and OCC's so-called, "true lender rule" would allow non-bank companies to charge rates as high as they would like even if their bank partners would merely put their name on the paperwork.

Similarly, special charters would allow non-bank companies to exercise special privileges without special regulation. During the pandemic and depression, we should be moving in exactly the opposite direction, including by instituting a 36-percent rate cap, and functionally expanding the Military Lending Act, to cover us all.

Although Fintech firms make many promises with respect to financial inclusion, we advise healthy skepticism. Too often, new tech yields predatory inclusion. Companies offer needed services to certain classes of users only for those benefits to evaporate or become eliminated in the long term.

The use of alt data, AI, predictive analytics, has already enabled price discrimination. Complex algorithms also make it difficult to know what factors an algorithm has used and how it has used them. This can lead to steering and additional redlining and generally shields violators of the Equal Credit Opportunity Act or Fair Housing Act from claims of disparate impact.

We strongly agree with Professor Wilmarth that Wall Street and Silicon Valley are irresponsibly integrating banking and commerce. Congress should close the ILC loophole and generally separate the ownership of financial institutions from large tech companies.

We are especially concerned by dominant tech platforms' recent encroachment into payments, most notably, the proposed Facebook Libra project. Payments data allows platforms to more easily engage in predatory pricing, to self deal, sparring rivals in next adjacent markets, and to generally accumulate political power.

Mobile payment platforms also avoid most banking regulation. Constitutional law professors Dan Awrey and Kristin van Zwieten call them, "shadow payment platforms." Big Tech should not be storing funds without appropriate protections, but the U.S. cur-

rently lacks a general law of deposit that would facilitate sufficient oversight. Congress must step up.

We also urge Congress to shift the burden of privacy protection away from consumers who cannot meaningfully consent to surveillance and toward Big Tech. Congress should establish a list of permissible purposes for data collection and ban all others.

We also urge Congress to protect cash as an option. We shouldn't supplant money that doesn't track us with money that necessarily creates a more detailed picture of our intimate political, religious, familial, and romantic lives. As Justice Thurgood Marshall warned in the 1970s, evolved banking also leads to easier access to data which corporations and law enforcement agencies may use inappropriately.

This task force should more deeply consider the social and political consequences of Fintech. We strongly support innovation in the public interest, and for that reason, call for privacy-respecting public options for real-time payments, safe deposits, remittances, and other basic services provided by the Federal Reserve, Treasury, and USPS, institutions we can more readily hold accountable compared to Big Finance and Big Tech.

Thank you.

[The prepared statement of Mr. Carrillo can be found on page 28 of the appendix.]

Chairman LYNCH. Thank you.

Mr. Sands, you are now recognized for a 5-minute presentation of your written testimony. Thank you.

STATEMENT OF EVERETT K. SANDS, CHIEF EXECUTIVE OFFICER, LENDISTRY

Mr. SANDS. Thank you very much. I appreciate that.

Chairman LYNCH. Thank you, sir.

Mr. SANDS. Task Force Chair Lynch, Task Force Ranking Member Emmer, Chairwoman Waters, Ranking Member McHenry, and distinguished members of the task force, it is an honor for me to appear before you today. My name is Everett K. Sands, and I appreciate the committee's interest in financial technology and this opportunity to provide insights and information.

My testimony will address several of the task force's areas of interest, and will focus on lending generally and on small business lending, so many of my comments are also applicable to other areas of lending, as they are closely tied in terms of credit parameters from a consumer perspective and origination activity from Fintech lenders.

The single, unified perspective that ties together my testimony is this: In lending, there are good and responsible actors, and there are bad and unscrupulous actors. And it is my belief and experience that the best protection against bad actors is to take action designed to incentivize more good actors to come into the field, making their offerings more available and crowding out bad actors.

Fintechs can have a constructive role in lending if their rates and product offerings are responsible. Today, small businesses, and consequently, the United States, are in crisis. The stakes for expanding responsible lending are enormous, and urgent need for action in this regard cannot be overstated.

I have more than 20 years of experience in the banking and lending field. Prior to starting Lendistry, I was part of both national and community banking. I have served as a board member and as an executive, and I have led high-growth business units and closed more than $3 billion in transactions.

Businesses I have led have been regulated by the CDFI Fund, FDIC, FHA, FHSA, FHLB, OCC, OTS, SBA, VA, and several State regulators.

Today, I am the CEO of Lendistry. Lendistry is a minority-owned and technology-enabled CDFI. We are dedicated to providing economic opportunities to underserved urban and rural small business borrowers and their communities. Lendistry is also a signatory to the Small Business Borrowers' Bill of Rights, which are guidelines set by the Responsible Business Lending Coalition.

As a hybrid of a Fintech lender and a community bank, Lendistry combines the best of Fintech—efficiency, scalability, and seamless user experience—with the best of traditional lending—low cost of acquisition, low cost of funds, and strong risk management.

Currently, Lendistry is playing a very active role in the COVID-19 small business recovery effort. To briefly summarize, Lendistry has originated, processed, and approved more than $180 million in Paycheck Protection Program (PPP) loans to more than 3,500 businesses in the 12 States where the Small Business Administration (SBA) gave us temporary authorization to lend.

We have also utilized our technology platform to process more than 50,000 small business Coronavirus Aid, Relief, and Economic Security (CARES) Act-related grant applications for the State of Pennsylvania, and we will fund approximately 10,000 of those grants, totalling $190 million, and up to an additional $50 million for several other counties, all in partnership with the PA CDFI network.

I will focus the remainder of my remarks on responsible lending in the context of the areas the committee is exploring. It is my view that incentivizing and expanding responsible lending is the best protection against predatory lending. Importantly, the Federal Government should empower and harness systems and authorities it already has. Congress should use these systems to create compelling incentives for Fintechs to choose to operate within a regulated framework and conduct lending activities in a responsible manner.

I would like to introduce one such incentives-oriented solution today, and it begins with making more effective use of the CDFI Fund. The solution has three components. First, create compelling incentives to be a CDFI, and include automatic approval for all of SBA's products, membership to the Federal Reserve, and the ability to lend nationally, as well as easier access to capital from banks.

Second, raise the bar for qualifying to be a CDFI, for example, an interest rate ceiling of 36 percent APR, standardized payment cycles including no more than two payments a month, and additional disclosures and accountabilities.

Third, empower the CDFI Fund to monitor compliance with additional requirements.

The membership asked about OCC special charters. Though we believe in an enhanced role for the CDFI Fund as the preferred so-

lution, it should be adopted for the OCC. But payment and lending each require significant adjustments to regulation, and we suggest the OCC focus on payments first as new technology like Bitcoin, blockchain, and cryptocurrency gain traction.

The task force asked about industrial loan charters (ILCs). Despite theoretical risks of ILCs to the banking system, historically, the mixing of banking and commerce has not had a negative impact on the consumer and the deposit insurance fund. We think ILCs are a viable solution. However, the parent company must be subject to the Bank Holding Act.

Finally, I would like to emphasize the importance of annual oversight. Whatever path is taken moving forward, the evolution and speed of the Fintech industry demands that the regulatory authorities be empowered and mandated to conduct annual reviews of the requirements in order to ensure accountability and transparency.

I thank you for opportunity to be here today.

[The prepared statement of Mr. Sands can be found on page 150 of the appendix.]

Chairman LYNCH. Thank you, Mr. Sands.

Next up, Professor Wilmarth. You are now recognized for 5 minutes for a presentation of your written testimony.

STATEMENT OF ARTHUR E. WILMARTH, JR., PROFESSOR EMERITUS OF LAW, GEORGE WASHINGTON UNIVERSITY LAW SCHOOL

Mr. WILMARTH. Thank you, Chairman Lynch, Ranking Member Emmer, and distinguished members of the committee and the task force.

My testimony today criticizes recent attempts by the OCC and the FDIC to confer banking powers and privileges on nonbanks and commercial firms without requiring those companies to comply with the regulations that govern banks and bank holding companies.

The OCC's and FDIC's initiatives are unlawful and contrary to the public interest. They represent a dangerous form of regulatory arbitrage that allows nonbanks and commercial firms to evade fundamental policies embodied in our Federal statutory framework for banking institutions.

I urge Congress to use its legislative and oversight powers to block these initiatives or persuade the agencies to withdraw them.

I am going to focus my oral testimony on the OCC's nondepository Fintech Charter and the FDIC's proposed ILC rule. The National Bank Act, the Federal Reserve Act, and the Federal Deposit Insurance Act prohibit the OCC from granting national bank charters to financial firms that do not accept deposits, and I point the committee to 12 U.S.C. §222 in particular. The only national banks that are permitted to operate without deposit insurance are nondepository, special purpose trust companies, and those companies were specifically authorized by a special amendment, a very narrow amendment, adopted by Congress in 1978. The OCC has no other authority to charter institutions that don't accept deposits.

Bank deposits play a very vital role in our monetary system, and as Gerald Corrigan observed 20 years ago, depository institutions serve as a transmission belt for the nation's monetary policy. De-

pository institutions have a very privileged relationship with the Federal Reserve, and they receive very beneficial services from the Fed, including discount window loans, Fed payment services, and Fed settlement and custody services. Fedwire, for example, guarantees immediate final payment among financial institutions. No nondepositories can get access to these services.

The OCC's nondepository Fintech Charter would create massive conflicts with the Fed's design. Those firms, if they got charters, could claim that they have the automatic right to become Fed members and to get all of the benefits that depository institutions get from the Fed.

For example, nondepository Fintech banks could get discount window loans. That is completely contrary to Section 13-3 of the Federal Reserve Act which puts very, very strict restrictions on the ability of the Fed to give any loans to nondepository firms.

Also, Big Tech firms could get very significant influence on our monetary and economic policies. They would have the right, if they were admitted as Fed members, to vote for Federal Reserve Regional Reserve Bank Presidents, who participate on the Federal Open Market Committee (FOMC), so they would be able to directly influence monetary policy decisions.

Now, let's turn for a moment to the FDIC's ILC proposed rule. This would allow any type of commercial company to acquire FDIC-insured depository institutions, known as ILCs, who basically can conduct very close to a full service banking business. This would be an even greater threat to the current policy, which has been long established of separating banking and commerce. It would give them direct access to all of the Fed services, and, of course, to the very important Federal deposit insurance part of the safety net.

So, we can see that these OCC Fintech Charters and the FDIC's proposed ILC rule would essentially allow commercial firms, and especially Big Tech firms, to get the advantages of all that the Federal safety net offers.

This would give them huge competitive advantages over smaller commercial firms that could not afford to acquire Fintech Charters or ILCs. This is certainly completely contrary to the Bank Holding Company Act, and our long history of separating banking and commerce, and it would, in my view, pose great systemic dangers.

The Federal Government bailed out several very large corporate owners of ILCs during the financial crisis, as I explained in my statement. We can anticipate that the same problem would occur again if Big Tech firms are allowed to acquire banking institutions with direct access to the safety net but without complying with the Bank Holding Company Act and many other statutes.

I would be happy to discuss this further in response to questions. Thank you very much.

[The prepared statement of Mr. Wilmarth can be found on page 159 of the appendix.]

Chairman LYNCH. Thank you, Professor.

Mr. Knight, you are now recognized for 5 minutes for an oral presentation of your written testimony.

STATEMENT OF BRIAN KNIGHT, DIRECTOR, INNOVATION AND GOVERNANCE PROGRAM, MERCATUS CENTER

Mr. KNIGHT. Hello, Chairman Lynch, Ranking Member Emmer, and members of the FinTech Task Force. I congratulate you all on your leadership and thank you for the opportunity to testimony today.

My name is Brian Knight. I am the Director of the Program of Innovation and Governance, and Senior Research Fellow at the Mercatus Center. Any opinions I express today are my own and do not necessarily reflect those of my employer.

The goal of this hearing is to examine the rules governing which firms are allowed to lend and process payments in the age of Fintech. That is an excellent question and is both timely and relevant. I submit for your consideration four key points.

First, the technological and economic reality has overtaken existing law, leading to an overly burdensome regulatory environment that harms Americans.

Second, both the OCC and the States have shown an admirable willingness to attempt reform, but their ability to get it right is limited under existing law.

Third, Congress can and should reform the law to allow nondepository lenders and money transmitters, subject to appropriate requirements, to operate on a nationwide scale.

Finally, this does not mean, however, that a Federal license or charter should be the only option. Rather, Congress should enable State-licensed or chartered nondepository entities to compete nationally.

Nonbanks and tech firms have become significant competitors in the financial services market, and Americans have embraced these services due to a variety of factors including cost, convenience, speed, and availability.

While these firms may take advantage of cutting-edge technology, they are still subject to a regulatory system that did not contemplate them.

Contrary to some assertions, Fintech firms are not unregulated or even necessarily less regulated than traditional banks on a line-of-business basis. In fact, these firms frequently find themselves subject to cumbersome State-by-State regulation that places them at a disadvantage.

For example, under Federal law, a nationally chartered bank or an FDIC-insured State-chartered bank can lend nationwide on the basis of its home State law governing interest. Conversely, Fintech firms must obtain lending licenses in every State they operate in and are subject to the laws of each State regarding the definition and control of interest. Likewise, national banks are not required to obtain a State money transmitter license, and State money transmitter licenses generally exempt State-chartered banks. Conversely, non-bank money transmitters have to get licenses in every State.

And, finally, while banks can generally access the Federal Reserve's payment system to help transmit payments, non-bank Fintech money transmitters cannot. It is cumbersome and uneven regulation, it is frequently unjustified, and it can result in higher costs, reduced service, and competitive inequality.

Recognizing this mismatch between the regulatory environment and the economic and technological reality, both Federal and State regulators have shown an admirable willingness to innovate, but the efficacy of those efforts is questionable due to legal constraints.

At the beginning of the Obama Administration, the Office of the Comptroller of the Currency announced a plan to offer special purpose national bank charters to nondepository lenders and money transmitters.

In response, State regulators announced a host of regulatory reforms aimed at lowering the burden of State regulation, as well as suing the OCC. The OCC plan isn't perfect. It does, arguably, represent the best regulatory option currently available. However, it is not at all clear that the legal powers and burdens that come with being a national bank are needed or appropriate for nondepository entities.

Likewise, while the States are resorting to litigation to stop the OCC charter for Federal, it is also understandable. Under current law, a State cannot offer a charter or license comparable to the OCC Fintech Charter even if it wanted to, because of the lack of Federal enabling legislation like that enjoyed by State-chartered depositories.

So, what should Congress do? Congress should encourage competition by aligning regulation with technological and economic reality. Nondepository institutions that offer credit or money transmission services nationwide should be able to do so without being placed under undue regulatory disadvantage.

This could include Congress making clear that both States and the Federal Government can authorize firms, whether through a special purpose charter or a license, to lend or facilitate payments with relevant authority comparable to their banking competitors.

Critically, any requirements or limitations should be properly calibrated to the risks created by the actual products, services, and business models rather than applied simply because they apply to depository institutions.

The exact contours of what these rules should look like remain to be determined, and there are important questions that need to be answered. But first, we should acknowledge that the current regulatory regime is outdated and should be modernized. Congress should take advantage of its unique ability to create an environment conducive to innovation and competition that benefits the American people.

Thank you again for the opportunity to testify, and I look forward to your questions.

[The prepared statement of Mr. Knight can be found on page 54 of the appendix.]

Chairman LYNCH. Thank you very much, Mr. Knight.

I now recognize myself for 5 minutes for questions. I think, taken together, the testimony of all of the witnesses really lays out what the problem is. And when we look at the traditional barrier between banking and commerce, it has served us well in the past.

When you think about the special privileges we give to banks—I know the professor mentioned the discount window, and we have taken to bailing out banks because we see them as so important to our economy. I think that also with FDIC insurance, we actually

have an interest on behalf the American taxpayer to preserve the stability of banks.

Now, we have the suggestion, and I understand that Fintech is responding to consumer preferences. I have 2 girls who are college age, and I don't believe either one of them has ever stepped foot in a bank. Everything is remote; everything is mobile banking.

So I get that the model is changing, and the regulations are, indeed, outdated, but the question is, what do we do to fix that problem in a way that preserves the protections for consumers, for the American taxpayers?

I think, Professor Wilmarth and Mr. Carrillo, you both spoke to that issue regarding the separation of commerce from traditional banking. Could you talk a little bit about, not just the dangers of commingling those two activities, but could you also suggest what a solution might look like?

Mr. Carrillo, you mentioned privacy and the size of some of—if you look at tech, if you look at these massive firms, I see too-big-to-fail Fintechs in the future in a big, big way. And I am just very, very nervous about seeing that concentration of power that we see in the tech world transmitted into the banking world. That is a very real concern that I have. So, could you take a crack at that? Thank you.

Mr. CARRILLO. Thank you very much for your question, Chairman Lynch.

I also share your concerns about eventually needing to bail out a Facebook or an Amazon or facing public pressure to do so if we continue to go down this road. And Professor Wilmarth's research has very much highlighted that financial institutions that are owned by commercial companies tend to make risky bets or engage in imprudent activities on behalf of their parent company.

I would also say that the added dimension here involves economic and political power in our society. I am somewhat disappointed that none of the other panelists addressed Big Data or mass surveillance. We have to consider that in this new age of banking, it is not just about extracting money. It is about extracting information about people.

And my response, in addition to suggesting that there should be further barriers provided by Congress and regulators between Big Tech and high finance, is to create public options which would introduce competitive pressure into the space and help keep Big Tech and high finance honest in terms of building out this understandably necessary infrastructure. Thank you.

Chairman LYNCH. Thank you.

Professor Wilmarth?

Mr. WILMARTH. Thank you, Mr. Chairman. I think that you are exactly right, that if we allow Big Tech to acquire banks, and we can expect that if that happens, they will be very large banks, the pressure would be unavoidable, and it's inevitable that if any problem came, the Federal Government would bail out the entire institution. That is exactly what happened to the so-called shadow banks financial conglomerates during the financial crisis.

I would point the task force's attention to the Wirecard debacle that has just occurred in Germany. Wirecard actually controlled a bank, and what was also very interesting is they were trying to ac-

quire Deutsche Bank shortly before they collapsed. Imagine if Wirecard had controlled Deutsche Bank before its accounting scandal was revealed?

Again, there was no regulation at the holding company level. I think the lesson of history is that you need consolidated, effective supervision at the holding company level, and I very much question whether that is possible for a major tech bank conglomerate.

If I could just make one suggestion, nobody has shown, in my opinion, that all of these services cannot be obtained by banks through proper contracts with proper supervision by the Federal regulators.

I think the proper approach is to make sure that banks enter into contracts when needed to get the technology they need to serve their customers, but those contracts should be carefully supervised by the regulators.

I do not see that putting the banks into the hands of Big Tech would cause anything but major problems, and I think the resulting conglomerates would be completely uncontrollable by both regulators, and I am afraid even perhaps by Congress.

Chairman LYNCH. Thank you very much. I see that my time has expired.

The Chair now recognizes the ranking member of the task force, Mr. Emmer, for 5 minutes for questions.

Mr. EMMER. Thank you, Mr. Chairman. Again, thank you for holding this hearing.

Mr. Knight, under this Administration, you have seen a lot of forward progress in terms of regulators understanding technology and fostering innovation. What areas do you think regulators should be doing more work in, to understand and to ensure clear and consistent regulation?

Mr. KNIGHT. Thank you, Representative Emmer. I believe that the areas that regulators should be focusing more on are, one, and I am surprised, given the topic of this hearing, the implications of technology. Because while the application of technology to financial services is not new, we are in a period of very high technological innovation, and therefore, be it within the traditional banking system, non-banking financial firms or emerging startups and new competitors, the application of a host of technologies, AI and Big Data was mentioned earlier.

Cryptocurrencies and that sort of ledger system are all emerging and really need to be well-understood by the regulators so that they can do their job appropriately and neither fall asleep at the wheel nor unduly panic.

Mr. EMMER. Thanks. Have you been following the litigation, the SEC litigation, including the *Kik* and the *Telegram cases?* And what do you make of Commissioner Peirce's proposed safe harbor and express concerns regarding the Telegram enforcement action?

Mr. KNIGHT. Sir, I will confess that I have not followed that as closely as I should have. I will say that—

Mr. EMMER. Let me do this, Mr. Knight. Hester Peirce said, "Enforcement actions can be instructive to people other than the wrongdoer but are not an appropriate mechanism to create new law. Our regulatory integrity demands that enforcement actions be premised on a violation of a clearly articulated statue or rule."

Hopefully, that helps.

Mr. KNIGHT. Sir, Hester is, per usual, absolutely right. We do not want regulation by enforcement. The concept of justice and, frankly, efficiency and effectiveness indicate that we should have clearly laid down rules before we are going to bring an enforcement action and punish someone for a violation. That is, I think, a core component of our concept of justice.

Mr. EMMER. Thank you.

What do you recommend, Mr. Knight? What do you recommend Congress do, following the task force's work? Should a stronger focus be placed on these technologies? And are there any short-term, say, 1- or 2-year priorities that you can identify?

Mr. KNIGHT. Thank you, sir. I absolutely believe that Congress should continue to monitor and, in fact, increase its interest in these topics because they are not going away, and they cut to an essential component of a functioning life, which is the ability to access financial services. That is a key component.

In terms of short-term goals, as I mentioned earlier, I think that we really should consider how we can modernize the ability for firms to operate on an interstate basis, either within the banking system with the caveat that there is a debate about just whether or not banking is inherently involving depositories, or outside of the banking system where Congress can give the necessary powers but not be bound by the interlocking laws that have developed over time with regard to banks to allow nonbanks to compete.

That competition will benefit customers. It will help keep all of the participants honest because it will give consumers more options so that they can walk away from a service provider who is not treating them well.

It may also help lower moral hazard to the extent that we are not forced to engage in a federally-insured depository environment for all transactions.

Mr. EMMER. This is focusing in on one particular area, but would you agree that to resolve uncertainty and, quite frankly, a patchwork of different regulations and laws, for instance, the OCC suggesting there should be some type of national license for money transmitters, and we have actually had a bill along these lines, would you agree that is one of those things that could bring certainty and clarity to the marketplace?

Mr. KNIGHT. Absolutely. And in addition to the OCC providing a license or special purpose charter, you could also enable, like you would do with banks, State license transmitters to more effectively compete interstate to maintain a dual financial and market-preserving federalist system.

Mr. EMMER. Excellent.

Thank you, Mr. Chairman. I see my time has expired, so I yield back.

Chairman LYNCH. The gentleman yields back.

Petrina, would you handle the order of the questions? I am not sure who is next.

MS. THOMAS. Yes, sir. Mr. Hill should be next.

Mr. HILL. Thank you, Mr. Chairman. I must say I want to echo the comments of my good friend, Tom Emmer, that one of the real highlights of this Congress was the decision by Chairwoman Max-

ine Waters and Ranking Patrick McHenry to form our two task forces on FinTech and Artificial Intelligence, particularly this year in the pandemic, where legislative work has become much more modest.

The work here will lay the groundwork for tremendous efforts, I think, for our State regulators, our Federal regulators, and our congressional policymakers working with this Administration and the incoming Administration, be it Trump or Biden, to continue to prepare America to be a leader in Fintech.

And I appreciate the Treasury's 2017 survey and analysis on all of these issues that we are talking about today, and it really made for a more educated group of Members of Congress on both sides of the aisle to work on these important topics, so thanks for having this hearing.

I am a little shocked that you didn't schedule the hearing for 9:00 tonight, because I think people would really be fascinated by Fintech and the future of their country, and you would be the star, so I am sorry about that.

Let me start and say that I introduced bipartisan legislation, H.R. 6306, the Immediate Funds Availability Act, which would increase the amount of funds bank customers are able to receive, and would require them to be made available immediately during the pandemic, and it would sunset over 3 years. My friend, Mr. Foster of Illinois, introduced that bill with me.

And I hear from constituents pretty frequently, wondering why it takes so long for even a U.S. check to be credited to their account.

Mr. Knight, what are some of the current obstacles that cause banks to not be able to provide more immediate credit to consumers?

Mr. KNIGHT. Thank you, Representative Hill, for that question.

One of the existing issues is that the underlying infrastructure, and that doesn't mean the automatic clearinghouse system, is not a real-time system and, instead, is a batch system that has, I believe, gone to 3 windows, 5 days a week. And so, they batch up all the payments and transmit them during those periods.

So if your payment doesn't fall within one of those periods, it will have to move to the next day, or sometimes it can move—if it comes in late on a Friday, it may take until Monday or Tuesday to get there.

That system made sense when it was created, and that is a very efficient way to do it. It is a cheap way to do it, which is important in a payment system, but technology has moved on to the point where we can move to real-time payments. Other countries have moved to real-time payments. There is a funding system that provides real-time payments, and the Fed has announced a move to real-time payments. So, all of those things should allow for more expedient payment.

Mr. HILL. Thank you very much.

Mr. Sands, I really enjoyed your testimony, and I want to congratulate you on the success of your business. I was on the CDFI Advisory Board during the George W. Bush Administration as the community bank representative, and I want to congratulate you on all the good work you are doing, and thanks for participating so

vigorously for our minority community, but also in the PPP program. I enjoyed looking at your testimony.

You mention the importance of partnerships. I assume in the loan origination arena, that this idea of providing liquidity to Fintech lenders through the use of a bank for balance sheet strength, you think is a good idea if it is done right, I take it, from your testimony?

Mr. SANDS. That would be correct, sir. One of the things I think we look at is that the U.S., right now, is effectively losing a war at home, and let me just give you an example.

Let's take a look at the Citi report that came out last week, entitled, "Closing the Racial Inequality Gaps: The Economic Cost of Black Inequality in the U.S.", which found that over the last 2 decades, $16 trillion in GDP could have been created if we had closed the wealth gap. If the gaps are closed going forward, GDP will be increased by $5 trillion over 5 years, or $1 trillion a year.

Let's just be clear about that. There are 195 countries in the world. This will be better than 178 countries' GDP, or 2½ times what we are doing with Chinese tariffs right now.

So I think it is very, very important that we solve some of these things, and we figure out a constructive measure on how we move forward.

Mr. HILL. I appreciate that, and I also took note of your exam frequency suggestions on the CDFI loan funds. I look forward to following up with you on that.

And let me just conclude by your constructive comment also on cryptocurrency. Bill Foster and I really are working with the Fed on a digital dollar and have encouraged that work, and I am pleased to see it advancing. And we need a cryptocurrency payment rail as a part of our payment system reforms.

I thank my friend, the chairman, and I yield back.

Chairman LYNCH. The gentleman yields back.

The Chair now recognizes Mr. Davidson for 5 minutes for questions.

Mr. DAVIDSON. I appreciate the chairman, and I really just want to say thanks so much to the committee for having this hearing.

Frankly, between last week's roundtable and this week's hearing, these are topics that I have sought to address since joining the committee in 2017. My sincere hope is that Speaker Boehner's saying about how Congress works which is, to sum it up, "very slowly until it is very fast," I hope that holds true for this long-overdue area of responsibility for the House Financial Services Committee.

To adequately regulate this area, we also need to address a foundational principle, which is privacy—frankly, consumer privacy. Wrongly applying existing Bank Secrecy Act provisions, for example, to a true distributed ledger blockchain architecture would undermine privacy, undermine the security inherent to that technology, and undermine the efficiency that Fintech offers our consumers, innovators, and investors, whether it is any number of unfathomable use cases, but in particular, as we talk about payments facilitated in bank charters.

Mr. Carrillo laid out the challenges and opportunities nicely. While I don't agree with his conclusion that all of this needs to be centrally managed, particularly by the Postal Service, his expo-

sition on the stakes for privacy merits primary attention for the regulatory framework and civil liberties protections America needs.

America needs a strong law protecting consumer privacy, and holding every company, website, app, OEM, et cetera, accountable not just for complying with whatever they want to put in their terms of service, but with meaningful legal protections for an individual's personal data.

Concurrent with the development of that privacy law, we need a more unified, not more fragmented, approach to regulation—one prudential bank regulator rather than a bigger, broader patchwork.

In the absence of action by Congress, some States have already moved ahead, some with poor results like New York's bit licensed approach, and have scared capital and innovation offshore. And others have been much better, but no State has worked with more precision and clarity than Wyoming.

Mr. Knight, as you look at the approach in Wyoming that resulted in Kraken's bank charter, what are you seeing as being the most important features for the Federal level in ensuring that this kind of innovation takes place across the United States?

Mr. KNIGHT. Thank you, Representative Davidson.

When I look at that and the broader innovation picture, I think what we need is a system that allows for interstate competition that can involve a federally-licensed or chartered entity, but it should also allow State-licensed and chartered entities to have the essential powers they need to compete interstate, and allow consumers to choose which system they want and what laws they want to take advantage of.

And then to your point about privacy, I think you are absolutely right, and this is something we need to think very hard on. And, yet, as Mr. Carrillo mentioned, first of all, I think getting rid of cash is a bad idea.

But, second, we do need to be thinking about privacy protections balanced with the legitimate needs of law enforcement, and that applies to private sector actors, and it applies to public sector actors as well.

I think those are some of the essential things Congress needs to be looking at.

Mr. DAVIDSON. Yes. So, we are blending things here, but when we look at the architecture of distributed ledger technology, it goes about it in a different way.

Probably, many of the members of the committee and some of our witnesses saw the Buzzfeed article that highlighted the suspicious activity reports (SARs) approach that, frankly, hasn't resulted in a real stop to money laundering. There is still a big problem.

The Financial Crimes Enforcement Network (FinCEN) highlights that. But, frankly, the approach is essentially the concern I have with Mr. Carrillo. We are concerned about what was surveillance, so why would we give the people who are doing the most warrantless surveillance more power to do more?

Why would we go double down on Bank Secrecy Act anti-money-laundering provisions that create a bigger black market, frankly, that underserves the underbanked already? And that is where I think the encouraging work in Fintech companies like Bank U,

which are banking the unbanked and creating a transaction history, really helps build an identity for people.

They are doing that outside the United States, but are an Austin-based company. And when you look at these kinds of companies, before they can be regulated as a bank, they have to raise the capital. That is why getting the certainty into the regulatory framework as to what is a security and what is not a security is so vital.

So, I hope our committee will take that up and notice some of the bills in this space. As you can tell, I have more to cover in that space than we can in this hearing, but thanks again to the committee for the work to put this together.

Thanks, Mr. Foster and Mr. Emmer, for getting it here, and I appreciate our witnesses.

Thanks again, and I yield back.

Chairman LYNCH. The gentleman yields back. Much appreciated.

The Chair now recognizes my friend from Michigan, Ms. Tlaib, for 5 minutes for questions.

Ms. TLAIB. Thank you so much, Mr. Chairman.

As we all know, the pandemic and COVID-19 has exposed a number of broken systems, not only in our healthcare system but also the economic divide in our country. And this includes the barriers that exist due to lack of bank branches in many low- and moderate-income neighborhoods, and most notably, in Black neighborhoods, like those in my district.

To me, there is no doubt, and I truly believe this, that companies like Amazon, Facebook, JPMorgan Chase, and Venmo will take advantage of the financial gap in the market that will lead to exploitation of the unbanked and underbanked communities.

I know the OCC has proceeded to move forward and really, I believe, overstepped its authority by determining what a bank is or removing that authority from Congress to determine ultimately, again, what is in the best interest of the American people.

Mr. Carrillo, do you think that the consumers should be treated differently or be offered less protection by Fintech companies than they are with traditional banks?

Mr. CARRILLO. Thank you, Representative Tlaib. The short answer to your question is no, I don't think that consumers should have fewer protections, mainly because they are using a Big Tech platform, for instance, that portends to store funds for long periods of time but not offer corollary protections.

And to your point, I think that Congress needs to step up here, define what a deposit is, define what banking is, and make sure when funds are exposed and used in this manner, that consumers have specific protections. This is especially important when mobile payment platforms and other Fintech technologies are being advertised to communities of color as a way up, as a path towards upward mobility in our society.

Privacy protections are also extremely important here. Consumer protections cannot be voided in that realm either. We cannot ask communities of color to fundamentally sacrifice their privacy, especially given the way the data is used for corporations for targeted ads, et cetera, but also the way that law enforcement agencies may intend to misuse the data that is collected, especially from Black

folks, Muslim folks, Latino folks, indigenous folks, and people who have political dissent with the existing government.

Thank you.

Ms. TLAIB. Given our recent negative experience with unregulated shadow banks, which is a huge issue, regarding the safety and soundness of privately issued mobile money, it is really risky to allow unregulated Fintech companies to offer critical payment services provided to moderate-income communities. And so one of the things I want—when I am trying to explain this to my mom, what is the worst-case scenario here for many of our residents at home?

Mr. CARRILLO. We are talking about fundamentally moving payments towards a system that is not appropriately protected. I agree with Mr. Knight and the other panelists that things are changing via the pandemic, but I have actually not seen any hard evidence that these private Fintech companies are, "saving the day." In fact, I am worried about the transactions occurring without proper protections. And if anything, as I mentioned in my testimony, it is even more important to make sure that we are establishing a framework in the public interest.

Ms. TLAIB. Yes. And actually, during the pandemic, I see them expanding their services, which seems to be more in the vein of traditional banks right now. Do you believe that the OCC is the best suited to have regulatory authority over Fintech companies offering stable coin deposits, or is there an agency more suited to deal with the coin resulting payment system like the FDIC or the Fed?

Mr. CARRILLO. Another excellent question. Thank you, Representative Tlaib. I think that the banking regulators and Congress need to have a discussion about extending protections. But to your point, there is fundamentally a gap in the law right now that allows shadow banking generally, as Professor Wilmarth's research has shown, and as Vanderbilt Law Professor Morgan Ricks' research has shown, and this has to be addressed or we are not going to have coherent banking law and we are not going to have it before Silicon Valley enters the fray and makes it all the more necessary.

Ms. TLAIB. Yes. I am really pleased. Thank you, Mr. Chairman, for allowing me to be part of this last task force hearing. All of those Fintech companies may be offering new benefits, but this type of product offered goes beyond the reach of fair lending laws and regulations, which is what we should be worried about the most right now. So, I hope that we move forward in trying to create, again, some sort of way to make sure that our residents are protected as these Fintech companies move in towards traditional banking in our communities.

Thank you so much, and I yield back.

Mr. SANDS. Representative Tlaib, may I ask you a quick question?

Ms. TLAIB. Sure. I have 18 seconds. Go ahead.

Mr. SANDS. I think we need to be careful about defining "underserved" versus "poorly served." One of the things I would like to recommend this committee to do is—we constantly are talking about the "stick," but we have not talked about the "carrot." And if we can incentivize good practitioners to come in, then States like

your own and others could properly serve. There are good institutions that are trying to do these things.

Thank you.

Ms. TLAIB. No, I agree, and I have worked with many of the local institutions to do that. We are just not doing enough of it.

Chairman LYNCH. At this point, I am just going to go with one follow-up question, and, of course, I will afford Mr. Emmer a follow-up question on the Republican side.

Mr. Sands, one of the great promises of Fintech was the idea that it might help us to bank the unbanked, and the evidence is really mixed. We have seen examples where the use of certain algorithms has blocked out people; they have been an obstacle to financial access. And I have seen areas in Nigeria and other parts of Africa where it is the only game in town, there has been no legacy banking system there, so it has actually worked wonders in some of those countries. Somalia is a particular problem, and I think the answer has to be Fintech in some fashion or mobile banking.

How do we maximize that promise of banking the unbanked, especially where we are looking at this shift where Fintech—arguably, large tech firms come in, and they are the driving force in this. How do we make sure that we fulfill that promise of banking the unbanked in whatever the final version of our solution might look like? You have a great perspective, in your position, and I would love to hear your thoughts on that.

Mr. SANDS. Thank you, Chairman Lynch, for the opportunity. This is one of the things I would like to ask all of us to consider, is that we have to be very careful about the stick and not think about the carrot, as I mentioned before. The modernization of laws would be very important if we enabled the good guys to be able to do what they do in a high-quality way.

I will give you an example, Chairman Lynch. I wanted, and Lendistry wanted, to provide PPP loans in your State, but we were not allowed to because of the current rules. Again, the current rules, under SBA and others, have been made to be a form of risk management. While we respect them, there needs to be some type of review so that the good guys aren't fighting the fight with one hand behind their back.

Representative Tlaib just mentioned that we are not doing things in a scaleable fashion. Part of the reason why we are not doing them in a scaleable fashion is because we are not allowed to.

Another example will be, we are not allowed to participate in the Main Street Program. We are not allowed to become members of the Federal Reserve System. I really think that if we look and we give the good guys an opportunity to participate in a high-quality way, you are going to see massive change, and you are going to see massive things happen. And then, I think the good guys will overshadow and, quite frankly, beat, from a competitive perspective, many of the unscrupulous players.

Thank you, again, Chairman Lynch.

Mr. EMMER. Mr. Lynch, this is Tom Emmer. I let your staff know that I had no objection to an additional question, and I don't have one right at this moment.

Chairman LYNCH. Okay. Mr. Carrillo, could you follow up on that question? I know I have about a minute and 45 seconds left. I thought you might have an interesting perspective as well.

Mr. CARRILLO. Just to clarify, Chairman Lynch, you would like me to comment on how we best approach the problem of serving the unbanked and the underbanked?

Chairman LYNCH. Right. That is the big promise, that we can bank the unbanked, and the results so far have been mixed, and I would like to figure out, if you can just elaborate, on how we can do better.

Mr. CARRILLO. Yes, sir. I think that if providing payments infrastructure and banking services is as important as everybody on this panel says it is today, then we need to establish a public option. We need to start treating this sort of infrastructure like it is integral to the economy, as it very much is. And I think that fundamentally, firms, no matter how noble or altruistic they may be in their outlook, tend to gain customers based on whether those customers are going to be profitable to them. There is no public service mandate for these companies, and I doubt that folks who run the companies would welcome such a mandate.

If we do think that it is important as everybody needing to have basic digital financial services in the 21st Century, then we need to treat this like railroads, like canals, like telecom infrastructure is in other countries, and provide it to everybody as a matter of course.

Chairman LYNCH. Thank you very much.

Mr. WILMARTH. If I may comment, Chairman Lynch?

Chairman LYNCH. Please, go right ahead.

Mr. WILMARTH. I think that as we go forward, it is critical not to allow nonbanks to do what banks are doing without the same type of regulatory and public interest safeguards that we have established for banks. And Mr. Carrillo focused on the issue of deposits, that payments providers are essentially holding deposits without any deposit insurance or any of the other requirements that we impose on depository institutions. What if one of those payment providers fail? The customers are going to demand their money back and there is going to be no deposit insurance.

The one other thing I would say is, I think there is good space for partnerships between banks and Fintechs if it is done in a legal and responsible way. And I would point the committee task force to the recent *Marlette Funding,* and *Avant* settlements in Colorado, where the bank that partners with a nonbank lender has to maintain control over the lending, and they have to comply with the 36 percent cap on interest rates. They can't simply claim preemptive immunity and try to make 100 percent loans.

So, I think there is room for good partnerships, but we have to maintain the integrity of banking regulation and the public interest safeguards with which we expect banks to comply.

Chairman LYNCH. I appreciate that, and I agree. Thank you.

Mr. EMMER. Mr. Chairman, I will change my approach. I would like to follow up, if you don't mind.

Chairman LYNCH. Please, go right ahead, Mr. Emmer.

Mr. EMMER. Thank you. I appreciate it.

Mr. Carrillo, this struck me when you were speaking earlier: Beware of the promise of helping out the unbanked. With an open distributive ledger-type technology, I think the promise is enormous, and I think government, quite frankly, is putting up obstacles, and the uncertainty is getting in the way of the idea that we have to have intermediaries in all of these things, which is, I think, where all of you are coming from, and that is not exactly the way all cryptocurrency works.

Mr. Knight, do you have another side of this coin where we should be looking at the real promise that this would afford? Not just to innovation and the ability to access capital, but for the unbanked, the folks who just haven't been included in the system, where there is someone on the other side of the world because of cultural reasons, maybe it is a young woman who isn't allowed to do this sort of thing, or hasn't been, this would give them a lot of hope. I would appreciate your perspective.

Mr. KNIGHT. Thank you, Representative Emmer. Yes, I do believe that you are perhaps giving short shrift to the value of competition and innovation in helping to serve people. And that is not to say that there aren't rules of the road that should be followed, though those rules really need to be tied to the actual risks created and not just applied holistically across all competitors regardless of differences in business models.

And I do think that we have seen that changes in business models, changes in technology, more efficiencies gained, can help make providing services to some groups, where it used to previously not be cost-effective or feasible—it helps improve that.

Now, the changes are often marginal, right? We don't go from 10 percent lack of access to zero lack of access. But marginal improvements do matter. And I think we need to be very cautious and always bear in mind that the costs of regulation, the costs of the foregone service, in addition to the potential risks from a lack of regulation, it is two sides of the balance and they both need to be considered.

Mr. EMMER. Amen.

Mr. Chairman, at this point, I would respectfully yield the balance of my time to my colleague from Ohio, Mr. Davidson.

Mr. DAVIDSON. I thank the ranking member. Thanks for this extra question here.

Mr. Sands, as you spoke, I thought of so many companies that I have met with and so many innovators I have met with who have been frustrated by the lack of regulatory clarity or the stigma that, frankly, bad actors have put on this innovative space. And their plea hasn't been for no regulation. Frankly, they have pled for some regulatory clarity. In fact, a lot of companies have left the United States, not to avoid our laws, but to find regulatory clarity so they can do the very things they have promised here in the United States but, frankly, for others.

And so, as we think about the charter that we are talking about, or as we think about even raising capital, have you heard about this phenomenon? And then, when you think about the architecture that some, whether it is your firm or others in the space, have, what are the challenges of having this technology that maybe has

a similar objective—faster payments, for example—but a different architecture?

It seems to me that the regulatory framework has to allow for both in States, as consumer protection, for example, to happen, but maybe compliance is done in a different way. You deliver the protection in the firm, but you may be able to comply differently than somebody who maybe gets really good at printing off some more SARs and providing surveillance services for Federal agencies.

Mr. Sands, could you address that?

Mr. SANDS. Absolutely. Thank you, Representative Davidson. I think one of the keys to success that we are—we haven't quite focused on, but it can't be underscored, is that, as I mentioned, I have been regulated by eight different regulators at a time. Even here at Lendistry, we have five different regulators. The convergence of multiple regulators at the same time is part of the secret to success of regulation. So I want us to always keep that in the forefront and think about that as we move into the future decisions.

One of the things that we do need to make sure we think about with the OCC is that they kind of crawl, walk, run. Because if they step out by themselves without some, what I will call peers, it could change things. That being said, we do need to definitely think about how do we modernize and how do we think about the future. There is an amazing opportunity to grow GDP, grow tax revenue, and I think it is important, if we can do this correctly.

Thank you, sir.

Mr. DAVIDSON. Thank you so much.

Mr. Emmer, I yield your time back that I have fully consumed.

Chairman LYNCH. Okay. That concludes our witness testimony. I want to thank Mr. Carrillo, Mr. Sands, Professor Wilmarth, and Mr. Knight for your contributions, and your very thoughtful commentary.

Just in conclusion, I do want to note that, without objection, the following letters will be placed into today's record: the Conference of State Banking Supervisors; the American Bankers Association; the Utah Department of Financial Institutions; the Center for Responsible Lending; the Electronic Transactions Association; and the National Association of Federal Credit Unions.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned. Thank you, and please stay safe. Have a great day.

[Whereupon, at 1:32 p.m., the hearing was adjourned.]

A P P E N D I X

September 29, 2020

Task Force on Financial Technology Hearing
Opening Statement: Ranking Member McHenry
Date: September 29, 2020

I think we can all agree the coronavirus is the Great Accelerator, prompting widespread adoption of technologies that were once viewed as *mere conveniences* in January but are now **necessities.**

For financial institutions and consumers, the great accelerator has facilitated the use of digital banking.

And yet, we still have a patchwork of state laws and outdated banking regulations.

That won't work.

We should be promoting a regulatory framework that meets the challenges of today. That means encouraging

innovation and competition to make banking easier, safer, and more accessible and inclusive for more Americans.

I look forward to our discussion. I yield back.





Testimony before the

U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES
Task Force on Financial Technology

Regarding

"License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age"

September 29, 2020

Raúl Carrillo, Esq.
Policy Counsel, Demand Progress Education Fund
Fellow, Americans for Financial Reform Education Fund

Summary

Chairman Lynch, Ranking Member Emmer, and Members of the Financial Technology Task Force, thank you for inviting me to testify regarding the legal framework governing who can lend and process payments. I offer my testimony as Policy Counsel to the Demand Progress Education Fund (DPEF)[1] and a Fellow at the Americans for Financial Reform Education Fund (AFR Education Fund).[2] I have previously served as Special Counsel to the Enforcement Director at the Consumer Financial Protection Bureau (CFPB).

Today, I would like to provide a public interest perspective on developments in the fintech sector. While many relatively new "bank-like" technologies may provide benefits to individual users, they also present risks to the integrity of the financial system, consumer protections, and our civil rights (especially our rights to privacy). Moreover, many of these innovations only serve to entrench the power of Big Tech and further erode our democracy.

I echo previous calls for policymakers to adopt a bright-line, precautionary approach to digital "bank-like" activities.[3] What industry calls "innovation" is often easily mapped to a longstanding financial service and therefore the existing laws should apply. At the same time, certain tools and certain forms of partnerships should have no place in our economy whatsoever.[22] Treating innovation as an unqualified good leads regulators to ignore both considerations of equity and long-term, sustainable innovation. Give the interface between powerful corporations, complex products, and the public, precaution should be the norm, as it is in food and drug regulation.[4]

In this testimony, I discuss the following (non-exhaustive) list of concerns:

- The existing regulatory framework allows nonbank companies to "rent" a bank charter in order to evade state consumer protection laws. The recent "*Madden*-fix rules" adopted by the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), as well as the OCC's proposed "true lender rule", exacerbate this problem.

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[1] DPEF is a fiscally-sponsored project of New Venture Fund, a 501(c)3 organization. DPEF and our more than two million affiliated activists seek to protect the democratic character of the internet — and wield it to render government accountable and contest concentrated corporate power.

[2] AFR Education Fund is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR Education Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.

[3] *See, e.g.* Saule T. Omarova, *Dealing with Disruption: Emerging Approaches to Fintech Regulation*, 61 WASH. U. J.L. & POL'Y 27, 34-36 (2020) (discussing the problem with "smart" regulation: regulation that is "iterative, flexible, carefully tailored, risk-sensitive, and innovation-friendly."); JULIE E. COHEN, BETWEEN TRUTH AND POWER: THE LEGAL CONSTRUCTIONS OF INFORMATIONAL CAPITALISM 174, 182-187 (2019) (underscoring the importance of understanding platform digital activities in order to meet systemic threats).

[4] COHEN, *supra* note 3, at 91-92.

- The use of artificial intelligence (AI) and predictive analytics for marketing, loan underwriting and monitoring, and the pricing of various products and services raises fundamental consumer protection risks and fair lending concerns.

- Existing partnerships between banks and surveillance-based technology companies have already raised unique, specific concerns regarding discrimnation.

- Rather than providing consistent guidance and oversight through proper process, many regulators have adopted a *laissez faire* attitude toward fintech.

- Wall Street and Silicon Valley are irresponsibly integrating banking and commerce (and payments and platforms).

- Global stablecoin projects proposed by Big Tech would entrench corporate power and threaten financial stability.

- Wall Street, Silicon Valley, and the fintech industry are waging a "war on cash", leading to heightened surveillance, increased corporate power, and financial exclusion.

- Financial data collection is becoming increasingly intertwined with federal, state, and local law enforcement and threatening our civil rights.

With these concerns in mind, the Americans for Financial Reform EF and DPEF urge Congress to pursue the following (non-exhaustive) list of recommendations

- Prevent the issuance of Special Purpose National Bank Charters (SPNBCs) and clarify the narrow range of financial institutions that can receive National Banking Charters.

- Close the "Industrial Loan Corporation" (ILC) Loophole.

- Strengthen consumer protections, including by instituting a 36% rate cap.

- Designate the deposit-like obligations of dominant tech platforms as "deposits", prohibiting the platforms from issuing such obligations absent approval by banking regulators.

- Constrain corporate data usage to a short list of permissible purposes.

- Re-establish a bright line between the ownership of large tech companies and financial institutions.

- Establish privacy-respecting public options for real-time payments, safe deposits, international money transfer, and other basic digital financial services.

The fintech industry's "endless capacity for self-referential growth"[5] suggests prudence. In fact, it can only be disciplined by policymakers' own forward thinking about services people actually need in an informational economy.[6] Policymakers must avoid being swayed by general promises of innovation and create systems for real accountability on behalf of the public.

Discussion

The existing regulatory framework allows nonbank companies to "rent" a bank charter in order to evade state consumer protection laws. The OCC and FDIC's recent "*Madden*-fix Rules" and the OCC's proposed "true lender rule" exacerbate this problem.

Some bank and non-bank company partnerships may provide important benefits to individual customers. But others exist primarily as a means for the nonbank company to "rent" a bank charter in order to evade state consumer protection laws.[7]

Since the American Revolution, states have set interest rate caps to protect their residents from predatory lending. Courts have long rejected efforts to evade usury laws, looking beyond the technical form of a transaction and toward its substance.[8] Beginning with a 1978 Supreme Court decision, a combination of federal and state law changes eliminated rate caps for most banks. Still the vast majority of states retain interest rate limits for longer-term loans by *nonbank companies*.[9] Around one in three states also maintain interest limits for shorter loans.[10]

In *Madden v. Midland Funding*,[11] the Second Circuit Court of Appeals held that the National Bank Act (NBA) does not regulate what nonbank assignees may charge, and that limiting the interest charged by debt buyers purchased debt for pennies on the dollar did not significantly interfere with the business of banking. This decision is consistent with the aforementioned, longstanding power of states to regulate interest rates charged by *nonbank companies*, and with the traditional rule that state consumer protection laws are not preempted unless they significantly interfere with banks.

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[5] *Fintech: Examining Digitization, Data, and Technology: Hearing Before the U.S. S. Comm. on Banking, Hous., and Urban Affairs*, 115th Cong. 17 (2018) (Statement of Saule T. Omarova, Prof. of Law, Cornell L. Sch.), *available at* https://www.banking.senate.gov/download/omarova-testimony-and-appendix-91818.

[6] *See, e.g.*, Amy Kapczynski, *The Law of Informational Capitalism*, 129 YALE L.J. 1460, 1467 (2020) ("we need...a more serious engagement with the political economy of data, grounded in the recognition that data is a social relation--an artifact not only of human cognition but also of legal structures.")

[7] *See generally* Letter from Center for Responsible Lending (CRL) et al. to OCC (Sept. 3, 2020), https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/OCC-True-Lender-Comments.pdf ("CRL et al. True Lender Comments").

[8] *Id.*

[9] For example, 43 states and the District of Columbia cap the rate on a $500, 6-month loan, at a median of about 36%. NAT'L CONSUMER LAW CTR. (NCLC), STATE RATE CAPS FOR $500 AND $2,000 LOANS, (2020), https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/FactSheet-StateRateCap.pdf. In addition, in recent years, votes in many states, including Arizona, Colorado, Montana, and South Dakota have approved rate cap initiatives that eliminate both short-term and longer-term high-cost loans.

[10] CRL, MAP OF U.S. PAYDAY INTEREST RATES (2019), https://www.responsiblelending.org/research-publication/map-us-payday-interest-rates.

[11] 786 F.3d 246, 249-53 (2d Cir. 2015).

Recent rulemaking by the OCC and FDIC — the so-called "*Madden*-fix rules" — permit *nonbank companies* to ignore state caps if the loan was originated by a bank and assigned to the nonbank company.[12] The OCC has also recently proposed a rule ("true lender rule") that would specify that a national bank or federal savings association "makes" a loan when, as of the date of origination, the bank is either "named as the lender in the loan agreement" or "funds the loan."[13] In concert, the rules would allow a *non-bank company* to charge as high of an interest rate as it would like, even if the partnering bank only touches a loan for a mere second.

The OCC's true lender proposal entirely fails to even mention the loans peddled by existing "rent-a-bank" schemes include some of most exorbitantly priced and irresponsible loans on the market. The proposed rule is irrational, arbitrary and capricious, and outside the OCC's authority. The OCC has not even made a pretense of complying with the Dodd-Frank Act's requirements for preempting state law, nor can it, because it has no authority to preempt state interest rate limits as applied to *nonbank companies.*[14]

We have long argued the OCC has also threatened consumer protections by offering a SPNBCs,[15] which New York successfully challenged in Federal District Court[16] and which the OCC is appealing to the Second Circuit.[17]

The use of AI and predictive analytics for marketing, loan underwriting and monitoring, and the pricing of various products and services raises fundamental consumer protection risks and fair lending concerns.

Many claims are made about the promise of Big Data to increase financial inclusion, but those claims fail to reckon with, much less solve, the systemic reasons people are left out or more accurately deliberately excluded. Data analytics can potentially benefit individual consumers, especially consumers who have a "thin file" or no file on record with a traditional

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[12] The OCC and FDIC rules state that when a bank sells, assigns, or otherwise transfers a loan, interest permissible prior to the transfer continues to be permissible following the transfer. In other words, if a bank originates a loan at 160% in South Dakota, where voters adopted a 36% interest rate cap in 2016, the loan could be sold to a nonbank lender that could continue to charge new interest at 160%. *See* NCLC, FDIC/OCC PROPOSAL WOULD ENCOURAGE RENT-A-BANK PREDATORY LENDING, (Dec. 2019), https://www.nclc.org/images/pdf/high_cost_small_loans/ib-fdic-rent-a-bank-proposal-dec2019.pdf.

[13] *Id.*

[14] *See* 12 U.S.C. § 25b(b)(1)(B) (Dodd-Frank states that the OCC may preempt state consumer financial laws "only if" the law discriminates against national banks or the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers).

[15] OCC, "Exploring Special Purpose National Bank Charters for Fintech Companies," (Dec. 2016), https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-special-purpose-nat-bank-charters-fintech.pdf.

[16] Vullo v. OCC, 378 F. Supp. 3d 271, 292-98 (S.D.N.Y. 2019).

[17] Notice of Appeal, Lacewell v. OCC, No. 1:18-cv-08377 (S.D.N.Y. Dec. 19, 2019).

credit reporting agency.[18] However, data analytics can also worsen existing disparities.[19] In light of the way that exploitation of unbanked and underbanked communities of color is baked into our financial system, industry plans for greater "financial inclusion" demand careful scrutiny.[20] So-called "alternative data" can be used inappropriately to charge higher prices to those least able to afford them. Analysis of price sensitivity and propensity to comparison shop may lead to higher prices for less sophisticated consumers, those with more limited internet access, those with fewer banks in their community, and those with fewer options.

Banks and fintech partners are increasingly using payments and deposit data to evaluate credit applications.[21] Some banks partner with lenders that access transaction data through data aggregators.[22] This trend raises myriad concerns. For instance, deposit pattern analysis could lead to lending based on ability to collect, rather than ability to repay, which can have multiple negative consequences for borrowers and for markets. Data that goes into lending or other decisionmaking could be attributed to the wrong consumer or be otherwise erroneous. The conclusions of computer algorithms could be off-base. The Fair Credit Reporting Act (FCRA), which is aimed at ensuring accuracy, predictiveness, transparency, and appropriate data usage, may not be applied to "alternative data." Thus, many fintech consumers lack access to dispute mechanism, resolution rights, and other FCRA protections.

Existing partnerships between banks and surveillance-based technology companies have already raised unique, specific concerns regarding disparate impact, digital redlining, predatory inclusion, and racialized surveillance.

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[18] National Bureau of Economic Research, The Role of Technology in Mortgage Lending, Working Paper 24500, April 2018 *available at* https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr836.pdf.

[19] *See, e.g.*, Carol Evans, Board of Governors of the Federal Reserve System, *Keeping Fintech Fair: Thinking about Fair Lending and UDAP Risks*, Consumer Compliance Outlook (Second Issue 2017) 4 ("[T]he fact that an algorithm is data driven does not ensure that it is fair or objective."); *Banking on Your Data: The Role of Big Data in Financial Services: Hearing Before the H. Comm. on Fin. Services*, 116th Cong. 20-21 (2019) (Statement of Lauren Saunders, Assoc. Dir., NCLC), *available at* https://www.nclc.org/images/pdf/cons-protection/testimony-lauren-saunders-data-aggregator-nov2019.pdf (discussing fintech and the ECOA); *Banking on Your Data: The Role of Big Data in Financial Services: Hearing Before the H. Comm. on Fin. Services*, 116th Cong. 20-21 (2019) (Statement of Dr. Seny Kamara, Assoc. Prof., Dept. of Comp. Sci., Brown Univ.), *available at* https://financialservices.house.gov/uploadedfiles/hhrg-116-ba00-wstate-kamaras-20191121.pdf ("[Algorithmic bias] is a serious concern in the context of the ECOA and the FHA, both of which prohibit discriminatory lending practices").

[20] *See, e.g,* NCLC, Past Imperfect: How Credit Scores and Other Analytics "Bake In" and Perpetuate Past Discrimination 2, (2016), http://www.nclc.org/images/pdf/credit_discrimination/Past_Imperfect050616.pdf [https://perma.cc/S8ED-WTDR].

[21] Account data will almost certainly exhibit disparities by race because one of the factors used by scoring models is likely to be overdrafts. African-Americans are disproportionately affected by bank overdraft practices, 25 which often encourage people to overdraft rather than helping them avoid fees. CRL et al. True Lender Comments, *supra* note 7, at 7.

[22] Some financial services companies have argued that the security practices of data aggregators are not comparable to the standards applied at banks and the security practices of consumer fintech application providers are even weaker. *See* Amer. Bankers Assoc., *Fintech – Promoting Responsible Innovation* (May 2018), at 3-4, *available at* https://www.aba.com/Advocacy/Documents/fintech-treasury-report.pdf.

Too often, promises of technological empowerment yield "predatory inclusion" — a process whereby financial institutions offer needed services to specific classes of users, but on exploitative terms that limit or eliminate their long-term benefits.[23] They may also simply produce new costs and fees for consumers while producing no benefit. Many longer-term loans originated based on alternative data are marketed toward "underbanked" low-income households, but carry extremely high interest rates and are made with little regard for the borrower's ability to repay.

Creditworthiness is often determined by a closed box of algorithms,[24] which assesses our 'digital character' in an opaque manner,[25] and may perpetuate discrimination in doing so.[26] In theory, facially neutral algorithms mitigate the risk that consumers will face intentional discriminatory treatment based on protected traits such as race, gender, or religion.[27] But evidence demonstrates that the data sets being used are often incomplete or inaccurate, and that discriminatory outcomes can result from use of data that correlates with race. The Equal Credit Opportunity Act (ECOA) prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, age, and other factors.[28] The Fair Housing Act (FHA) prohibits discrimination in the sale, rental or financing of dwellings and other housing-related activities on the basis of race, color, religion, national origin, sex, disability or familial status.[29] Both statutes prohibit policies or practices that have a disproportionately negative impact on a protected class even though the creditor has no intent to discriminate and the practice appears neutral on its face.

Much like the factors that drive the disparities in traditional credit scores, new sources of data reflect deeply ingrained structural inequalities in employment, education, housing and economic opportunity.[30] Geolocation data reflects deeply entrenched racial and ethnic segregation in housing. Even seemingly neutral variables, when used alone or in combination, can correlate with race, ethnicity and other prohibited factors. Machine learning (ML) algorithms may pick up subtle, but statistically significant patterns that correlate with race and other

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[23] Louise Seamster & Raphaël Charron-Chénier, *Predatory Inclusion and Education Debt: Rethinking the Racial Wealth Gap*, 4 Soc. Currents 199, 199-200 (2017) (describing the targeting of mortgagors and students who borrow to purchase homes or education as "predatory inclusion."). *See also* Kristin Johnson et al., *Artificial Intelligence, Machine Learning, and Bias in Finance: Toward Responsible Innovation*, 88 Fordham L. Rev. 499, 505, 517–21 (2019) (arguing fintech firms may "hardwire predatory inclusion" into financial markets for the "next several generations").

[24] *See generally,* Frank Pasquale, The Black Box Society: The Secret Algorithms that Control Money and Information (2015).

[25] *See* Tamara K. Nopper, *Digital Character in the "Scored Society": FICO, Social Networks, and the Competing Measurements of Creditworthiness, in* Captivating Technology: Race, Carceral Technoscience, and Liberatory Imagination in Everyday Life 170, 170-188 (Ruha Benjamin ed., 2019), (coining and analyzing the concept of "digital character").

[26] *See, e.g.*, Danielle Keats Citron & Frank Pasquale, *The Scored Society: Due Process for Automated Predictions*, 89 Wash. L. Rev. 1, 13 (2014).

[27] *See, e.g.* Alex P. Miller, *Want Less-Biased Decisions? Use Algorithms*, Harv. Bus. Rev. (July 26, 2018).

[28] 15 U.S.C. §§ 1691 et seq.

[29] 42 U.S.C. §§ 3601 et seq.

[30] *See* NCLC, *supra* note 19 (noting African American, Latinx, and Asian consumers have lower credit scores as a group than whites).

protected characteristics and replicate existing bias.[31] ML algorithms may also analyze variables that engineers did not intend them to analyze.[32] In any case, alternative credit can be mined to extract protected characteristics and produce discriminatory outcomes.

Steering occurs online when a consumer is directed towards or away from a loan product or feature because of a prohibited characteristic, rather than a consumer need or other legitimate factor.[33] For example, a creditor may steer limited English proficient (LEP) consumers to a different range of products than non-LEP borrowers.[34] *Digital redlining* occurs when a creditor provides unequal access to credit or unequal terms of credit based on prohibited characteristics.[35]

Alternative data and analytics have enabled creditors to engage in *price discrimination,* targeting people of color and those living in low-income neighborhoods with high-cost products with poor terms.[36] The recent action against Facebook by the Department of Housing and Urban Development (HUD) highlighted the discriminatory impact of these targeted advertising and marketing practices.[37] Consumers of color may be directed to subprime credit cards based on personal characteristics, even though they could qualify for more competitive rates. In the mortgage context one study noted that fintech lenders reduced but did not erase discriminatory lending patterns, particularly with respect to mortgage pricing.[38]

Concerns regarding transparency abound. Big Data's records are often inaccurate.[39] For instance, errors might arise as the data is passed along, especially when screen scraping (using a

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[31] *See* Moritz Hardt, *How Big Data is Unfair, Understanding Unintended Sources of Unfairness in Data Driven Decision Making*, MEDIUM (Sept. 26, 2014), http://www.cs.yale.edu/homes/jf/HardtHowBigDataIsUnfair.pdf; Andrew Selbst, *A New HUD Rule Would Effectively Encourage Discrimination by Algorithm*, SLATE (Aug. 19, 2019), https://slate.com/technology/2019/08/hud-disparate-impact-discrimination-algorithm.html.

[32] Johnson et al., *supra* note 23, at 510.

[33] Carol Evans, Board of Governors of the Federal Reserve System, *From Catalogs to Clicks: The Fair Lending Implications of Targeted, Internet Marketing*, Consumer Compliance Outlook (Third Issue 2019) at 4.

[34] *See* CFPB, Supervisory Highlights, Issue 13 (Oct. 2016), http://s3.amazonaws.com/files.consumerfinance.gov/f/documents/Supervisory_Highlights_Issue_13__Final_10.31.16.pdf.

[35] *Id.*

[36] Comment from Nathan Newman, Research Fellow, New York Univ. Information Law Institute, to FTC (Aug. 2014), https://www.ftc.gov/system/files/documents/public_comments/2014/08/00015-92370.pdf.

[37] The data used to target Facebook users was unwittingly provided through the actions of users, and those associated with them, on and off the platform. Such behavioral data enabled Facebook to classify users based on protected characteristics and invited advertisers to discriminatorily target or exclude housing-related ads to users based on these imputed protected traits. HUD v. Facebook, Charge of Discrimination, FHEO No. 01-18-0323-8 at paragraph 12.

[38] Robert Bartlett, Adair Morse, et al., *Consumer Lending Discrimination in the Fintech Era, National Bureau of Economic Research*, Working Paper 25943 (June 2019), https://www.nber.org/papers/w25943 (Latinx and African American borrowers paid 7.9 and 3.6 basis points more in interest for home purchase and refinance mortgages respectively because of discrimination. These magnitudes represent 11.5% of lenders' average profit per loan).

[39] For example, an examination of consumer reports generated by eBureau, which has since been acquired by TransUnion, revealed that the underlying information used to assess income and education level was incomplete and primarily gathered without the consumer's knowledge. *See* NCLC, BIG DATA, A BIG DISAPPOINTMENT FOR SCORING CONSUMER CREDITWORTHINESS 18 (2014), https://www.nclc.org/issues/big-data.html.

consumers' username and password to access an account) is involved.[40] Any data used for credit decisions must comply with the ECOA and the FCRA, which at a minimum mandate that data used be accurate and predictive of creditworthiness,[41] and require that creditors provide credit applicants with notices stating the reasons for credit denial or for taking other adverse actions on an application. These notices may provide clues to help uncover whether the creditor's decision was in fact, discriminatory.[42] However, where complex algorithms are based on unknown alternative data, it is impossible to know exactly what factors were used and how they were used. The opaqueness undermines the legislative intent of ECOA.[43]

Existing partnerships between bank and surveillance-based technology companies have already raised issues. For instance, the new Apple Card — offered in partnership with Goldman Sachs — is currently the subject of a New York State investigation for gender discrimination.[44] Amazon now offers credit cards in tandem with Synchrony Bank, formerly GE Capital Retail Bank, which the CFPB ordered to provide an estimated $225 million in relief to consumers harmed by illegal and discriminatory credit card practices.[45] A checking account partnership between Google and Citibank has drawn criticism from privacy advocates, who argue Google wants to sell or share financial data for targeted advertisement or other purposes.[46]

The fintech companies that have applied for banking charters have also raised red flags. When private equity-funded mobile banking start-up Varo Money first applied for a national charter, the National Community Reinvestment Coalition (NCRC) outlined how the bank would not meet Community Reinvestment Act (CRA) priorities.[47] Social Finance (SoFi) pulled its previous application for a national bank charter after its CEO announced he would resign due to

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[40] *CFPB's Symposium on Consumer Access to Financial Records, Section 1033 of the Dodd-Frank Act*, (2020) (Statement of Chi Chi Wu, Staff Attorney, NCLC), *available at* https://files.consumerfinance.gov/f/documents/cfpb_wu-statement_symposium-consumer-access-financial-records.pdf.

[41] ECOA, 15 U.S.C. § 1691 et seq.; FCRA, 15 U.S.C. § 1681 et seq.

[42] Reg. B, 12 C.F.R. § 1002.9(a)(3)(i)(B). *See also* Curley v. JP Morgan Chase Bank, 2007 WL 1343793 (W.D. La. May 7, 2007) (discussing the provision), aff'd, 261 Fed. Appx. 781 (5th Cir. 2008).

[43] For a list of studies, see NCLC, *supra* note 20.

[44] Neil Vigdor, *Apple Card Investigated After Gender Discrimination Complaints*, N.Y. TIMES (Nov. 10, 2019), https://www.nytimes.com/2019/11/10/business/Apple-credit-card-investigation.html.

[45] Kate Rooney, *Amazon launches a credit card for the 'underbanked' with bad credit*, CNBC (Jun. 10, 2019), https://www.cnbc.com/2019/06/10/amazon-launches-a-credit-card-for-the-underbanked-with-bad-credit.html; CFPB, CFPB Orders GE Capital to Pay $225 Million in Consumer Relief for Deceptive and Discriminatory Credit Card Practices (Jun. 19, 2014), https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-ge-capital-to-pay-225-million-in-consumer-relief-for-deceptive-and-discriminatory-credit-card-practices/.

[46] John Constine, *Leaked pics reveal Google smart debit card to rival Apple's*, TECHCRUNCH (April 17, 2020), https://techcrunch.com/2020/04/17/google-card/.

[47] Comment from NCRC to OCC (Nov. 8, 2018), https://ncrc.org/ncrc-comments-regarding-advance-notice-of-proposed-rulemaking-docket-id-occ-2018-0008-reforming-the-community-reinvestment-act-regulatory-framework/#_edn33. *See* also OCC, Conditional Approval No. 1205 2 (Sept. 2018), https://www.occ.treas.gov/topics/charters-and-licensing/interpretations-and-actions/2018/ca1205.pdf. *See also* Comment from Ams. for Fin. Reform to FDIC (July 19, 2017), https://ourfinancialsecurity.org/2017/07/letter-regulators-afr-opposes-sofis-deposit-insurance-application/ (arguing SoFI's CRA plan baldly proposed serving low-and-middle income consumers with substandard products).

allegations of sexual harassment and skirting risk and compliance controls.[48] Since then, SoFi has been the target of a class action lawsuit alleging it systematically denied and limited access to lending and refinancing opportunities for participation in the federal Deferred Action for Childhood Arrivals (DACA) program.[49] A recent application by Formative Bank — which would only serve fintechs — appears to have simply copy-and-pasted CRA plans from OCC guidance, indicating a lack of meaningful commitment to equity.[50]

Rather than providing consistent guidance and oversight through proper process, many regulators have adopted a laissez faire attitude toward fintech, issuing no-action letters and creating "sandboxes." Some banking regulators are even attempting to cede or delegate core oversight functions to the tech industry or industry-led bodies.

We are concerned by the recent trend of encouraging fintech companies to regulate themselves. Several regulators have created "sandboxes" — "safe spaces" where fintech companies can develop and test their innovations without being subject to the full extent of financial regulation.[51] By providing guidance or taking ad hoc actions such as issuing no-action letters, regulators ostensibly enable fintech firms to better innovate, insofar as they are able to better recognize what kind of regulatory burden they might face.[52] However, consumer advocates have strenuously objected to sandboxes and no-action letters.[53] State regulators have also signalled opposition. For instance, the Conference of State Bank Supervisors has also issued a letter objecting to the CFPB's recent "experimentalist approach, arguing "[t]he Bureau is not authorized to prevent state officials from enforcing federal consumer financial laws."[54] Twenty-two state attorneys general have also opposed these policies.[55]

We have also urged the FDIC to refrain from delegating its responsibilities to a public-private standard-setting organization (SSO) and to instead to develop its own expertise in the context of a robust, precautionary, approach to oversight. Simply facilitating compliance with

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[48] Katie Brenner & Nathaniel Popper, *Chief Executive of Social Finance, an Online Lending Start-Up, to Step Down*, N.Y. TIMES (Sept. 11, 2017), https://www.nytimes.com/2017/09/11/technology/sofi-mike-cagney-sexual-harassment.html.

[49] Press Release, Lawyers for Civil Rights, DACA Discrimination Class Action Against Online Lender (May 19, 2020), http://lawyersforcivilrights.org/our-impact/economic-justice/daca-recipient-files-discrimination-class-action-against-major-online-lender/.

[50] Comment from NCRC et al. to OCC (Sept. 23, 2020), https://ncrc.org/ncrc-comment-on-formative-application-to-occ/.

[51] Dirk Zetzsche, Ross Buckley, Douglas Arner & Janos Barberis, *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation*, 23 FORDHAM J. CORP. & FIN. L. 31, 64 (2017).

[52] *See* Chris Brummer & Yesha Yadav, *Fintech and the Innovation Trilemma*, 107 GEO. L.J. 235, 283 (2019).

[53] Comments from Ams. For Fin. Reform et al. to CFPB (2019), https://ourfinancialsecurity.org/wp-content/uploads/2019/02/NAL-Product-Sandbox-comments-consumer-groups-FINAL.pdf.

[54] Conference of State Bank Supervisors, Comment Letter on Proposed Policy Guidance and Procedural Rule on No-Action Letters and Product Sandbox (Feb. 11, 2019), https://www.csbs.org/sites/default/files/2019-02/CSBS%20Letter--CFPB%20NAL%20Policy%20Revisions%20and%20Product%20Sandbox_%20021119%20FINAL%20NOSIG.pdf.

[55] Comments from state AGs to CFPB (2019), https://ag.ny.gov/sites/default/files/cfpb_nal_and_sandbox_comment_final.pdf.

SSO standards is not an acceptable means of regulation, nor an acceptable alternative to regulation. We especially oppose privatizing responsibility for standard-setting at a time when the FDIC and other regulators are opening the banking franchise to Big Tech and surveillance-driven technology.[56]

Wall Street and Silicon Valley are irresponsibly integrating banking and commerce (and payments and platforms).

We strongly advise against allowing Wall Street and Silicon Valley to intertwist any further.[57] Historically, commercially-owned banks have made unsound loans to business partners, denied services to competitors, and generally engaged in imprudent activities to spur commercial user purchases.[58] Commercial firms that also engage in financial services tend to use such enterprises to fund other risky business activities, heightening the moral hazard of bailout.[59] The risk of predatory behavior increases. Allowing Big Tech to take advantage of federal deposit insurance and other attendant protections (without concomitant responsibilities) threatens responsible practices within the tech sector overall. Just as distressingly, allowing Big Tech to engage in shadow banking activity jeopardizes financial stability.[60] These combinations should not be allowed.[61]

The FDIC's recently proposed rule concerning ILCs[62] only stands to make a bad situation worse. ILCs have frequently failed due to problems such as reckless lending, inadequate capital, and insufficient liquidity.[63] The dangers typically flowed from the broader activities of the ILC parent company. Strikingly, zero of the core elements of Bank Holding Company (BHC)

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[56] *See, e.g,* Lev Menand & Morgan Ricks, *Policy Spotlight Lacewell v. OCC,* JUST MONEY (Aug. 5, 2020), https://justmoney.org/lacewell-v-occ/ (discussing the OCC's plans to grant SPNBCs to fintech companies that do not issue or maintain deposit balances, exempting them from key federal regulations).

[57] *See* Comment from Arthur E. Wilmarth, Jr., Prof. of Law, Geo. Wash. Univ. L. Sch., to FDIC (Apr. 10, 2020), https://www.fdic.gov/regulations/laws/federal/2020/2020-parent-companies-of-industrial-banks-3064-af31-c-002.pdf.

[58] Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN L. REV. 1539, 1598-1606 (2007).

[59] *Id.* at 1569.

[60] For relevant background, see, e.g., L. Randall Wray, *Global Financial Crisis: Causes, Bail-Out, Future Draft*, 80 UMKC L. REV. 1101, 1107 (2012) (describing how the shift of economic power to shadow banks triggered the operation of "Gresham's Law", whereby safer and stabler financial firms were driven out of business).

[61] We have also called on regulators to more thoroughly review all tech acquisitions of financial services companies. Comments from AFR Education Fund & DPEF to FDIC (July 2, 2020), https://ourfinancialsecurity.org/wp-content/uploads/2020/07/Americans-for-Financial-Reform-EF-DPEF-Comment-FDIC-Docket-RIN-3064-AF31-.pdf.

[62] *See* FDIC Docket RIN 3064-AF31, 85 Fed. Reg. 17771 (Mar. 31, 2020), https://www.fdic.gov/news/press-releases/2020/pr20031a.pdf.

[63] Thirteen ILCs failed between 1982 and 1984. ILCs declined from 58 to 23 between the beginning of the financial crisis in 2007 and the end of 2019, and the total assets of ILCs dropped from $177 billion to $141 billion.# Moreover, several parent companies failed and were rescued by the federal government during the global financial crisis. Other parent companies, including General Motors Acceptance Corp. (GMAC), Merrill Lynch, Goldman Sachs, and Morgan Stanley, would have failed had they not received generous bailouts. *See* AFR Education Fund & DPEF Comments to FDIC, *supra* note 60.

supervision are included in the proposed eight commitments that an ILC parent company must agree to under the proposed rule.[64] The FDIC's limited supervisory powers over parent companies and other affiliates of ILCs are plainly inadequate to prevent the systemic risks, conflicts of interest, and threats to competition and consumer welfare created by commercially-owned ILCs.[65]

We agree with Prof. Wilmarth that Big Tech firms would not be satisfied with making "toehold" acquisitions of ILCs and will do what they can to take advantage of the loophole, including by making deals with private equity investors.[66] Regulators should bear in mind that data collection in the ILC context is its own form or arbitrage.[67] Providing data processing, data storage, and data transmission services is permissible for BHCs and their subsidiaries. However, the Bank Holding Company Act (BHCA) limits the activities of BHCs and their subsidiaries to banking, managing and controlling banks and other subsidiaries, and performing services for its subsidiaries.[68] Companies collecting data from a customer's social media account or their lifestyle, for instance, could avoid these limitations. There may be few privacy protections on the use of financial data, period.[69] But ILC arrangements threaten these safeguards — especially when it comes to consumer protection. Fundamentally, banks have commercial reasons *not* to share certain personal data. Banks understand that the core transactional data and increasingly the identity data is unique to banks. Customers do not expect their banks to capture data that would support commercial business lines, outside of contexts regulated by the FCRA.[70]

We are also concerned by the encroachment of dominant platforms into the payments space. Big Tech companies use their "platform privilege" not only to analyze users, but to acquire and appropriate from competitors that rely on the infrastructure they supply.[71] According to a new poll released by Consumer Reports, six in ten Americans support the government taking

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[64] *Id.*
[65] *See* Wilmarth Comment, *supra* note 57, at 10.
[66] AFR SoFi Letter, *supra* note 47.
[67] *See generally* Cinar Oney, *Fintech Industrial Banks and Beyond: How Banking Innovations Affect the Federal Safety Net*, 23 FORDHAM J. CORP. & FIN. L. 541, 552–53 (2018).
[68] *See* 12 U.S.C. § 1843(a)(2).
[69] Heather Hogsett, *Consumer Protections and the Digital Evolution in Banking*, MORNING CONSULT (Feb. 13, 2020), https://morningconsult.com/opinions/consumer-protections-and-the-digital-evolution-in-banking/.
[70] *See* Astra Taylor & Jason Sadowski, *How Companies Turn Your Facebook Activity Into a Credit Score*, THE NATION (May 27, 2015), https://www.thenation.com/article/archive/how-companies-turn-your-facebook-activity-credit-score/.
[71] *Competition in Digital Technology Markets: Examining Self-Preferencing by Digital Platforms: Hearing Before the Subcomm. on Antitrust, Competition Policy and Consumer Rights of the H. Comm. on the Judiciary*, 116th Cong. 5 (2020) (Testimony of Sally Hubbard), *available at* https://www.judiciary.senate.gov/imo/media/doc/Hubbard%20Testimony.pdf

more steps to regulate online platforms.[72] Still, most powerful platform-based companies have opposed even the mildest, most established forms of financial regulation.[73]

The systematic monitoring of financial activity allows dominant platforms to become even more extractive and more powerful.[74] As payment transactions illuminate the social links between fund senders and recipients, companies that already collect similar social data find payments data extremely valuable. With a more comprehensive perspective on consumer behavior, dominant platforms can more easily take over adjacent markets, engage in predatory pricing, self-deal, increase the monetary value of their advertising, and accumulate more economic power. They can use the integrated information to both enhance existing products and offer new services (like credit scoring) to new groups of consumers.[75] Because corporate currencies are literally means of paying for other products, they could render the ability to tie and bundle products together limitless.[76] As TenCent has demonstrated in China, combining a payments network with a massive social media platform allows powerful companies to generate extreme pricing power within captive ecosystems.[77]

Payment platforms can be dangerously insecure and lack proper consumer protections. Many mobile money platforms do not simply transfer funds, but store balances unprotected by federal deposit insurance, or any equivalent mechanism.[78] By avoiding custody agreements with FDIC-insured institutions, mobile payment companies avoid most banking regulation,

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[72] Chris Mills Rodrigo, *Majority of Americans want more government regulation of tech platforms: poll*, THE HILL (Sept. 24, 2020), https://thehill.com/policy/technology/518020-majority-of-americans-want-more-government-regulation-of-tech-platforms.

[73] *See, e.g.* PayPal's recent lawsuit over the CFPB Prepaid Rule - a rule that most of the payments industry does not oppose. *Is Cash Still King? Reviewing the Rise of Mobile Payments Testimony: Hearing Before the H. Comm. on Fin. Services*, 116th Cong. 8 (2020) (Statement of Christina Tetreault, Sr. Policy Counsel, Consumer Reports), *available at* https://advocacy.consumerreports.org/wp-content/uploads/2020/01/Hhrg-116-ba00-wstate-tetreaultc-20200130-u1-1.pdf (arguing protections are threatened by litigation initiated by PayPal).

[74] *See* Letter from AFR Education Fund & DPEF to H. Comm. on the Judiciary (Apr. 17, 2020), https://ourfinancialsecurity.org/2020/04/joint-letter-promote-tradition-of-separating-banking-and-commerce-regarding-dominant-platforms/ (arguing for the structural separation of large tech platforms and payments).

[75] BANK FOR INTERNATIONAL SETTLEMENTS, BIG TECH IN FINANCE: OPPORTUNITIES AND RISKS, BANK FOR INTERNATIONAL SETTLEMENTS ANNUAL ECONOMIC REPORT, https://www.bis.org/publ/arpdf/ar2019e3.htm.

[76] Indeed, competitors have already alleged that Facebook used an older payment system, Facebook Credits, to instigate *per se* unlawful tying arrangements. *Kickflip, Inc. v. Facebook, Inc.*, 999 F. Supp. 2d 677, 689 (D. Del. 2013).

[77] Jacky Wong, *The Next Level for China's Tencent: Global Domination*, WALL ST. J (Nov. 13, 2019) https://www.wsj.com/articles/the-next-level-for-chinas-tencent-global-domination-11573655785; In 2012, Mark Zuckerberg explicitly stated he wanted to create a payment product to exercise pricing power over third-party developers. MATT STOLLER, LIBRA BASICS: WHAT IS FACEBOOK'S CURRENCY PROJECT?, OPEN MKTS INST. (updated July 19, 2019), https://openmarketsinstitute.org/reports/libra-basics-facebooks-currency-project/.

[78] Federal deposit insurance programs only protect deposits in commercial banks and federal savings institutions. *See, e.g.* Sarah Jane Hughes & Stephen T. Middlebrook, *Advancing A Framework for Regulating Cryptocurrency Payments Intermediaries*, 32 YALE J. ON REG., 495, 527 (2015); U.S. GAO, GAO-18-254, ADDITIONAL STEPS BY REGULATORS COULD BETTER PROTECT CONSUMERS AND AID REGULATORY OVERSIGHT 18 (2019).

constituting "shadow payment platforms."[79] In the event of disaster, the last line of defense is general corporate bankruptcy law, rather than a central bank balance sheet.[80] Federal regulation of money services business (MSBs) provides a shallow consumer protection arrangement, primarily in the form of mandated disclosure.[81] Fifty different state MSB regulators also apply a mix of minimum net worth requirements, surety bond, and other security and investment requirements. These laws have proven ineffective in keeping MSBs afloat.[82]

Global stablecoin projects proposed by Big Tech would entrench corporate power and threaten financial stability in multiple jurisdictions, including the United States.

In late June, we released the "Libra Black Paper", arguing policymakers should prevent Facebook and the Geneva-based Libra Association — a cartel of junior Silicon Valley partners — from moving forward with their global corporate currency project.[83] Our concerns extend well beyond financial regulation. For instance, in April, we filed a comment asking the House Judiciary Committee to tackle the risk of unfair competition in the payments space.[84] To put it bluntly, Facebook stands to leverage its platform power to expand its digital advertising monopoly, take over adjacent markets, self-deal, and establish a global surveillance system.

The general idea is to use "Libra Coins" and other tools to build a parallel "vibrant financial services economy." The project exhibits multiple features of shadow banking. But Libra-based payments also generate data. Dominant platforms grow by expanding their platforms' user base and information access, securing revenue by selling products directly to their users or by selling access to their users to third parties.[85] Through the Libra Project and its new subsidiary Novi — which would offer digital wallets to hold Libra Coins — Facebook could easily take advantage of integrated, intimate information about what people like, do, and buy, in

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[79] *See* Dan Awrey & Kristin van Zwieten, *Mapping The Shadow Payment System* 41-44 (SWIFT Institute Working Paper No. 2019-00, 2019), *available at*: https://ssrn.com/abstract=3462351 (discussing comparative approaches in the U.S., UK, EU, and China).

[80] *See* Dan Awrey, *Bad Money,* 106 CORNELL L. REV. 1, 23 (forthcoming 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3532681 (discussing how the corporate bankruptcy regime fails depositors). *See also* Ryan Surujnath, *Off the Chain! A Guide to Blockchain Derivatives Markets and the Implications on Systemic Risk*, 22 FORDHAM J. CORP. & FIN. L. 257, 301 (2017) (discussing how this dynamic can be especially dangerous when distributed ledger technology (DLT) is involved, as a lack of clear transaction finality may make it difficult to determine liability in the context of corporate insolvency).

[81] 12 C.F.R. § 1005.3. *See also* Awrey, *supra* note 80, at 34.

[82] *Id.* at 39-41 (arguing state money transmitter laws do not provide "robust prudential regulation, deposit guarantee schemes, lender of last resort facilities, or special resolution regimes" equivalent to conventional deposit-taking banks" and often fail to protect consumer funds, rendering them insufficient to regulate peer-to-peer payment platforms and aspiring stablecoin issuers).

[83] RAÚL CARRILLO, BANKING ON SURVEILLANCE: THE LIBRA BLACK PAPER, AFR EDUCATION FUND & DPEF (2020), https://ourfinancialsecurity.org/wp-content/uploads/2020/06/Libra-Black-Paper-FINAL-2.pdf.

[84] Letter from AFR Education Fund & DPEF to H. Comm. on the Judiciary, *supra* note 74.

[85] *See, e.g.*, BANK FOR INTERNATIONAL SETTLEMENTS, *supra* note 75 (arguing Big Tech business models depend upon enabling direct, *monitored* interactions between more and more users. Firms learn from these interactions in order to deploy yet another range of services that generate further activity that generates more data.)

order to better sell ads as well as new products. It could also surveill business partners.[86] Under Libra's current design, a consortium of multinational corporations would share access to a ledger (the Libra Blockchain) that could reflect the transactions of billions of people. Currency exchanges and mobile wallet providers like Novi would know users' true identities. Although Novi claims it would not share that information with Facebook or third parties without customer consent, we have no idea what consent would actually entail. Facebook has previously made vows regarding firewalls between subsidiaries and quickly broken those promises. In any case, participants could collude to determine the true identities of transacting parties — or reconfigure the blockchain. Moreover, the Libra Association would constantly, affirmatively monitor the Libra network for suspicious activity. There would be no real privacy.

Surveillance could extend well beyond payments. Facebook already uses technology like Facebook "Like" buttons, to track users and non-users across the internet.[87] By centralizing this sensitive information, Facebook can further mine data and determine the maximum prices consumers and competitors are willing to pay for various services. The Ninth Circuit recently decided these "social plug-ins" may constitute "wiretaps."[88] But Novi could easily mimic this practice by embedding payment buttons across the internet. This is merely the beginning. We can expect Big Tech to further encroach on financial services. [89]

Wall Street, Silicon Valley, and the fintech industry are waging a "war on cash", leading to heightened surveillance, increased corporate power, and financial exclusion.

Policymakers must be mindful of the social and economic consequences of the "war on cash"[90] — the systematic replacement of physical, bearer instruments that do not track us (like cash and coins) with digital account-based instruments that do so (like bank account deposits). Noncash transactions generate vast amounts of data, recording the time, date, location, amount, and subject of each consumer's purchase. Those data are shared with or sold to digital marketers and advertisers. Paying with cash provides consumers with substantially more privacy than electronic forms of payment.

Cash is the most common form of payment for purchases and bill-paying, and its use is not limited to underbanked or unbanked consumers.[91] In fact, the study revealed that high cash

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[86] Facebook has historically spied on rivals to appropriate ideas or acquire rivals outright. It could also bully its potential partners into using Libra. *See generally* LIBRA BLACK PAPER, *supra* note 83.
[87] Lina M. Khan, *The Separation of Platforms and Commerce*, 119 COLUM. L. REV. 973, 1004 (2019).
[88] Shoshana Wodinsky, *Court Rules Facebook Widgets Can Be Considered Wiretaps*, GIZMODO (July 2, 2020), https://gizmodo.com/court-rules-facebook-widgets-can-be-considered-wiretaps-1844245159.
[89] John Detrixhe, *Amazon is invading finance without really trying*, QUARTZ (Nov. 1, 2017), https://qz.com/1116277/amazons-aws-cloud-business-is-reshaping-how-the-financial-services-industry-works/ (describing how Amazon already provides the cloud-computing systems that serve as the "technological backbone" of many fintech firms).
[90] Some organizers and scholars alternatively refer to the phenomenon as "the gentrification of payments." Brett Scott, *Gentrification of Payments Spreading the Digital Financial Net*, TRANSNAT'L INST. (Jan. 15, 2019), https://longreads.tni.org/state-of-power-2019/digital-payment-gentrification.
[91] Cardtronics and Javelin Strategy & Research, 2020 Health of Cash Study (Feb, 2020), *available at* https://landing.cardtronics.com/hubfs/Cardtronics/Docs/Health_Of_Cash_Study_2019.pdf.

users also employ many other forms of payment, including credit cards, debit cards, mobile wallets, and online checkout services. It also showed that consumers make the choice to use cash for a variety of reasons: privacy, security, reliability, availability, and even its universal and egalitarian nature. Cash users are not Luddites who shun fintech; they're all kinds of people who pay with cash for a variety of legitimate and understandable reasons.

Cities, states, and storefronts that have moved toward cashlessness and coinlessness have necessarily segregated the payment system, even if that is not the intention. Unbanked consumers have little access to noncash forms of payment.[92] Without a bank account, they are unable to obtain credit or debit cards or to use other non-cash payment methods, with the possible exception of prepaid cards.[93] Moreover, they fundamentally ask consumers to share data with third-party corporations and the government in order to gain financial inclusion. By contrast, some cities and states have enacted laws or ordinances that bar brick-and-mortar retail stores from refusing to accept cash.[94] Congress should follow suit.[95]

Financial data collection is becoming increasingly intertwined with federal, state, and local law enforcement and threatening our civil rights.

"Bulk" financial surveillance eventually creates a detailed picture of our most private social, familial, romantic, religious, and political activities. Data about a single transaction can be linked to purchase history, creating a "picture of the person behind the payment."[96] A massive data broker industry connects data regarding our finances to data about our employment, marital status, homeownership status, medical conditions, and even our interests and hobbies.

Law enforcement authorities use sensitive corporate data, including financial data, to target vulnerable communities.[97] As a general matter of course, "surveillance-as-a-service" companies sell data, including financial data, to local police departments.[98] Historically, the

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[92] Letter from Consumer Action, the Consumer Fed. of America, Ams. for Fin. Reform, Demand Progress, et al. to U.S. Sens. Kevin Cramer, Sen. Bob Menendez, and Rep. Donald M. Payne, Jr., https://www.consumer-action.org/press/articles/consumers-should-have-the-right-to-pay-retailers-with-cash.

[93] *Id.*

[94] Massachusetts, New Jersey, New York City, Philadelphia and San Francisco have enacted legislation protecting cash users. *Id.*

[95] *See also* Meera Jagannathan, "World Health Organization: We did NOT say that cash was transmitting the coronavirus," MarketWatch (March 9, 2020), *available at* https://www.marketatch.com/story/who-we-did-not-say-that-cash-was-transmitting-coronavirus-2020-03-06. (neither the World Health Organization (WHO) nor the Centers for Disease Control and Prevention (CDC) have concluded that cash presents any more danger than credit cards or other forms of payment).

[96] Albert Fox Cahn & Melissa Giddings, *In the Age of COVID-19, the Credit Card Knows All*, Surveillance Technology Oversight Project - Urban Justice Center (May 18, 2010), https://www.stopspying.org/latest-news/2020/5/18/in-the-age-of-covid-19-the-credit-card-knows-all.

[97] *See, e.g.*, Simone Browne, Dark Matters: On the Surveillance of Blackness 10-29 (2015) ("Surveillance is nothing new to black folks. It is the fact of antiblackness."); Virginia Eubanks, Automating Inequality 1-38 (2017) (detailing how programs have demanded poor people sacrifice their rights to privacy and self-determination); Cohen, *supra* note 3, at 61 (noting law enforcement agenices have conducted prolonged, intrusive surveillance of Muslim and Latinx communities, relying on corporate communications metadata).

[98] *See, e.g.*, Shoshana Zuboff, The Age of Surveillance Capitalism 37 (2019).

National Security Agency (NSA) and other federal law enforcement agencies have exploited corporations' growing troves of records.[99] Indeed, tech companies have a long history of spying on users at the behest of government agencies (which disregard court rulings as to the unconstitutionality of their practices).[100] It would be unwise for regulators to divorce analysis of corporate surveillance from government surveillance.[101]

As Justices Thurgood Marshall and William Douglas warned in the 1970s, technology that allows for faster and better banking has led to easier law enforcement access to depositor data.[102] While it is true that bank account holders are protected by statutes like the Right to Financial Privacy Act of 1978, this law only requires government agencies provide individuals with a notice and an opportunity to object before a bank discloses personal information to the federal government.[103] There is also a general carveout for certain law enforcement, rendering the law more of a procedural rather than substantive barrier to violations of civil liberties.[104]

All financial institutions must comply with Title III of the USA PATRIOT Act, which requires they implement robust customer identification programs, commonly labeled "know your customer" (KYC) provisions.[105] Financial institutions must generally assist police investigations

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[99] *See, e.g.,* COHEN, *supra* note 3, at 238-242 (arguing bulk collection and analysis of data generated by networked communications intermediaries have become "pillars" of state surveillance).

[100] *See* SEAN VITKA, DEMAND PROGRESS, "INSTITUTIONAL LACK OF CANDOR" A PRIMER ON RECENT UNAUTHORIZED ACTIVITY BY THE INTELLIGENCE COMMUNITY (Sept. 27, 2017), https://s3.amazonaws.com/demandprogress/reports/FISA_Violations.pdf.

[101] *See, e.g.,* COHEN, *supra* note 3, at 43 (describing a "surveillance-innovation complex", wherein the state and private sector producers of surveillance technologies form a "symbiotic relationship").

[102] Dean Galaro, *A Reconsideration of Financial Privacy and United States v. Miller*, 59 S. TEX. L. REV. 31, 54 (2017).

[103] *See* 12 U.S.C. § 3404.

[104] *See id.* at §§ 3406-08 (financial institutions can disclose customer records in response to a search warrant, subpoena, or written request from a government authority).

[105] *See, e.g.,* Letter from Rep. Tlaib et al., to the Treas. Sec. Steve Mnuchin, et al., (July 17, 2019), https://tlaib.house.gov/sites/tlaib.house.gov/files/Final_BWM_Regulators.pdf (arguing many Muslim and Arab Americans have been automatically labeled "high-risk" and are therefore unable to maintain access to financial services). For a history of the relevant PATRIOT Act amendments, see, e.g., Maria A. de Dios, *The Sixth Pillar of Anti-Money Laundering Compliance: Balancing Effective Enforcement with Financial Privacy*, 10 BROOK J. CORP. FIN & COM. L. 495 (2016); Cheryl R. Lee, *Constitutional Cash: Are Banks Guilty of Racial Profiling in Implementing the United States PATRIOT Act?*, 11 MICH. J. RACE & L. 557, 564 (2006) (arguing the Patriot Act 'puts banks in the business of practicing selective enforcement and racial profiling with every transaction, every hour of every business day"); Eric J. Gouvin, *Bringing Out the Big Guns: The USA PATRIOT Act, Money Laundering, and the War on Terrorism*, 55 BAYLOR L. REV. 955 (2003).

requiring financial information and provide specific information to law enforcement agencies,[106] including by filing "suspicious activity reports" (SARs).[107]

Given these obligations, and the racial injustices perpetrated by law enforcement, we are especially concerned by suggestions that banks — on their own initiative or in partnership with tech companies — should collect more geolocation or biometric data.[108] Geolocation data revealed by payment histories is uniquely difficult to anonymize.[109] Privacy and racial justice advocates vehemently oppose the use of biometric tools like facial recognition technology, iris-scanning, and palm prints.[110] Facial recognition software is likely to mislabel or misrecognize members of racial minority groups, especially Black Americans.[111] Overall, the general use of this kind of sensitive data not only increases the risk of predation by banks and civil liberties violations by governments, but security breaches by competitors and hackers.[112]

In general, we should question whether specific forms of financial exclusion are in fact technological at their roots. Heightened surveillance may actually stand to chill financial inclusion. FDIC surveys consistently note that many "unbanked" households refuse to open bank

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[106] The information in the database is accessible by federal, state and local law enforcement agencies, and can be used in investigations. *See*, *e.g.*, Daniel Bush, *How banks and the government keep track of suspicious financial activity*, PBS NEWSHOUR (June 12, 2020), https://www.pbs.org/newshour/politics/how-banks-and-the-government-keep-track-of-suspicious-financial-activity. For further background, see, e.g., Ben Hayes, *Counter-Terrorism, "Policy Laundering," and the FATF: Legalizing Surveillance, Regulating Civil Society*, 14 INT'L J. NOT-FOR-PROFIT L. 5, 19 (2012); Natsu Taylor Saito, *Whose Liberty? Whose Security? The USA PATRIOT Act in the Context of COINTELPRO and the Unlawful Repression of Political Dissent*, 81 OR. L. REV. 1051, 1116 (2002) (noting many companies report being pressured to "turn over customer records voluntarily, in the absence of either a court order or a subpoena, 'with the idea that it is unpatriotic if the companies insist too much on legal subpoenas first.'").

[107] 31 C.F.R. § 1022.320.

[108] *See, e.g.* Letter from Demand Progress et al. to Leaders McConnell and Schumer, Speaker Pelosi and Leader McCarthy (July 1, 2020), https://s3.amazonaws.com/demandprogress/letters/2020-07-01_Facial_Recognition_Moratorium_and_Divestment_Letter_FINAL.pdf; Alfred Ng, *Facial recognition has always troubled people of color. Everyone should listen*, CNET (June 12, 2020), https://www.cnet.com/news/facial-recognition-has-always-troubled-people-of-color-everyone-should-listen/.

[109] *See, e.g.*, Cahn & Giddings, *supra* note 96.

[110] *See, e.g.*, *A Biometric Backlash Is Underway — And A Backlash To The Backlash*, PYMNTS (May 17, 2019), https://www.pymnts.com/authentication/2019/biometric-backlash-privacy-law/; *Mandatory National IDs and Biometric Databases*, ELECTRONIC FRONTIER FOUND., https://www.eff.org/issues/national-ids (last visited Apr. 25, 2020); de Dios, *supra* note 105, at 501 (describing how prior to September 11, 2001, even non-biometric KYC data collection was widely considered an unacceptable, "massive invasion of financial privacy.").

[111] *See, e.g.,* Victoria Burton-Harris & Philip Mayor, *Wrongfully Arrested Because Face Recognition Can't Tell Black People Apart*, ACLU (June 24, 2020), https://www.aclu.org/news/privacy-technology/wrongfully-arrestedbecause.

[112] *See, e.g.*, Jason Leopold & Jessica Garrison, *US Intelligence Unit Accused Of Illegally Spying On Americans' Financial Records*, BUZZFEED (Oct. 6, 2017), https://www.buzzfeednews.com/article/jasonleopold/Us-Intelligence-unit-accused-of-illegally-spying-on (reporting that FinCEN employees have accused colleagues at the Office of Intelligence and Analysis of illegally collecting and storing private financial records); Aaron Mackey & Andrew Corker, *Secret Court Rules That the FBI's "Backdoor Searches" of Americans Violated the Fourth Amendment*, ELECTRONIC FRONTIER FOUND. (Oct. 11, 2019), https://www.eff.org/deeplinks/2019/10/secret-court-rules-fbis-backdoor-searches-americans-violated-fourth-amendment; Chen Han & Rituja Dongre, *Q&A. What Motivates Cyber-Attackers?*, TECH. INNOV. MGMT. REV. 40, 40-41 (2014), https://timreview.ca/article/838 (describing economic motivations for hacking).

accounts due to privacy concerns.[113] While providing increased access to digital financial services is important, a rapid shift to digitization stands to harm low-income people of color in particular.[114] Among other features, the fintech revolution presumes a certain technological infrastructure (like universal broadband),[115] not to mention a certain level of household financial stability.[116]

Recommendations

Prevent the issuance of SPNBCs and clarify the narrow range of financial institutions that can receive National Banking Charters.

The national bank charter must be respected. In various ways, scholars have argued the government has delegated some of its "money-creation" power to banks.[117] Indeed, 33 banking law scholars recently submitted an amicus brief to the Second Circuit, arguing that "[c]reating deposit dollars is a delegated sovereign privilege" and that OCC lacks the authority to charter Silicon Valley firms.[118] In a sound and health banking regime, the charter would create a logical site for regulation.[119] But myriad forces, including the Law and Economics movement, have driven a proverbial "race to the bottom" in terms of charter-based enforcement.[120]

The OCC lacks the authority to extend national bank charters to companies that do not hold deposits and are not banks in any traditional sense of the word.[121] But lending charters

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[113] FDIC, National Survey of Unbanked and Underbanked Households, 2017 4, 23-24, https://www.fdic.gov/householdsurvey/. *See also, id.* at 3 (noting Black households are nearly six times more likely to be unbanked than white households, while Hispanic households are nearly five times more likely to be unbanked than white households).

[114] Jay Stanley, *Say No to the "Cashless Future" — and to Cashless Stores*, ACLU (Aug. 12, 2019), https://www.aclu.org/blog/privacy-technology/consumer-privacy/say-no-cashless-future-and-cashless-stores.

[115] *See, e.g.*, Terri Friedline, *An Open Internet is Essential for Financial Inclusion, FinTech Revolution*, Huff. Post (Dec. 14, 2017), https://www.huffpost.com/entry/an-open-internet-is-essential-for-financial-inclusion_b_5a3345dce4b0e1b4472ac520.

[116] *See* Stanley, *supra* note 114.

[117] *See, e.g.*, Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 Cornell L. Rev. 1143, 1147 (2017) ("At its core, the modern financial system is effectively a public-private partnership ...."); Morgan Ricks, The Money Problem: Rethinking Financial Regulation (2016); Christine Desan, Making Money: Coin, Currency, and the Coming of Capitalism (2014); Katharina Pistor, *A Legal Theory of Finance*, 41 J. Comp. Econ., 315, 315 (2013) ("[F]inancial markets are legally constructed and as such occupy an essentially hybrid place between state and market, public and private.").

[118] Brief of Thirty-Three Banking Law Scholars as Amici Curiae in Support of Appellee in *Lacewell v. OCC*, No. 19 Civ. 4271 (2d Cir. July 29, 2020), *available at* https://justmoney.org/lacewell-v-occ/.

[119] *Id.*

[120] *See* William K. Black, *Neo-Classical Economic Theories, Methodology, and Praxis Optimize Criminogenic Environments and Produce Recurrent, Intensifying Crises*, 44 Creighton L. Rev. 597, 628 (2011) (arguing these scholars believe competition among the States to charter corporations acts like an 'invisible hand' to align the interests of investors and officers and produce governance rules that are 'optimal for society.)'

[121] Letter from NCLC to OCC 9 (Aug. 3, 2020), https://www.nclc.org/images/pdf/rulemaking/2020-OCC-fintech-NCLC-comments.pdf.

would simply be dangerous. Predatory lenders are eager to obtain national bank charters so that they can ignore state usury laws and charge rates that are illegal under most state laws. The OCC is already supporting predatory lenders that partner with national banks to evade state interest rate caps, and doing nothing to restrain the banks' role in predatory practices,[122] and we do not have confidence that a nonbank charter would not be available to predatory lenders. Moreover, the OCC does not intend for SPBNC recipients to be subject to the CRA, which only applies to depository institutions, creating a higher risk they would offer products that harm the communities where they do business rather than serve these communities with responsible products.

Close the "ILC Loophole."

The FDIC is poised to open the floodgates to the acquisition of ILCs by nonfinancial firms, including commercial businesses that depend on customer and business partner surveillance methods that have no place in our regulated banking system and should not be attached to the federal safety net. As a general matter, any companies acting as banks — regardless of the financial or nonfinancial nature of their parent companies — should be regulated as banks, under consolidated supervision. Companies acting as BHCs should be regulated as BHCs. In 2016, the Federal Reserve Board of Governors (Board) recommended that Congress should prohibit ownership of ILCs by commercial firms, based on the same risks and policy concerns cited by the FDIC when it adopted and extended its moratorium.[123] The FDIC did not endorse the Board's recommendation in the 2016 joint report, but the FDIC did not object to the Board's recommendation either. Moreover, it did not challenge the Board's analysis of the risks and policy concerns created by commercially-owned ILCs.[124] It is time to permanently end the ILC exemption.

Strengthen consumer protections, including by instituting a 36% federal rate cap.

Interest rate limits are the simplest and most effective protection against predatory lending.[125] AFR EF supports the bipartisan effort to extend the 36% APR interest rate cap on payday and car-title lenders in the Military Lending Act (MLA) to cover all Americans.[126] Every time a person takes out another loan, the overall amount of debt increases as interest and fees pile

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[122] CRL et al. True Lender Comments, *supra* note 7, at 52-57.

[123] Bd. of Governors of the Fed. Res. Sys. et al., Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act (2016), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908a1.pdf [https://perma.cc/3UDT-MKRV].

[124] *Id.* at 52, 74.

[125] NCLC, Misaligned Incentives: Why High-Rate Installment Lenders Want Borrowers Who Will Default, (2016), https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/report-misaligned-incentives.pdf.

[126] *See, e.g,* Letter from CRL, Ams. for Fin. Reform, et al. to Leaders McConnell and Schumer, Speaker Pelosi and Leader McCarthy (July 1, 2020), https://ourfinancialsecurity.org/wp-content/uploads/2020/03/CRL-Group-Letter-on-Financial-Services-Stimulus-Recommendations.pdf (All new loans made during the crisis should comply with consumer safeguards in the Military Lending Act, including a cap of 36% APR.)

on. Collectively, the "debt trap" is draining $8 billion every year from American consumers.[127] By prohibiting loans with an APR above 36%, we would fight the debt trap.

The CFPB should exercise all relevant powers available to it. The CFPB exercises supervisory powers over nonbank remittance providers,[128] allowing it to examine some these companies and to ensure they disclose certain information to users.[129] Consumer advocates have argued the CFPB should promulgate a rule authorizing it to supervise all "data aggregators" for compliance with consumer financial protection laws.[130] When the Bureau updated the regulations for the Electronic Funds Transfer Act in 2019, it declined to opine on whether error resolution rights and related protections apply to virtual currency wallets.[131] It should extend such safeguards now.

Designate the deposit-like obligations of dominant tech platforms as "deposits", prohibiting the platforms from issuing such obligations absent approval by banking regulators.

Some analysts have argued that mobile payments platforms should be subject to full-scale banking regulation.[132] Yet regulators lack the authority to simply designate a nonbank company, as a bank. In fact, federal laws contain several different and potentially conflicting definitions of a "bank",[133] limiting regulators ability to constrain banking activities to institutions with banking charters.[134]

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[127] DIANE STANDAERT ET AL., CRL, PAYDAY AND CAR-TITLE LENDERS DRAINNEARLY $8 BILLION IN FEES EVERY YEAR (2019), https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-statebystate-fee-drain-apr2019.pdf.

[128] *See* 12 C.F.R. § 1090.107; *see also* Defining Larger Participants of the International Money Transfer Market, 79 Fed. Reg. 56631 (Sept. 23, 2014).

[129] The CFPB may bring enforcement actions against any entity providing a "consumer financial product or service," or any entity materially assisting that provider. *See* 12 U.S.C. § 5536(a)(1); 12 U.S.C. § 5481(6)(A); 12 U.S.C. § 5481(15); 12 U.S.C. § 5481(26)(A). *See also* Nizan Geslevich Packin & Yafit Lev-Aretz, *Big Data and Social Netbanks: Are You Ready to Replace Your Bank?*, 53 HOUS. L. REV. 1211, 1260 (2016)(noting the CFPB and FTC currently assume concurrent responsibility of online nonbanking consumer protection).

[130] *See, e.g.*, EDITH RAMIREZ ET AL., FED. TRADE COMM'N, DATA BROKERS: A CALL FOR TRANSPARENCY AND ACCOUNTABILITY i-ix (2014), *available at* http://www.ftc.gov/system/files/documents/reports/data-brokers-call-transparency-accountability-report-federal-trade-commission-may-2014/140527databrokerreport.pdf (suggesting the CFPB could define "large data brokers" as subject to its examination authority under 12 U.S.C. § 5514(a)(1)(B)); Saunders, *supra* note 19, at 20-21 (2019) (arguing the same point).

[131] *Id.* See also, *Is Cash Still King? Reviewing the Rise of Mobile Payments Testimony: Hearing Before the H. Comm. on Fin. Services*, 116th Cong. 8 (2020) (Statement of Christina Tetreault, Sr. Policy Counsel, Consumer Reports), *available at* https://advocacy.consumerreports.org/wp-content/uploads/2020/01/Hhrg-116-ba00-wstate-tetreaultc-20200130-u1-1.pdf (arguing that what protections exist are threatened by litigation initiated by PayPal).

[132] *See, e.g.*, Paul Kupiec, *Why Libra Must Be Treated Like Traditional Banks and Currency*, THE HILL (Nov. 4, 2019), https://thehill.com/opinion/finance/468924-why-libra-must-be-treated-like-traditional-banks-and-currency.

[133] For discussions of these definitions, see, e.g., Awrey & Zwieten, *supra* note 79, at 816; Saule T. Omarova & Margaret E. Tahyar, *That Which We Call A Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L 113, 115 (2011).

[134] For extensive discussion, see Morgan Ricks, *Money As Infrastructure*, 2018 COLUM. BUS. L. REV 757, 811-821 (2018) (For instance, the Banking Act of 1933 classifies "banks" as institutions that take deposits and are examined and regulated by state or federal banking authorities. Section 21 makes it illegal for an entity to accept deposits

Despite widespread acknowledgement that definitional problems allow nonbanks to engage in arbitrage,[135] the issues remain unresolved. Banking regulators could attempt to promulgate rules clarifying the definitions of "bank" and "deposit", but courts have generally been unwilling to expand the scope of such statutory terms.[136] Congress must prevent the rise of a surveillance-driven shadow banking sector.[137] We need a forward-looking bill that seeks to integrate emerging digital financial technologies into traditional banking services in a way that strengthens regulatory supervision, clarifies the legal status and classification of digital financial assets, but above all, promotes safety of consumer funds. We should recognize as a deposit any digital financial asset that promises a fixed nominal value, on demand, denominated in or pegged to the U.S. dollar, and regulates the relevant institutions as depository institutions.

Policymakers may create a narrower space for firms that do not seek to engage in broader depository activities beyond accepting funds and making payments, but all companies must be subject to regulation that matches the risks posed to consumers and the broader public. We do not expect the OCC's Payments Charter to meet this goal.[138] As it stands the OCC lacks the authority to issue its Payments Charter.[139] But as a policy matter, the decision of whether and how to grant a national payments charter should be left to Congress. A payments charter raises important issues with respect to consumer and fair lending protections, the separation of banking and commerce, and supervision of holding companies.

Constrain corporate data usage to a short list of permissible purposes, and ban the use of data for other purposes.

Experts argue the U.S. data protection and federal privacy framework is fundamentally broken, and will face imminent revision.[140] When Big Tech is present, privacy is absent. For instance, assertion by social media giants that they will not commingle financial and social data

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without being regulated by a banking regulator. The provision has been interpreted as an "axiomatic" statement preventing firms other than banks from issuing deposit liabilities. Prof. Wilmarth has argued that it is a criminal offense for nonbanks to hold deposits. Unfortunately, the Banking Act of 1933 does not define "deposit", meaning regulators cannot easily invoke Section 21 to prevent nonbanks from engaging in general banking activities. Even if regulators or courts were to attempt to borrow the definition of "deposit" from another statute, there would be "no practical way forward." For instance, because the Federal Deposit Insurance Act defines a "deposit" as "money or its equivalent received or held by a *bank*..." (emphasis added), this creates a "perfect legal circle.")

[135] *See, e.g.*, U.S. TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (Oct. 8, 2009), https://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

[136] For instance, the Supreme Court struck down a Board regulation intended to expand the BHCA definition of "bank" to cover "nonbank banks." *See* Board of Governors v. Dimension Financial Corp, 474 U.S. 361, 374 (1986).

[137] *See* Kristin N. Johnson et al., *(Im)perfect Regulation: Virtual Currency and Other Digital Assets As Collateral*, 21 SMU SCI. & TECH. L. REV. 115, 142 (2018) (arguing that expanding the existing definition of "deposit accounts" to include virtual wallets and platforms would presumably subject them to a host of intermediary regulations imposed on more traditional depository institutions).

[138] See ABA, "Podcast: OCC's Brooks Plans to Unveil 'Payments Charter 1.0' This Fall," June 25, 2020.

[139] Comment from NCLC to OCC 5 (Aug. 20, 2020), https://www.nclc.org/images/pdf/rulemaking/2020-OCC-fintech-NCLC-comments.pdf.

[140] *See, e.g.*, Woodrow Hartzog & Neil Richards, *Privacy's Constitutional Moment and the Limits of Data Protection*, 61 B.C. L. REV. 1, 1687, 1687-88 (2020).

absent consumer consent are virtually meaningless. The very notion of digital consent has been complicated by "dark patterns" and other technology Big Tech uses to exploit limits in user cognition and understanding.[141] Consumers typically have no knowledge of what they are consenting to on the internet.[142] Many experts argue the existing notice-and-consent regime does *nothing* to curb commercial surveillance.[143]

While the FTC does have some tools at its disposal,[144] no overarching federal privacy law currently curbs the collection, use, and sale of personal data among corporations.[145] Ultimately, Congress should take action to minimize data collection to that which is narrowly tailored to permitted usages, so that many of the aforementioned anti-competitive practices become commercially unfruitful.[146] Legislation should also shift the burden of privacy protection away from consumers, who have minimal resources to protect themselves, and toward the companies, which profit immensely from the aggregation of our data.[147]

Reestablish a bright line between the ownership of large tech companies and the ownership of financial institutions.

Legislators should reestablish a bright line between the ownership of large tech companies and the ownership of financial institutions. We need structural partitions between

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[141] *See, e.g.*, Neil Richards & Woodrow Hartzog, *The Pathologies of Digital Consent*, 96 WASH. U. L. REV. 1461, 1461-1478 (2019) (borrowing a definition of dark patterns as "'tricks used in websites and apps that make you buy or sign up for things that you didn't mean to.'").

[142] Comment from Freedom from Facebook to FTC (Aug. 20, 2018), https://www.ftc.gov/system/files/documents/public_comments/2018/08/ftc-2018-0051-d-0008-147767.pdf.

[143] *See, e.g.*, Packin & Lev-Aretz, *supra* note 129, at 1279–81 (2016); Nathan Newman, *How Big Data Enables Economic Harm to Consumers, Especially to Low-Income and Other Vulnerable Sectors of the Population*, 18 J. INTERNET L. 11, 19 (2014).

[144] For extensive treatment, see Sandeep Vaheesan, *Resurrecting "A Comprehensive Charter of Economic Liberty": The Latent Power of the Federal Trade Commission*, 19 U. PA. J. BUS. 645, 650-698 (2017) (arguing the Sherman Antitrust Act of 1890 authorizes the FTC to break up a conglomerate when it is monopolizing or attempting to monopolize a market. This section was memorably used to sue Microsoft in the late 1990s. The FTC also retains expansive power to interpret the antitrust provision of Section 5 of the FTC Act, which prohibits "unfair competition", generally. Using this authority, the FTC should establish presumptions of illegality for competitively suspect practices, including certain surveillance practices, either through enforcement activity or through rulemaking).

[145] BERKELEY MEDIA STUDIES GROUP ET AL., THE TIME IS NOW: A FRAMEWORK FOR COMPREHENSIVE PRIVACY PROTECTION AND DIGITAL RIGHTS IN THE UNITED STATES, Citizen.org, (last visited Mar. 31, 2020), https://www.citizen.org/sites/default/files/privacy-and-digital-rights-for-all-framework.pdf.

[146] *See, e.g.*, Woodrow Hartzog and Neil M. Richards, *Privacy's Constitutional Moment and the Limits of Data Protection*, 61 BOSTON COLL. L. REV.(forthcoming 2020), *available at* https://ssrn.com/abstract=3441502; Press Release, Senate Democrats, *Privacy and Data Protection Framework* (Nov. 18, 2019), *available at* https://www.democrats.senate.gov/imo/media/doc/Final_CMTE%20Privacy%20Principles_11.14.19.pdf.

[147] Press Release: Statements of Support re: Data Accountability and Transparency Act (DATA 2020), Sen. Sherrod Brown (June 18, 2020), https://www.banking.senate.gov/download/statement-of-support.

commerce and banking, profit-driven enterprise and "money creation",[148] and platforms and payment systems.[149]

Finally, we urge Congress to establish privacy-respecting public options for real-time payments, safe deposits, international money transfer, and other basic digital financial services.

We have commended the Board on its decision to establish and implement FedNow, a new interbank 24x7x365 real-time gross settlement (RTGS) system to facilitate real-time payments (RTP) between financial institutions of all sizes.[150] Households living paycheck to paycheck will be able to receive their wages more quickly and more easily pay bills when due, avoiding the common "cascade of negative consequences."[151]

In addition to upgrading our payments infrastructure, many central bankers, regulators, activists, and academics have pushed for some form of public banking option.[152] This could be utterly transformative. The COVID-19 pandemic response has shown that the very foundations of our economy are fragile. We are forced to rely on the banks as middlemen to deliver government assistance. Some of them have even seized emergency COVID-19 payments to collect debts.[153]

Today, only privileged banks and governmental entities are granted high interest, low fee accounts. The federal government could easily offer the same option to everyone, and provide better consumer safeguards than Wall Street, as well as higher interest, faster payments, and

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[148] For one vision of such separation, see Lev Menand, *Why Supervise Banks? The Forgotten Past and Uncertain Future of a Distinctive Form of Governance*, VAND. L. REV. 1, 23-24 (forthcoming 2020), *available at* https://ssrn.com/abstract=3421232 [https://perma.cc/W5H5-B2FN].

[149] *See* Awrey, *supra* note 80 at 41-43 (comparing various approaches to this issues); AFR Education Fund and DPEF Judiciary Letter, *supra* note 74 (arguing for the structural separation of large tech platforms and payments).

[150] *See* Letter from AFR Education Fund & DPEF to Board (2019) https://www.federalreserve.gov/SECRS/2019/December/20191230/OP-1670/OP-1670_110719_136983_394241172069_1.pdf. *See also* Comment from FTC Comm'r Rohit Chopra to FTC (Nov. 7, 2019), https://www.ftc.gov/public-statements/2019/11/comment-commissioner-rohit-chopra-federal-reserve-proposal-develop-round (urging the Board to proceed promptly, arguing that slow development has created space for the Libra project and "attempts to bypass our banking system altogether.")

[151] *Facilitating Faster Payments in the U.S.: Hearing Before the U.S. S. Comm. on Banking, Hous., and Urban Affairs*, 116th Cong. 1-2 (2019) (Statement of Sheila C. Bair, Former Chair, FDIC), *available at* https://www.banking.senate.gov/download/bair-testimony-9-25-19.

[152] *See, e.g.*, Mehrsa Baradaran, *It's Time for Postal Banking*, 127 HARV. L. REV. F. 165 (2014); Morgan Ricks et al., *A Public Option for Bank Accounts (or Central Banking for All)* 1 (VANDERBILT UNIV. LAW SCH., RESEARCH PAPER NO. 18-33, 2018), *available at* https://ssrn.com/abstract=3192162; Robert Hockett, *Money's Past is Fintech's Future: Wildcat Crypto, the Digital Dollar, and Citizen Central* Banking 2 STAN. J. BLOCKCHAIN L. & POL'Y 221 (2019).

[153] *See* Press Release, U.S. S. Comm. on Banking, Hous., and Urban Affairs, *Brown, Warren Call On Banks To End The Seizure Of Stimulus Checks* (Apr. 15, 2020), *available at* https://www.banking.senate.gov/newsroom/minority/brown-warren-call-on-banks-to-end-the-seizure-of-stimulus-checks.

complete deposit protection.[154] As a recent New York Times editorial endorsing FedAccounts for getting out stimulus payments put it: "Stop Dawdling. People Need Money."[155] Even after the pandemic, a public banking option could make it easier to prioritize assistance through more direct fiscal policy, avoiding ongoing issues with delayed funds, debt collection, and frozen bank accounts.

Some experts have called for Silicon Valley firms to partner with the government on this endeavor.[156] But Big Tech's involvement in public money development would doom any future for financial privacy.[157] Lest it fall victim to the same sort of criticisms as the Facebook Libra project, for instance, a new "digital dollar" would need to respect the privacy of its users.[158] Such respect would entail, among other features, offering digital wallets as well as bank accounts for all, preserving the existing choice of bearer instruments that do not track user activity (like paper Federal Reserve Notes) and registered instruments that do track user activity (like bank deposits).[159] While legal firewalls might prevent some level of abuse in an account-based system, technological solutions are necessary. If the owner of a public centralized ledger system, (for instance, the Federal Reserve Bank of New York) were able to access digital dollar transaction activity at any given time, that data could be inappropriately accessed by other governmental entities, including law enforcement.[160] By contrast, within our existing monetary system, the Federal Reserve System does not make any records of where individual Federal Reserve Notes are at any given time; circulation is merely recorded as a single aggregate liability on the Fed's balance sheet titled 'Federal Reserve Notes Outstanding.'[161]

A new public option for financial services should proceed from the principle that data that is not harvested in the first place cannot be abused. It should not ask users to choose between financial inclusion and privacy. In order to mitigate illicit flows, policymakers could choose to

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[154] *See* Raúl Carrillo, *For Fairer Relief, Fix the Pipes!*, TAKE ON WALL ST. BLOG (May 7, 2020), https://takeonwallst.com/2020/05/stimulus-checks-fed-accounts/.

[155] *Stop Dawdling. People Need Money*, N.Y. TIMES (Apr. 15, 2020), https://www.nytimes.com/2020/04/15/opinion/coronavirus-stimulus-check-payment.html.

[156] *See, e.g., The Digitization of Money and Payments: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs,* 116th Cong. 7-10 (2020) (Statement of Hon. J. Christopher Giancarlo, Chair Emeritus, CFTC), *available at* https://www.banking.senate.gov/download/giancarlo-testimony-6-30-20&download=1.

[157] As would Wall Street's involvement. *See, e.g.,* Raúl Carrillo, *Postal Banking: Brought to you by JP Morgan Chase?*, TAKE ON WALL ST. BLOG (Aug. 27, 2020), https://takeonwallst.com/2020/08/postal-banking-jp-morgan-chase/.

[158] *See, e.g.*, Jason Brett, *Congress Considers Federal Crypto Regulators In New Cryptocurrency Act Of 2020*, FORBES (Dec. 19, 2019), https://www.forbes.com/sites/jasonbrett/2019/12/19/congress-considers-federal-crypto-regulators-in-new-cryptocurrency-act-of-2020/#716eff165fcd (describing the popularization of the idea of the digital dollar in response to Libra's development).

[159] *See* JONATHAN DHARMAPALAN & ROHAN GREY, THE CASE FOR DIGITAL LEGAL TENDER: THE MACROECONOMIC POLICY IMPLICATIONS OF DIGITAL FIAT CURRENCY, ECURRENCY MINT LTD. (2018), https://www.ecurrency.net/static/resources/201802/TheMacroeconomicImplicationsOfDigitalFiatCurrencyEVersion.pdf.

[160] *See, e.g.*, Matla Garcia Chavolla, *Cashless Societies and the Rise of the Independent Cryptocurrencies: How Governments Can Use Privacy Laws to Compete with Independent Cryptocurrencies*, 31 PACE INT'L L. REV. 263, 273 (2018).

[161] Rohan Grey, *Administering Money: Coinage, Debt Crises, and the Future of Fiscal Policy*, KY. L.J. 1, 16-18 (forthcoming 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3536440.

only offer anonymity under a certain threshold of holdings, as federal law does now with paper cash.[162] Public sector innovation is necessary to truly regulate the space, and privacy and public sector innovation need not conflict.[163]

[162] *See* Marco Dell'Erba, *Stablecoins in Cryptoeconomics: From Initial Coin Offerings to Central Bank Digital Currencies*, 22 N.Y.U. J. LEGIS. & PUB. POL'Y 1, 43 (2020). However, *see also*, Jason Leopold et al., *The FinCEN Files*, BUZZFEED (Sept. 20, 2020), https://www.buzzfeednews.com/article/jasonleopold/fincen-files-financial-scandal-criminal-networks (arguing the post-9/11 AML, CFT, and sanctions regime, in addition to violating civil rights, does not work as purported. Surveillance has not necessarily led to increased law enforcement).

[163] Kamara, *supra* note 19 (arguing cutting-edge pro-privacy technology has applications for financial services).

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TESTIMONY

FINTECH REGULATION NEEDS TO KEEP PACE WITH ECONOMIC AND TECHNOLOGICAL EVOLUTION

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US Committee on Financial Services, Task Force on Financial Technology
License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age

September 29, 2020

Good day, Chairman Lynch, Ranking Member Emmer, and members of the Task Force on Financial Technology. Thank you for the opportunity to testify today.

My name is Brian Knight and I am the director of and a senior research fellow for the Program on Innovation and Governance at the Mercatus Center at George Mason University. Much of my research focuses on the interplay between technological innovation and regulation in the provision of financial services. Any opinions I express today are my own and do not necessarily reflect the views of my employer.

First, let me congratulate Representatives Lynch, Emmer, and the other members of the task force for their leadership on the topic of fintech regulation. I also applaud your solicitation of the views of a wide range of knowledgeable people. I look forward to a collegial and productive discussion.

The goal of this hearing is to examine the rules governing which firms are allowed to lend and process payments in the age of fintech.[1] This issue that is both timely and relevant. The past few years have seen significant reform and controversy from state and federal regulators on that very topic, including litigation between state bank regulators and the OCC. However, contra *Macbeth*, this sound and fury signifies something very important—namely, that the technological and economic reality of how Americans access financial services has outpaced the law. And while both the states and the OCC deserve credit for recognizing this reality and trying to be responsive, an optimal and stable solution will likely require action by Congress.

I submit, for your consideration, four key points in my testimony:

1. Technological and economic progress has overtaken existing law, leading to an overly burdensome and unfair regulatory environment that impedes innovation and competition, to the detriment of Americans.

1. "Fintech" is a term susceptible to multiple definitions. For the purposes of my testimony I will use it to refer to nonbank lenders and money transmitters who use innovative technology as a significant part of their value proposition.

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The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.

2. Both the OCC and the states have taken admirable steps to reform financial regulation, but under existing law, even their best efforts are not likely to establish an optimal policy framework.
3. Congress can and should reform the law to allow nondepository lenders and money transmitters, subject to appropriate requirements, to operate on a nationwide scale on the basis of a unified license or charter—and with powers similar to those enjoyed by national banks with regard to governing interest and access to the Federal Reserve payments system.
4. This does not mean that a federal license or charter should be the only option. Rather, the states should be able to serve as competitive laboratories of democracy within a "market-preserving federalism"[2] framework buttressed by federal law, similar to how state-chartered, FDIC-insured banks were granted parity with national banks when it comes to interest rate exportation.[3]

THE PROBLEM WITH THE STATUS QUO

Nonbank fintech firms have become a significant source of competition in a financial services market once thought to be resistant, if not immune, to significant disruption. American consumers seem to have embraced this newly emerged form of competition. For example, the share of loans involving nonbank fintech lenders exploded from around 5 percent in 2013 to 38 percent in 2018.[4] Likewise, fintech payments firm have seen significant increases in usage over the past decade.[5] For example, PayPal, one of the earliest nonbank fintech firms, has seen its global payment volume grow from approximately $50 billion in the first quarter of 2014 to almost $225 billion in the second quarter of 2020.[6] Consumer adoption has been driven by various factors including cost, convenience, speed, and availability.[7] There is also evidence that fintech lenders may be somewhat less discriminatory than traditional lenders.[8]

While these fintech firms may take advantage of cutting-edge technology, they are still subject to a regulatory system that did not contemplate the ability of nonbanks to serve customers nationwide instantly. Contrary to some assertions, fintech firms are not "unregulated" or even necessarily less

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2. As described by Barry Weingast, "market-preserving federalism" reflects an environment where there is competition between governments (in his construction, subnational governments) to regulate within the context of a common market, such that consumers can choose which rules they wish to utilize. The exportation of laws governing interest for bank is to some degree an example of this in that credit customers can choose credit products crafted under different states' laws as part of a national common market. Barry R. Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development," Journal of Law, Economics & Organization 11, no. 1 (1995): 1–31. While the national banking system may be seen as a threat to market-preserving federalism, to the extent that state- and nationally chartered banks play by the same rules, this threat is to a degree at least mitigated.
3. 12 U.S.C. § 1831d (2018).
4. TransUnion, "FinTechs Continue to Drive Personal Loan Growth," press release, February 21, 2019, https://newsroom.transunion.com/fintechs-continue-to-drive-personal-loans-to-record-levels/.
5. Caitlin Reilly, "Mobile Payments Up but Pace of Growth Slows," *Roll Call*, June 18, 2019.
6. J. Clement, "PayPal's Total Payment Volume from 1st Quarter 2014 to 2nd Quarter 2020" (dataset), Statista, August 13, 2020, https://www.statista.com/statistics/277841/paypals-total-payment-volume/.
7. Usman Ahmed et al., "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises," *Innovations* 10, no. 3/4 (2015): 35. The authors find that PayPal Working Capital loans were disproportionately disbursed to areas with relatively high declines in the number of banks and to traditionally underserved populations. Julapa Jagtiani and Catharine Lemieux, "Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information" (Working Paper No. 17-17, Federal Reserve Bank of Philadelphia, Philadelphia, PA, July 6, 2017); Julapa Jagtiani and Catharine Lemieux, "The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform" (Working Paper No. 18-15, Federal Reserve Bank of Philadelphia, Philadelphia, PA, January 2019); Isil Erel and Jack Liebersohn, "Does FinTech Substitute for Banks? Evidence from the Paycheck Protection Program" (Working Paper No. 2020-16, Charles A. Dice Center for Financial Economics, Columbus, OH, September 16, 2020); Julapa Jagtiani and Catharine Lemieux, "Do Fintech Lenders Penetrate Areas That Are Underserved by Traditional Banks?" (Working Paper No. 18-13, Federal Reserve Bank of Philadelphia, Philadelphia, PA, March 2018).
8. Bartlett et al., "Consumer-Lending Discrimination in the FinTech Era" (NBER Working Paper No. 25943, National Bureau of Economic Research, Cambridge, MA, June 2019).

regulated than traditional banks on a line-of-business basis. Instead, these firms find themselves frequently subject to cumbersome state-by-state regulation that places them at a disadvantage compared to their chartered bank rivals.[9]

For example, while under federal law national and FDIC-insured state-chartered banks may lend nationwide on the basis of their home state's laws defining and governing interest, fintech firms must generally obtain lending licenses from and are subject to the laws of every state in which they offer credit.[10] Likewise, national banks are not required to obtain a state money transmitter license to provide money transmission services.[11] State money transmitter law also generally exempts state-chartered banks.[12] Conversely, nonbank fintech money transmitters must obtain licenses in every state in which they offer services. Additionally, while banks can generally access the Federal Reserve's payments system to transmit payments, nonbank fintech firms cannot, unless they are acting as an agent of a bank.[13]

This cumbersome and uneven regulation is unjustified and can result in higher costs, reduced service, competitive inequality, and even political inequality.[14]

This unfair discrepancy in regulation frequently forces fintech firms to partner with banks and pay banks for access to government services, such as the payment system that they are excluded from, or play a lesser role in the transaction than they could have but for the regulation.[15] Even this partnership is not fully stable, however, with litigation in some cases undermining the stability of the partnerships and resulting in diminished access to financial services,[16] potentially to the significant detriment of the public.[17]

CURRENT REFORM EFFORTS ARE WELL MEANING BUT SUBOPTIMAL

Recognizing the mismatch between the regulatory environment and the economic and technological reality facing fintech firms, both federal and state regulators have shown an admirable willingness to innovate. Beginning in the Obama administration, the OCC announced a plan to offer special-purpose national bank charters to nondepository lenders and money transmitters.[18]

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9. For a thorough discussion of this dynamic, please see Brian Knight, "Federalism and Federalization on the Fintech Frontier," *Vanderbilt Journal of Entertainment Technology & Law* 20, no. 1 (2017): 129–206.
10. Knight, "Federalism and Federalization," 141, 144–45.
11. 12 U.S.C. § 24 (Seventh) (2008); 12 C.F.R. § 5.20(e) (2017); Kevin V. Tu, "Regulating the New Cashless World," Alabama Law Review 65, no. 1 (2013): 1377.
12. Tu, "Regulating the New Cashless World," 89.
13. Brian Knight and Trace Mitchell, "Private Policies and Public Power: When Banks Act as Regulators within a Regime of Privilege," New York University Journal of Law and Liberty 13, no. 1 (2019): 93, citing George Selgin, *Re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments: Docket No. OP-1625* (Washington, DC: Cato Institute, December 14, 2018).
14. To the extent that firms are forced to conform the product they offer nationwide to the requirements of the largest states—even though citizens of other states have no representation in those decisions—the citizens of smaller states are in effect being regulated by other states. Knight, "Federalism and Federalization," 191–98.
15. It must be noted, however, that not every fintech–bank partnership is driven by regulation and that in many cases fintech firms and banks partner purely because it is mutually beneficial.
16. Colleen Honigsberg, Robert J. Jackson Jr., and Richard Squire, "How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment," *Journal of Law and Economics* 60, no. 4 (2017): 673.
17. Piotr Danisewicz and Ilaf Elard, "The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy" (working paper, 2020); but see Marco Di Maggio and Vincent Yao, "Fintech Borrowers: Lax-Screening or Cream-Skimming?" (working paper, June 2020). The authors find that borrowers from fintech firms are more likely to default than borrowers from banks but also that fintech loans serve as a resource to recently unemployed borrowers.
18. Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016.

The response from the states was mixed. On the positive side, state bank regulators have announced a host of regulatory reforms aimed at lowering the burden of state regulation.[19] On the negative side, however, states have sued the OCC, seeking to block the fintech charter, arguing that the OCC has exceeded its authority and, with some narrow exceptions, cannot charter nondepositories as banks. New York's efforts have succeeded at the trial-court level and this decision is currently being appealed by the OCC before the US Court of Appeals for the Second Circuit.

While the question of whether the OCC has exceeded its authority is interesting, with knowledgeable experts disagreeing, it is also arguably beside the point for this body. Congress is in the enviable position of being able to create, amend, or repeal law, subject to Constitutional limitations. This is good, because both the OCC and the states are forced to operate under suboptimal conditions under current law.

While the OCC's plan is by no means perfect, it does arguably represent the best regulatory option currently available. However, it is not at all clear that the burdens that come with being a national bank are needed or appropriate for nondepository entities. Additionally, critics have raised concerns that, under the interlocking body of law that applies to national banks, there may be unintended and potentially undesirable consequences to nondepository firms being able to obtain a bank charter.[20]

Likewise, while states' resorting to litigation to stop the OCC charter is regrettable, it is also at least somewhat understandable. Under current law a state cannot offer a charter or license comparable to the OCC fintech charter to a nondepository fintech firm, even if it wanted to. For example, to obtain the ability to lend nationwide on the basis of its home state's law governing interest, a state bank is required to be an FDIC-insured depository institution.[21] It is worth noting here that the ability of FDIC-insured state banks to lend nationwide is a product of Congress recognizing both that it was necessary to restore competitive parity between state-chartered and nationally chartered banks and that there was no justification in allowing one set of competitors to enjoy a regulatory advantage over similarly situated firms.[22]

Additionally, while Congress has called for states to harmonize their money transmission laws,[23] and the states have recently made some strides in that direction,[24] the fact remains that absent federal enabling law that would prevent states from erecting barriers to out-of-state competition, there is no way to guarantee a state licensed money transmitter a comparable,[25] durable ability to operate in a national market without the risk that states will re-erect regulatory barriers.

WHAT CONGRESS SHOULD DO

All of this leaves policymakers in search of a better path forward. To find that better path, Congress should encourage competition and market-preserving federalism by aligning regulation with technological and economic reality. Nondepository institutions that offer credit or money transmission

19. CSBS, "State Regulators Roll Out One Company, One Exam for Nationwide Payments Firms," press release, September 15, 2020, https://www.csbs.org/regulators-announce-one-company-one-exam-for-payments-companies; CSBS, "CSBS Announces Vision 2020 for Fintech and Non-Bank Regulation," press release, May 10, 2017, https://www.csbs.org/newsroom/csbs-announces-vision-2020-fintech-and-non-bank-regulation.

20. Brief of Thirty-Three Banking Law Scholars as *Amici Curiae* in Support of Appellee, Submitted July 29, 2020, Lacewell v. Office of the Comptroller of the Currency, Joseph M. Otting, United States Court of Appeals for the Second Circuit. The scholars express concerns about, *inter alia*, the issue of the separation of banking and commerce posed by the OCC fintech charter.

21. 12 U.S.C. § 1831d (2018).

22. Greenwood Tr. Co. v. Massachusetts, 971 F.2d 818, 826 (1st Cir. 1992). The source quotes a statement by Senator Dale Bumpers.

23. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(a)(1), 108 Stat. 2160, 2246-48 (1994) (codified as amended at 31 U.S.C. § 5311 (2012).

24. CSBS, "State Regulators Roll Out."

25. It should be noted that while state money transmission law generally exempts banks chartered by other states, there is no constitutional requirement that this be done. Therefore, in theory, even state-chartered banks may find themselves requiring money transmission licenses to do business in other states.

services nationwide should be able to do so without being faced with an undue regulatory disadvantage compared to their traditional bank competitors, especially with regard to barriers to entry or operation when engaging in interstate commerce.

To this end, Congress should facilitate a means by which nondepositories that provide credit and payments services in interstate commerce be able to do so under a consistent rule set with minimal barriers to entry. This could take the form of making clear that both states and the federal government can authorize firms, whether through a special-purpose bank charter or a license, to lend or facilitate payments with comparable relevant authority to that currently enjoyed by nationally chartered depository banks. Critically, any requirements or limitations should be properly calibrated to the risks created by the actual products, services, and business models, rather than applied simply because they apply to depository institutions, who by their very nature have a significantly different business model and can pose different risks than nondepositories.

The exact contours of what these rules should look like remain to be determined. For example, should these firms be banks, even if they are special, given the regulatory legacy and regulator discretion that comes with a charter? Would nonbank licenses be more appropriate? And if so, should the federal government introduce a licensing system to go alongside those issued by the states? What risks do nonbank fintech lenders and money transmitters create? Which of those risks are the legitimate province of government regulation? And what should those regulations look like?

These are all important questions that should be answered, but first policymakers and researchers should acknowledge that the current regulatory regime is suboptimal and should be modernized. Both the OCC and the states are trying their best to keep up, but under existing law there are significant impediments. Congress should take advantage of its unique ability to modernize regulation and create an environment conducive to innovation and competition that benefits the American people.

Thank you again for the opportunity to testify. I look forward to your questions.

Appendix 1

Federalism and Federalization on the Fintech Frontier

Brian Knight[*+]

ABSTRACT

The rise of financial technology (fintech) has the potential to provide better-quality financial services to more people. Although these enhanced financial services have arisen in order to meet consumer need, their regulatory status threatens that progress. Many fintech firms are regulated on a state-by-state basis even though their transactions are interstate, and they compete with firms that enjoy more consistent rules through federal preemption. This dynamic can harm efficiency, competitive equity, and political equity. This Article examines developments in marketplace lending, money transmission, and online sales of securities in an attempt to identify situations in which greater federalization of the rules may be justified. It also considers a situation in which the federal government should abstain from intervening, even if it has the right to do so. Whether the states or federal government should take the lead in regulating fintech is an emerging and important question whose answer will affect the financial lives of consumers and investors. This Article seeks to begin a conversation about how to determine whether federalism or federalization is appropriate.

* The Author would like to thank Hester Peirce, J.W. Verret, Kelly Maguire, and two anonymous peer reviewers for their comments. The Author would also like to thank Vera Soliman and Nick Ingros, as well as Nicole Keefe and the staff of the *Vanderbilt Journal of Entertainment & Technology Law* for their very able research and editing assistance. Finally, the Author would like to thank Thaya Knight for her excellent feedback and near-infinite patience.

+ *Disclaimer:* The Author was a cofounder of, and retains an interest in, CrowdCheck, an online securities due diligence company.

TABLE OF CONTENTS

I. INTRODUCTION 131
II. WHAT CHARACTERISTICS OF FINTECH MATTER FOR FEDERALISM? 135
III. EXAMPLES FROM THE FINTECH FRONTIER 136
A. Consumer and Small-Business Lending and Interest Rates 136
1. State Regulation of Consumer and Small-Business Interest Rates 137
2. Federal Regulation of Consumer and Small-Business Interest Rates 139
3. The Regulation of Marketplace Lending 142
B. Money Transmission 153
1. State Regulation of Money Transmission 156
2. Federal Regulation of Money Transmission 158
C. Virtual Currency 161
1. State Regulation of Virtual Currency 165
2. Federal Regulation of Virtual Currency 168
D. Securities Offerings 172
1. State Regulation of Securities Offerings 173
2. Federal Regulation of Securities Offerings 174
3. Regulation A Offerings 176
4. Rule 147 Offerings 181
IV. WHO SHOULD REGULATE? 184
A. Efficiency 185
B. Competitive Equity 188
C. Political Equity Between Citizens of the Several States 191
D. Let's Not (Always) Make a Federal Case out of It 198
V. WHAT SHOULD BE DONE? 199
A. Who Should Write the Rules? 200
B. Who Should Enforce the Rules? 204
C. What About the Courts? 206
VI. CONCLUSION 206

I. INTRODUCTION

Financial technology, or "fintech," is the application of technology to the provision of financial services. Although fintech itself is not new, the ways in which people can transmit money, access credit, and invest have recently significantly changed. The influx of new competitors leveraging technology to provide more access, more efficiency, and better value than the status quo is destabilizing the financial industry because these new methods and market participants often do not easily fit in the existing regulatory boxes. These rapid changes are straining existing regulatory assumptions, including the issue of whether and how the states or federal government should regulate fintech firms.

Technology allows fintech firms, many of which lack a traditional financial pedigree or charter, to compete at scale with established entities such as banks—something previously considered too difficult to profitably do in the past. Adding to the momentum, venture capitalists and institutional investors put significant money into fintech startups, either as investors or customers.[1] Meanwhile, incumbents have reacted to the disruption with a mix of trying to "beat them,"[2] "join them,"[3] and "sic the cops on them."[4] Regulators and policymakers have also taken an interest in fintech; they have

1. JULIAN SKAN ET AL., FINTECH AND THE EVOLVING LANDSCAPE: LANDING POINTS FOR THE INDUSTRY 2–3 (2016), http://fintechinnovationlab.com/wp-content/uploads/2017/05/Fintech_Evolving_Landscape_2016.pdf [https://perma.cc/AW9Z-QPPQ]. In 2015, approximately $22.3 billion was invested in fintech firms globally—an increase of 75 percent from the previous year. *Id.* at 3.

2. *See, e.g.*, Jason Del Rey, *America's Biggest Banks Have Announced Their Venmo Competitor, Zelle*, RECODE (Oct. 24, 2016, 12:18 AM), https://www.recode.net/2016/10/24/13376676/payments-zelle-banks-venmo-paypal-send-money [https://perma.cc/PHP5-96M6] (discussing a product created by a consortium of banks to compete with Venmo for the person-to-person payments market); Kevin Wack, *The Battle Begins: Banks Take on Online Lending Rivals*, AM. BANKER (Oct. 30, 2016, 9:00 PM), https://www.americanbanker.com/news/the-battle-begins-banks-take-on-online-lending-rivals [https://perma.cc/88AZ-ABUT] (discussing bank-created online lending platforms designed specifically to compete with marketplace lenders).

3. *See, e.g.*, Peter Rudegeair, Emily Glazer & Ruth Simon, *Inside J.P. Morgan's Deal with On Deck Capital*, WALL ST. J. (Dec. 30, 2015, 6:44 PM), http://www.wsj.com/articles/inside-j-p-morgans-deal-with-on-deck-capital-1451519092 [https://perma.cc/F5EY-7THZ].

4. CLEARING HOUSE, ENSURING CONSISTENT CONSUMER PROTECTION FOR DATA SECURITY: MAJOR BANKS VS. ALTERNATIVE PAYMENT PROVIDERS 2–3 (2015), https://www.theclearinghouse.org/-/media/files/research/tchconsumer%20protection%20for%20data%20security%20august%202015%20final.pdf?la=en [https://perma.cc/3LAN-PE84] (arguing that regulation of nonbank payment services providers is inadequate and should be brought to the level of banks).

hosted events[5] and hearings[6] and have otherwise pondered what changes in technology mean for regulation.[7]

From a regulatory perspective, it is significant that fintech facilitates companies of all sizes to compete on a national scale.[8] Although certain market participants—especially banks—enjoy relatively uniform regulation of important aspects of their business because of federal law, many new competitors are governed on a state-by-state basis.[9] If these new entrants' activities are primarily intrastate, there is little cause for concern. However, if the scope of the transaction exceeds the reach of regulation, there could be a significant problem.

Incongruous regulation could place new entrants at an undue disadvantage compared to their incumbent competitors and may deprive consumers of a fully competitive market. Different business methods may create different risks, in which case differential regulation may be justified. However, if the ensuing risks are functionally identical, then different regulatory structures—such as a federal grant of uniformity for only some competitors—are inappropriate.[10]

However, new companies and their consumers are not the only ones who stand to lose from a mismatch between the economic reality and the level of regulation. This mismatch can also lead to people being subject to regulation without representation—as some states

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5. Adrienne Harris, *The Future of Finance Is Now*, WHITE HOUSE BLOG (June 10, 2016, 6:00 PM), https://www.whitehouse.gov/blog/2016/06/10/future-finance-now [https://perma.cc/8UCG-XWWJ] (summarizing a 2016 White House summer event regarding fintech); *see* Press Release, Office of the Comptroller of the Currency, Forum on Supporting Responsible Innovation in the Federal Banking System (June 23, 2016), https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-55a.pdf [https://perma.cc/NM6E-9JTB]; *see also* Adrienne Harris & Alex Zerden, *A Framework for FinTech*, WHITE HOUSE BLOG (Jan. 13, 2017, 6:36 PM), https://www.whitehouse.gov/blog/2017/01/13/framework-fintech [https://perma.cc/4ZS3-US63] (providing a framework for fintech policy).

6. *See Examining the Opportunities and Challenges with Financial Technology ("FinTech"): The Development of Online Marketplace Lending: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 114th Cong. (2016); *Disrupter Series: Digital Currency and Blockchain Technology: Hearing Before the Subcomm. on Commerce, Mfg., and Trade of the H. Comm. on Energy and Commerce*, 114th Cong. (2016); *Bitcoin: Examining the Benefits and Risks for Small Businesses: Hearing Before the H. Comm. on Small Bus.*, 113th Cong. (2014).

7. *See* Letter from Sens. Sherrod Brown & Jeffrey A. Merkley to Janet Yellen, Chair of Fed. Reserve, Thomas J. Curry, Comptroller of the Currency, Martin Gruenberg, Chair of the FDIC, Rick Metsger, Chair of the Nat'l Credit Union Admin. & Richard Cordray, Dir. of the CFPB (July 21, 2016), http://www.brown.senate.gov/download/fintech-letter_-2016-07-21.

8. *See infra* Part II.

9. *See* discussion *infra* Part III.A–C.

10. *See infra* Part IV.

may be more economically important than others—which may allow those states to disproportionally control the types of products that companies offer in national markets.

State regulation in certain situations has its benefits; after all, state regulation may lead to socially beneficial competition among regulators.[11] Nevertheless, when state regulators wrest control over national markets, the citizens of less powerful states may become subject to de facto regulation in which those citizens have no say.[12] This "predation," as Professors Samuel Issacharoff and Catherine Sharkey call it,[13] denies citizens democratic recourse and harms their autonomy. Conversely, if the transaction is intrastate, states are likely able to handle regulation and impose their own requirements without the federal government's intrusion, even if it technically has jurisdiction.

This Article considers whether the current balance of state and federal regulations in markets for credit, money transmission, virtual currency, and the sale of securities makes sense. Has the reality of those markets changed such that the balance should be reconsidered? Does the current balance damage the interests of efficiency, competitive equity among market participants, or political equity among citizens?

The answer is mixed. In cases of nonbank "marketplace lending"[14] (online lending by a nonbank entity that is funded by the

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11. *See* Henry N. Butler & Larry E. Ribstein, *A Single-License Approach to Regulating Insurance* (Nw. Univ. Pritzker Sch. of Law, Working Paper No. 154, 2008), http://scholarlycommons.law.northwestern.edu/facultyworkingpapers/154 [https://perma.cc/TQ6Q-Q4EY] (arguing for a federal law that allows insurance companies to sell insurance nationwide using their home state license); J.W. Verret, *A Dual Non-Banking System? Or a Non-Dual Non-Banking System? Considering the OCC's Proposal for a Non-Bank Special Purpose National Charter for Fintech Companies, Against an Alternative Competitive Federalism System, for an Era of Fintech Banking* 35–37 (George Mason Univ. Law & Econ., Research Paper No. 17-05, 2017), https://ssrn.com/abstract=2906329 [https://perma.cc/7XUQ-AAUQ].

12. *See infra* Part IV.C.

13. Samuel Issacharoff & Catherine M. Sharkey, *Backdoor Federalization*, 53 UCLA L. REV. 1353, 1431 (2006).

14. Strictly defined, marketplace lending would require a market for selling the loan to potential buyers, which already exists at lenders such as Prosper and Lending Club. *See How Does an Online Credit Marketplace Work?*, LENDING CLUB, https://www.lendingclub.com/public/how-peer-lending-works.action [https://perma.cc/YKZ7-UAPD] (last visited Sept. 28, 2017); *Peer-to-Peer Lending Means Everyone Prospers*, PROSPER, https://www.prosper.com/plp/how-it-works [https://perma.cc/QE2X-AMFZ] (last visited Sept. 28, 2017). However, the term "marketplace" has been used more broadly when discussing the wave of recent innovative lenders, as in the case of the California Department of Business Oversight's inquiry. *See* Press Release, Jan Lynn Owen, Comm'r of Bus. Oversight, Cal. Dep't of Bus. Oversight, California DBO Announces Inquiry into 'Marketplace' Lending Industry (Dec. 11, 2015), http://www.dbo.ca.gov/Press/press_releases/2015/DBO%20Inquiry%20Announcement%

sale of the loans or by lender equity, frequently involving a bank partnership),[15] money transmission,[16] virtual currency,[17] and the interstate sale of securities over the Internet,[18] the transactional reality has become far more national in nature. As a result, transactions subject to state-by-state regulation are less efficient and less equitable.[19] This lack of efficiency and equitability could justify harmonizing or displacing existing state regulations, either by the states themselves or through preemptive federal regulations. By contrast, the recent reform of Rule 147 by the Securities and Exchange Commission (SEC), a rule that initially sought to impose substantive federal requirements on inherently interstate transactions (use of the Internet notwithstanding), is an area where the federal government should defer to the states.[20]

This Article cannot tackle all the issues implicated by changes in financial technology.[21] Although this Article does not fully cover topics such as cybersecurity regulation, it offers principles for analyzing a wide range of topics.[22] This Article is agnostic as to the underlying substance of regulation. It takes no position on the wisdom of any interest rate limit or licensing requirement. Rather, this Article seeks to analyze whether discrepancies between the entities that regulate competitors are justified. Given the scope and breadth of the topic, the dynamism of the market, and the fact that some of these questions ultimately come down to different policy preferences, this Article does not purport to be the definitive work on the topic. Rather, it merely seeks to propose criteria to be used by policymakers and citizens and debated by all interested parties.

Part II of this Article discusses some of the characteristics of fintech that are most salient for determining whether the states or the

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2012-11-15.pdf [https://perma.cc/5LQP-9PEH]. This Article adopts the broader definition. *See infra* Part III.A.3.

15. *See infra* Part III.A.3.

16. *See infra* Part III.B.

17. *See infra* Part III.C.

18. *See infra* Part III.D.3.

19. *See infra* Part IV.

20. *See infra* Parts III.D.4, IV.D.

21. This Article does not address issues relating to international regulation of financial products and services. Although some of the issues and dynamics may be similar, there are also significant differences that merit their own examination.

22. In fact, cybersecurity is developing into an area where concerns about political equity among states are highly salient, as a small number of states may wield disproportionate influence. *See, e.g.*, Penny Crosman, *N.Y. Could Set National Standard with Cybersecurity Proposal*, AM. BANKER (Sept. 15, 2016, 1:53 PM), http://www.americanbanker.com/news/bank-technology/ny-could-set-national-standard-with-cybersecurity-proposal-1091341-1.html?zkPrintable=1&nopagination=1.

federal government should regulate the industry. Part III provides an overview of state and federal regulation of interest rates and the effect of such regulations on new marketplace lenders. Part IV then turns to money transmitters and the implications for fintech, followed first by the related but sufficiently separate topic of virtual currencies and then by the topic of online corporate securities offerings. Finally, Part V discusses how the interests of efficiency, competitive equity among market participants, and political equity among residents of various states affect whether the states or the federal government should take the lead in regulating a particular aspect of fintech.

II. WHAT CHARACTERISTICS OF FINTECH MATTER FOR FEDERALISM?

The modern fintech moment is marked by several characteristics that are relevant to the question of who should regulate the industry. Professor Christopher Brummer and Daniel Gorfine have identified several common elements of fintech that can change the economic and legal realities of financial transactions, including the use of borderless platforms, low barriers to entry, and disintermediation of traditional players and the entry of new competitors.[23]

As Brummer and Gorfine note, the Internet "does not observe geographic boundaries or borders."[24] As a result, assumptions about the geographic and political limits of a company's market that underpinned previous regulations may no longer hold. For example, it used to be relatively hard to reach customers in multiple states, but now it is fairly straightforward. The Internet makes it simple for anyone with a functioning search engine to find a financial services provider. To avoid reaching out-of-state customers, the service provider would need to take explicit steps to exclude customers on the basis of their location—steps that can be easily circumvented. This cross-border capability can make financial services more efficient by leveraging the economies of scale provided by a national market, but it places service providers at risk of running afoul of state regulations.

Technology allows new competitors to replace brick-and-mortar stores with customers' computers and smartphones and to replace some staff through automation.[25] By lowering barriers to entry, new technology allows new entrants into previously stable markets and

23. CHRISTOPHER BRUMMER & DANIEL GORFINE, FINTECH: BUILDING A 21ST-CENTURY REGULATOR'S TOOLKIT 4–6 (2014), http://www.milkeninstitute.org/publications/view/665 [https://perma.cc/7MP6-EZ6S].

24. *Id.* at 6.

25. *Id.* at 5–6.

allows new business models that would not have been possible with the markets' traditional economics. For example, by leveraging technology to lower overhead and to obtain capital efficiently, marketplace lenders can compete with banks[26] without the need for deposits or ancillary lines of business found in universal banks. As a result, companies with dramatically different corporate profiles and regulatory regimes can compete for the same customers.

Ease of access and the ability to offer products to a very broad audience have very quickly attracted new entrants to compete with traditional players.[27] It may be necessary to revisit regulations premised on relatively fixed typology for financial market participants. New companies and new methods, such as virtual currency, can quickly become significant from a regulatory perspective. Additionally, established players in other industries may now intentionally or inadvertently enter highly regulated financial markets.

These technological factors affect the economic and business reality of transactions in ways that implicate the division of state and federal regulation.[28] Although technology is not the be-all or end-all of the federalism debate, to the extent that innovation is changing the line between interstate and intrastate transactions, it bears consideration.

III. EXAMPLES FROM THE FINTECH FRONTIER

The examples that follow highlight situations where the changing technological and competitive landscape puts pressure on the current allocation of regulatory authority. This Part examines the examples of lending, money transmission, virtual currencies, and online securities offerings. It also examines how the allocation of power between state and federal law, and the differences between competitors, impact both the competitive landscape and how services can be provided.

A. Consumer and Small-Business Lending and Interest Rates

Lending is a highly regulated space with a long history. Although many lending basics remain unchanged, lending mechanics

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26. Letter from author to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 3–4 (May 12, 2016) (citing MIKLOS DIETZ ET AL., CUTTING THROUGH THE NOISE AROUND FINANCIAL TECHNOLOGY (2016)), https://www.occ.gov/topics/responsible-innovation/comments/comments-brian-knight.pdf [https://perma.cc/8PVM-8GZV].

27. BRUMMER & GORFINE, *supra* note 23, at 5.

28. *See infra* Part III.

are undergoing significant innovation. What was once a face-to-face transaction can now be handled over the Internet. Data and algorithms are supplanting community reputation and the loan officer's "gut," and the question of who should regulate the transaction has become more complex as geography becomes less relevant.

1. State Regulation of Consumer and Small-Business Interest Rates

State governments have traditionally played a leading role in lending regulation, including limitations on the amount of interest and fees a lender can charge.[29] Regulation has varied from state to state and over time.[30] Recent actions by the Consumer Financial Protection Bureau (CFPB) and federal banking regulators may indicate a growing "federalization" of interest rate regulation.[31] Although many observers believe that interest rate and fee limits protect consumers,[32] others argue that such limits are

29. *See* Efraim Benmelech & Tobias J. Moskowitz, *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, 65 J. FIN. 1029, 1036 (2010). The earliest usury laws on this continent predate the founding of the United States. For example, the Massachusetts Bay Colony enacted a usury law in 1641, with the remaining colonies following suit in the 1700s. *Id.*

30. *See* Thomas W. Miller, Jr. & Harold A. Black, *Examining Arguments Made by Interest Rate Cap Advocates*, *in* REFRAMING FINANCIAL REGULATION: ENHANCING STABILITY AND PROTECTING CONSUMERS 342, 343–44 (Hester Peirce & Benjamin Klutsey eds., 2016); Benmelech & Moskowitz, *supra* note 29, at 1029.

31. *See, e.g.*, CFPB v. CashCall, Inc., No. CV 15-7522-JFW (RAOx), 2016 WL 4820635, at *1 (C.D. Cal. Aug. 31, 2016); *see also* OFFICE OF THE INSPECTOR GEN., OIG-16-001, REPORT OF INQUIRY INTO THE FDIC'S SUPERVISORY APPROACH TO REFUND ANTICIPATION LOANS AND THE INVOLVEMENT OF THE FDIC LEADERSHIP AND PERSONNEL 2 (2016) (full report not publicly available), https://financialservices.house.gov/uploadedfiles/fdic_oig_ral_report_2-19-16-_searchable_redacted_3.16.16_redacted.pdf [https://perma.cc/R3GM-DKKN] (detailing supervisory conduct that the Office of the Inspector General (OIG) felt improperly discouraged certain banks from issuing refund anticipation loans, a high-interest but legal product). *But see* Letter from Doreen R. Eberley, Dir. of FDIC Risk Mgmt. Supervision & Charles Yi, FDIC Gen. Counsel, to Fred W. Gibson Jr., Acting Inspector Gen. for the FDIC 8 (Feb. 17, 2016), http://www.ballardspahr.com/~/media/files/alerts/2016-FDIC-letter-February [https://perma.cc/V4JV-VEZQ] (disputing many of the OIG's conclusions).

32. *See, e.g.*, Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 81 (2008) (lamenting that interest rate exportation has rendered states "powerless to protect their citizens from such lending practices [rates in excess of a state's cap] going on within their borders"); Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. REG. 143, 157 (2009) ("Usury laws were historically the major form of consumer protection in banking because they shielded borrowers from assuming obligations that they could not afford."); Amanda Katherine Sadie Hill, Note, *State Usury Laws: Are They Effective in a Post-GLBA World?*, 6 N.C. BANKING INST. 411, 421 (2002) (noting that "[t]he primary public policy reason supporting usury laws is consumer protection").

counterproductive at best and a means of rent-seeking by incumbents at worst.[33]

In the late nineteenth and early twentieth centuries, there was concern that interest rate limits too low to attract legal capital for small loans left borrowers at the mercy of illegal lenders (or "loan sharks").[34] This concern prompted reformers—most notably the Russell Sage Foundation—to propose changing state laws to allow lenders to charge significantly higher interest rates[35] in exchange for complying with certain requirements, including licensing, registration, and a simplified and limited cost structure that prohibited noninterest fees.[36]

This arrangement reflected the realization that to attract and maintain stable legal lenders, the potential rates of return had to be sufficient.[37] It also reflected the reformers' belief that what made small loans dangerous was not necessarily their cost, but the lack of transparency and the loan sharks' use of fraudulent or misleading terms.[38] Lenders that wanted to operate under the new law would be able to charge more interest than previously allowed but would need to maintain high levels of transparency and simplicity.[39] These recommendations took the form of the Uniform Small Loan Law of 1916 (USLL), which was passed in various versions by two-thirds of states.[40] The USLL faced opposition from a classic "bootleggers and Baptists"[41] coalition of (1) illegal lenders who feared competition from

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33. *See* Benmelech & Moskowitz, *supra* note 29, at 1070–71 (arguing that rent-seeking by incumbents looking to cut off competition for capital better explains the course of state usury laws in the nineteenth century than the alternative public interest explanation); Miller & Black, *supra* note 30, at 344 (asserting that one explanation for interest rate caps is rent-seeking behavior by those who set them); William Cullen Bryant, Editorial. *On Usury Laws*, N.Y. EVENING POST (Sept. 26, 1836), *as reprinted in* 31 FREEMAN 45 (1981), https://fee.org/media/16244/1981-01.pdf [https://perma.cc/ZF52-MJPY] (arguing that interest rate limits harmed the poor by cutting off access, to the benefit of the rich).

34. Bruce G. Carruthers, Timothy W. Guinnane & Yoonseok Lee, *Bringing "Honest Capital" to Poor Borrowers: The Passage of the U.S. Uniform Small Loan Law, 1907–1930*, 42 J. INTERDISC. HIST. 393, 395 (2012); Miller & Black, *supra* note 30, at 360–61.

35. Carruthers, Guinnane & Lee, *supra* note 34, at 403; Letter from Thomas W. Miller, Jr., Todd Zywicki & author, to CFPB for the Rule on Payday, Vehicle Title, and Certain High-Cost Installment Lending (Oct. 7, 2016) (on file with author) (explaining that relevant interest rates were generally under 10 percent per year, and the Russell Sage Foundation proposed allowing rates between 36 percent and 42 percent).

36. Carruthers, Guinnane & Lee, *supra* note 34, at 400.

37. *Id.* at 403; Miller & Black, *supra* note 30, at 360–61.

38. Carruthers, Guinnane & Lee, *supra* note 34, at 403.

39. *Id.*

40. *Id.* at 394.

41. The phrase "bootleggers and Baptists" derives from Bruce Yandle's observation that opposition to pro-competition regulation often is raised by oddly matched partners—civic groups

legitimate lenders and (2) community advocates who thought the interest rates allowed by the USLL were too high.[42] The USLL also influenced numerous subsequent lending regulations,[43] including the federal Truth in Lending Act.[44] To this day, states continue to regulate rates[45]—and the definition of interest[46]—for both banks and nonbank entities, sometimes applying different standards to each.[47]

2. Federal Regulation of Consumer and Small-Business Interest Rates

As the federal government developed a national banking system to compete with the state-chartered banking system,[48] it began to take a greater interest in lending regulation. National banks had to be able to compete with state-chartered depositories and nondepository institutions regulated by the states. Congress passed the National Currency Act of 1863[49] and its successor statute, the National Bank Act of 1864 (NBA),[50] to help further the Union's war effort by increasing the federal government's control over the banking sector.[51] These Acts created a national currency, a federal bank

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that worry about the public effect (the Baptists) and market participants that worry they will face increased competition and diminished profit (the bootleggers). Bruce Yandle, *Bootleggers and Baptists—The Education of a Regulatory Economist*, 7 REG. 12, 13 (1983).

42. *See* Carruthers, Guinnane & Lee, *supra* note 34, at 401–02.

43. *Id.* at 394 n.1 (citing ELIZABETH RENUART, PUB. POLICY INST., PAYDAY LOANS: A MODEL STATE STATUTE 6 n.6 (2000)).

44. Truth in Lending Act of 1968, Pub. L. 90-321, §§ 101–45, 82 Stat. 146, 146–59 (1968) (codified as amended at 15 U.S.C. §§ 1601–1667f (2012)); *see* Carruthers, Guinnane & Lee, *supra* note 34, at 394.

45. *See, e.g.*, TENN. CODE ANN. § 47-14-103 (2017) (providing general interest rate limits).

46. *See, e.g.*, S.D. CODIFIED LAWS § 54-3-1 (2017) (defining what constitutes interest); TENN. CODE ANN. § 47-14-102(8) (same).

47. *See, e.g.*, S.D. CODIFIED LAWS § 54-3-13. For example, South Dakota is famous (some may say infamous) for not having a maximum usury rate for its banks. *See id.* However, South Dakota recently applied a 36 percent interest rate to payday and car title loans issued by nonbank entities. *South Dakota Voters Approve Interest Rate Cap on Payday Loans*, KSFY (Nov. 8, 2016, 10:30 PM), http://www.ksfy.com/content/news/South-Dakota-voters-approve-interest-rate-cap-on-payday-loans-400489561.html [https://perma.cc/LU6A-ZN9M].

48. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 314–15 (1978) (discussing the legislative history of the National Bank Act); *see also* CONG. GLOBE, 38th Cong., 1st Sess. 1256 (1864) (statement of Rep. Samuel Hooper) (stating the purpose of the National Bank Act was to "render the law so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters").

49. National Currency Act of 1863, ch. 58, 12 Stat. 665 (repealed 1864).

50. National Bank Act of 1864, ch. 343, § 1, 18 Stat. 123 (1864) (codified as amended at 12 U.S.C. § 38 (2012)).

51. Bank Activities and Operations, 68 Fed. Reg. 46119, 46120 (proposed Aug. 5, 2003) (to be codified at 12 C.F.R. pt. 34); *see* Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CHI. L. REV. 1631, 1633 (2016).

charter, and the Office of the Comptroller of the Currency (OCC)—charged with granting charters to and monitoring federally chartered banks.[52]

Given the NBA's intent to replace the state-chartered system with a federal one, the Supreme Court interpreted the NBA as protecting national banks from "unfriendly legislation by the States" and "ruinous competition with State banks."[53] Section 85 of the NBA, for example, allowed a national bank to either export its home-state interest rate to any state in which it did business or to use the host state's rate.[54]

This interest rate exportation power became especially important with the rise of credit cards, which allowed banks to easily lend to borrowers across state lines. In the landmark 1978 case of *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*,[55] the Supreme Court held that a bank could charge a borrower the rate of interest of the state in which the bank—not the borrower—was located.[56] The Court considered and rejected the argument that extending credit into Minnesota effectively located the bank there.[57] Instead, the Court looked to the bank's charter[58] and to where the bank actually conducted the bulk of its business[59] to determine its location.

Congress, its ardor to replace state banks having cooled, acted quickly after the *Marquette* decision to provide parity to federally insured, state-chartered banks. Section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA)[60] included language similar to Section 85 of the NBA, and both courts and regulators have interpreted the provisions in parallel.[61] Congress sought to "allow[] competitive equity among financial institutions, and reaffirm[] the principle that institutions offering similar products

52. Bank Activities and Operations, 68 Fed. Reg. at 46120.

53. Tiffany v. Nat'l Bank of Missouri, 85 U.S. (18 Wall.) 409, 413 (1873); *see also* Smith, *supra* note 51, at 1634–35.

54. 12 U.S.C. § 85 (2012); Smith, *supra* note 51, at 1634.

55. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299 (1978).

56. *Id.* at 312–13.

57. *Id.* at 310–13.

58. *Id.* at 309–11.

59. *Id.* at 311–12.

60. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 521, 94 Stat. 132, 164–65 (1980) (codified as amended at 12 U.S.C. § 1831d (2012)).

61. Greenwood Tr. Co. v. Massachusetts, 971 F.2d 818, 826–27 (1st Cir. 1992); General Counsel's Opinion No. 10 on Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 19258, 19259 (Apr. 17, 1998).

should be subject to similar rules."[62] As a result, both federally insured, state-chartered banks and federally chartered banks can charge the higher of either the interest rate allowed in their home state or the rate in the borrower's state.[63]

Section 85 of the NBA and Section 521 of DIDA allow banks to export not only the numerical rate of interest, but also the definition of interest used by their home state.[64] In addition, banks enjoy "most favored lender" status, allowing them to charge the highest rate available to any lender—not just banks—under a state's laws.[65] However, bank regulators have been known to discourage banks from making high-interest loans that are technically legal but, in the regulators' view, harmful to consumers or to the safety and soundness of the bank.[66]

Meanwhile, the law of the borrower's home state generally governs the interest nonbank lenders can charge.[67] State laws are, according to Professor Elizabeth Schiltz, "idiosyncratic," without consistent interest rates or a consistent definition of what constitutes interest.[68] However, the CFPB may be using its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to attempt to federalize interest rate regulation.[69] Likewise, the recent and controversial Operation Choke Point may represent an effort by banking regulators to discourage high-interest

62. *Greenwood*, 971 F.2d at 826 (quoting 126 CONG. REC. 6907 (1980) (statement of Sen. Bumpers)).

63. *Id.* at 827.

64. *See* Smiley v. Citibank (S.D.), N.A., 517 U.S. 735, 743–46 (1996) (holding that a national bank could charge out-of-state credit card customers interest payments consistent with OCC reasonable interpretation regarding § 85 and allowed by the bank's home state but prohibited in states where cardholders reside); 12 C.F.R. §§ 7.4001(c), 560.110(c) (2017); General Counsel's Opinion No. 10 on Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. at 19259 (citing 12 C.F.R §§ 7.4001(a), 560.110(a) (2017)).

65. *See* 12 C.F.R. §§ 7.4001(b), 560.110(b); General Counsel's Opinion No. 10 on Interest Charges Under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. at 19259.

66. *See, e.g.*, OFFICE OF THE INSPECTOR GEN., *supra* note 31, at 13. *But see* Letter from Doreen R. Eberley & Charles Yi to Fred W. Gibson Jr., *supra* note 31, at 1–2 (disputing many of the OIG's conclusions).

67. *See e.g.*, TENN. CODE ANN. § 47-14-103 (2017) (limiting interest that can be charged under certain circumstances); VA. CODE ANN. § 6.2-1520 (2017) (limiting interest that can be charged by consumer finance companies in Virginia).

68. Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 525 (2004).

69. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of U.S.C.); *see infra* Part III.A.3.

loans from nonbank entities by cutting off those lenders' access to banks.[70]

3. The Regulation of Marketplace Lending

It was against the backdrop of federal and state regulation that marketplace lending emerged. Marketplace lending is a broad term encompassing several recent models of nonbank lending.[71] Marketplace lenders share certain characteristics, including use of the Internet to solicit borrowers (and, in some cases, investors to provide loan capital), use of proprietary data and algorithms to assess risk, and use of nondeposit capital to fund loans.[72] The first marketplace lenders directly matched borrowers with members of the public, who would pledge to fund a portion of the loan in exchange for a fixed-rate debt security which the borrower's loan backed. However, over time institutional investors came to play a dominant role in this space,[73] which has led to the proliferation of different models. Business models now include the sale of entire loans to institutional investors, the securitization of loans into asset-backed securities, and investor funding of lenders that hold loans on the lenders' own balance sheets.[74] Some lenders originate their loans directly, whereas others

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70. STAFF OF H. COMM. ON OVERSIGHT AND GOV. REFORM, 113TH CONG., THE DEPARTMENT OF JUSTICE'S "OPERATION CHOKE POINT": ILLEGALLY CHOKING OFF LEGITIMATE BUSINESSES? 1 (2014); Alan Zibel & Brent Kendall, *Probe Turns up Heat on Banks*, WALL ST. J. (Aug. 7, 2013, 10:27 PM), https://www.wsj.com/articles/probe-turns-up-heat-on-banks-1375923859 [https://perma.cc/3U64-7TWH].

71. *See supra* note 14 and accompanying text.

72. Although banks may purchase loans from marketplace lenders—either directly or via asset-backed securities—with funds generated from deposits, the marketplace lender itself is a non-depository institution and does not have its own deposits to fund loans. U.S. DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING 5 (2016) [hereinafter TREASURY REPORT], https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf [https://perma.cc/Y7UH-GPGR] (listing funding sources used by marketplace lenders, including funds invested by depository institutions but omitting deposits placed with the marketplace lender itself); Andrew Friedman, *WTF Is Marketplace Lending?*, TEARSHEET (Apr. 26, 2016), http://www.tearsheet.co/2016/04/26/what-is-marketplace-lending [https://perma.cc/WKC7-V85D].

73. Shelly Banjo, *Wall Street Is Hogging the Peer-to-Peer Lending Market*, QUARTZ (Mar. 4, 2015), https://qz.com/355848/wall-street-is-hogging-the-peer-to-peer-lending-market/ [https://perma.cc/CD9Z-NV9D]; *see, e.g.*, Prosper Funding LLC, Prospectus for Borrower Dependent Notes (Form 424B3) 73 (Jan. 12, 2017) (noting whole loans sold to institutional investors comprised 82 percent of the total loans originated in the quarter that ended Sept. 30, 2016); Lending Club Corp., Quarterly Report (Form 10-Q) 39 (Nov. 11, 2016) (showing of the $2 billion in loans that Lending Club originated in the third quarter of 2016, $1.3 billion, or 65 percent, came from whole loan sales to institutions).

74. TREASURY REPORT, *supra* note 72, at 5–8.

partner with a bank to originate the loan that the marketplace lender then purchases and services.[75]

Marketplace lending has grown significantly since its inception.[76] It has allowed borrowers and lenders nationwide to access and extend credit.[77] Marketplace lenders compete with banks and other traditional lenders on cost, speed, and access. Some borrowers are able to obtain credit more cheaply than they previously could[78] or to obtain credit that traditional sources would have refused to provide.[79] This expanded access to credit is in part because market lenders do not bear the costs of physical branches and outdated technological infrastructure.[80] A lender's cost structure is an important determinant of the rates the lender can offer borrowers.[81] Meanwhile, borrowers turn to marketplace lenders because those lenders are often faster than traditional lenders.[82]

Marketplace lenders face exposure to a complex regulatory environment because of their nonbank status and the Internet's use as a distribution channel. Moreover, they lack any physical barriers to

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75. *Id.* at 5–6.

76. *Id.* at 9.

77. ROBERT WARDROP ET AL., BREAKING NEW GROUND: THE AMERICAS ALTERNATIVE FINANCE BENCHMARKING REPORT 53 (2016), https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2016-americas-alternative-finance-benchmarking-report.pdf [https://perma.cc/3P5U-LEGC].

78. Yulia Demyanyk & Daniel Kolliner, *Peer-to-Peer Lending Is Poised to Grow*, FED. RES. BANK OF CLEVELAND (Aug. 14, 2014), https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2014-economic-trends/et-20140814-peer-to-peer-lending-is-poised-to-grow.aspx [https://perma.cc/GYM9-UZSZ]; *see also* Julapa Jagtiani & Catharine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information* 26 (Fed. Reserve Bank of Phila., Working Paper No. 17-17, 2017), https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2017/wp17-17.pdf [https://perma.cc/YXL9-CE87].

79. Usman Ahmed et al., *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, 10 INNOVATIONS 35, 35–36 (2015) (finding PayPal Working Capital loans disproportionately disbursed to areas with relatively high declines in the number of banks and to traditionally underserved populations); *see also* TREASURY REPORT, *supra* note 72, at 21; Jagtiani & Lemieux, *supra* note 78, at 19–22.

80. Miklos Dietz et al., *Cutting Through the Noise Around Financial Technology*, MCKINSEY & CO. FIN. SERVS. (Feb. 2016), http://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology [https://perma.cc/4T9N-6K33].

81. THOMAS A. DURKIN, GREGORY ELLIEHAUSEN & MIN HWANG, RATE CEILINGS AND THE DISTRIBUTION OF SMALL DOLLAR LOANS FROM CONSUMER FINANCE COMPANIES: RESULTS OF A NEW SURVEY OF SMALL DOLLAR CASH LENDERS 5–6 (2014), http://ssrn.com/abstract=2533143 [https://perma.cc/7KYD-X37S].

82. Richard D. Olson, Jr., *Online Lending: Friend or Foe of Community Bankers?*, COMMUNITIES & BANKING, Fall 2014, at 13, 13, https://www.bostonfed.org/commdev/c&b/2014/fall/online-lending-friend-or-foe.htm [https://perma.cc/T6TU-NYJC].

extending credit and raising investment capital nationwide, possessing the capability for instant scale. However, they face regulatory barriers. Federal law provides state-chartered and federally chartered banks significant regulatory consistency regarding what they can charge for loans across state lines.[83] By contrast, marketplace lenders, as nonbank financial companies, face regulatory inconsistency and duplication. They are subject to federal regulation in a number of areas: the federal prohibition on unfair, deceptive, or abusive acts or practices;[84] consumer protection laws; fair lending laws; and the Bank Secrecy Act (BSA).[85] But they are also frequently subject to state-by-state regulations, including usury laws and licensure requirements.[86]

Licensing is one area in which banks enjoy broad consistency[87] while marketplace lenders face inconsistent, state-by-state regulation. With the exception of licensing of mortgage lenders,[88] state licensing laws for lenders often vary. States have different rules for which activities require licensure[89] and different substantive legal requirements for the license. Some lenders cite the lack of regulatory consistency as a significant problem because it increases complexity and costs while lowering certainty.[90]

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83. *See supra* Part III.A.2.

84. 12 U.S.C. § 5531 (2012).

85. Bank Secrecy Act of 1970, Pub. L. No. 91-508, §§ 201–42, 84 Stat. 1114, 1118–24 (1970) (codified as amended at scattered sections of 12 U.S.C. and 31 U.S.C.); *see* TREASURY REPORT, *supra* note 72, at 36.

86. TREASURY REPORT, *supra* note 72, at 5; John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INST. 17, 31–32 (2016).

87. Douglas, *supra* note 86, at 34.

88. Mortgage lender requirements are relatively more consistent as a result of the Nationwide Multistate Licensing System and Registry (NMLS), a joint project of the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. *See* Douglas, *supra* note 86, at 33. The Secure and Fair Enforcement for Mortgage Licensing Act mandated that mortgage loan originators register with NMLS, which helped drive uniformity. *Id.*; *see* Pub. L. No. 110-289, §§ 1501–17, 122 Stat. 2654, 2810–24 (codified as amended at 12 U.S.C. §§ 5101–16 (2012)). Note that mortgages are also subject to a federal law that exempts them from state usury laws, *see* 12 U.S.C. § 1735f-7, and regulations that impose significant additional requirements on certain high-cost mortgages, in effect discouraging lenders from making them, *see* 12 C.F.R. § 1026.32 (2017).

89. Douglas, *supra* note 86, at 32.

90. *See, e.g.*, Letter from Manuel P. Alvarez, Gen. Counsel, Affirm Inc., to Laura Temel, Senior Advisor, U.S. Dep't of the Treasury 7 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0080&attachmentNumber=1&contentType=pdf [https://perma.cc/3HLZ-ENHN]; Letter from Sam Hodges, Co-Founder and U.S. Managing Dir., Funding Circle, & Connor French, Legal & Regulatory Dir., Funding Circle, to Laura Temel, Senior Advisor, U.S. Dep't of the Treasury 27 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0081&attachmentNumber=1&contentType=pdf [https://perma.cc/7JH9-B656]; Letter from

The desire for consistency—especially in loan pricing—is one reason some lenders partner with banks. As discussed above,[91] banks are able to charge consistent interest rates nationwide, permitting comparable borrowers to be treated alike regardless of the idiosyncrasies of state law. By partnering with a bank, marketplace lenders can offer uniform prices and extend credit to borrowers whose risk profiles necessitate an interest rate above the state limit imposed on nonbank financial companies. This model relies on two traditionally well-accepted legal doctrines: the previously mentioned ability of banks to export interest rates and the common law doctrine of "valid when made."[92] The latter is one of "two cardinal rules in the doctrine of usury."[93] A loan that is not usurious when it is made (in this case, because of the bank's ability to export its home state interest rate to the borrower's state) cannot subsequently become usurious because it is sold to another party—even if that party itself could not have legally originated the loan.[94]

Frequently, in the bank partnership model, the marketplace lender will conduct independent marketing and serve as the intake point for potential borrowers.[95] The marketplace lender performs its own underwriting to assess risk and determines whether to extend a loan and, if so, at what price.[96] If the marketplace lender wishes to extend credit and its bank partner agrees, the bank will originate the loan and sell it to the marketplace lender after a short period of time.[97] In some cases, the bank sells the loan directly to a third

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Robert S. Lavet, Gen. Counsel, Social Fin., Inc., to Laura Temel, Senior Advisor, U.S. Dep't of the Treasury 3–5 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0050&attachmentNumber=1&contentType=pdf [https://perma.cc/DDU2-9X6X]; Letter from Mitria Wilson, Vice President of Gov't Relations, Oportun, to Office of the Undersec'y for Domestic Fin., U.S. Dep't of the Treasury 11–13 (Sept. 30, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0084&attachmentNumber=1&contentType=pdf [https://perma.cc/3MM2-F9YE].

91. *See supra* Part III.A.2.

92. *See* Nichols v. Fearson, 32 U.S. (7 Pet.) 103, 109 (1833) (describing the foundation for the "valid when made" doctrine).

93. *Id.*

94. *Id.* at 110.

95. TREASURY REPORT, *supra* note 72, at 6–9.

96. *Id.*; *see also* Colleen Honigsberg, Robert J. Jackson, Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment* 13 (Columbia Bus. Sch., Research Paper No. 16-38, 2017), https://ssrn.com/abstract=2780215 [https://perma.cc/AN2D-7S2U].

97. TREASURY REPORT, *supra* note 72, at 6; Letter from Renaude Laplanche, Founder & CEO, Lending Club, to Laura Temel, Senior Advisor, U.S. Dep't of Treasury 8 (Sept. 30, 2015), http://ir.lendingclub.com/interactive/lookandfeel/4213397/LendingClubResponseToTreasuryRFI.pdf [https://perma.cc/Y248-9YHS] (responding to the Treasury Department's request for information on marketplace lending).

party.[98] The marketplace lender services the loan, either on its own behalf or on behalf of the purchaser of the loan.[99]

This bank partnership model has come under pressure recently from both the courts and state regulators. The recent case of *Madden v. Midland Funding, LLC*[100] calls into question the ability of banks to sell loans to nonbank entities that service the loans on the original loan terms. In *Madden*, a borrower sued a debt-buying service, claiming that the debt was usurious and therefore invalid under New York law.[101] The borrower executed a credit card contract with a federally chartered bank, using an interest rate under the bank's home state law.[102] The borrowers account was then sold to another federally chartered bank.[103] The borrower subsequently defaulted, her debt was declared nonperforming, and the loan was sold.[104]

The debt purchaser, Midland Funding, tried to collect the debt under the terms of the original contract, including interest accrued at the original interest rate of 27 percent[105]—a rate in excess of New York's 25 percent limit.[106] The borrower argued that Midland Funding was not entitled to interest that accrued after it purchased the debt because it was not a bank and therefore was not able to take advantage of the NBA's interest rate export provision.[107] Midland Funding maintained that, as assignee of a national bank's debt, it was entitled to preemption under the NBA.[108]

The US Court of Appeals for the Second Circuit sided with the borrower, finding that the nonbank debt buyer was neither covered by the NBA nor able to administer the contract on the same terms as the bank.[109] The court reasoned that preventing a nonbank debt purchaser from enforcing loans on the same terms as the bank that made and sold the loan did not sufficiently impair the bank's powers[110] to trigger the NBA's preemption of New York's usury statute.[111]

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98. TREASURY REPORT, *supra* note 72, at 6.
99. *Id.*; *see also* Honigsberg, Jackson & Squire, *supra* note 96, at 14.
100. Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).
101. *Id.* at 248.
102. *Id.* at 247–48.
103. *Id.* at 248.
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.* at 249.
108. *Id.* at 250.
109. *Id.* at 249.
110. *Id.* at 251.
111. *Id.* at 249.

The Office of the Solicitor General and the OCC strongly criticized the Second Circuit's decision as a misunderstanding of the law and precedent.[112] They argued that the power of banks under the NBA to make a loan includes the power to sell the loan to a nonbank entity and have the loan remain valid.[113]

Even though *Madden* did not involve a marketplace lender, it has clear implications for marketplace lending. Marketplace lenders that partner with banks are in a somewhat similar position to the defendant in *Madden*, and the validity of loans that could violate usury laws in New York, Connecticut, and Vermont (the states covered by the Second Circuit) can no longer be assumed. Some marketplace lenders initially represented to investors that contractual choice-of-law provisions applying Utah law (which excludes interest rate caps) would be sufficient to avoid any impact from *Madden*.[114] However, lenders have changed the structure of their partnerships with banks to let the bank retain an interest in the loan's performance, likely as a way to protect against preemption questions.[115]

The market seems less confident that such a choice-of-law approach rests on solid legal ground.[116] As evidence of the market's uncertainty, the amount of investment pledged to loans with interest rates in excess of state usury caps in the states covered by the Second Circuit has declined significantly after *Madden*, despite growth in states not covered by that decision.[117] After the Supreme Court's refusal to hear the case, concern has grown about credit access for risky borrowers. A bill was introduced in Congress in 2016 to codify

112. Brief for the United States as Amicus Curiae Supporting Petitioners at 6, Midland Funding, LLC v. Madden, 136 S. Ct. 2505 (2016) (No. 15-610).

113. *Id.* at 7.

114. *See* Sean Murray, *Renaud Laplanche on* Madden v. Midland, DEBANKED (Aug. 8, 2015), http://debanked.com/2015/08/renaud-laplanche-on-madden-v-midland [https://perma.cc/M23E-YQ2D].

115. Smith, *supra* note 51, at 1680.

116. Joseph Cioffi & Massimo Giugliano, *Spotlight Remains on Marketplace Lenders Post-*Madden, LAW360 (July 13, 2016, 4:13 PM), http://www.law360.com/articles/816802/spotlight-remains-on-marketplace-lenders-post-madden [https://perma.cc/G2UL-RQVD] ("Lenders could include a choice-of-law provision in their loan agreements that mandate[s] the application of the originating bank's home state's laws, including usury laws. The effectiveness of such a provision may be case-specific, however, because a borrower may overcome it by demonstrating that application of the chosen law would undermine a fundamental policy of the borrower's home state."); *see also* Douglas, *supra* note 86, at 31 (noting that choice-of-law provisions "must bear some substantial relationship to the transaction.").

117. Honigsberg, Jackson & Squire, *supra* note 96, at 27–29.

the "valid when made" principle,[118] but it failed to pass. However, in 2017 similar provisions have been introduced in the House and Senate.[119]

Although *Madden*'s impact on marketplace lending may be somewhat indirect, it has prompted at least one suit that directly takes aim at the bank partnership model. *Bethune v. LendingClub Corp.* is a civil suit by a borrower who accused Lending Club of engaging in corrupt practices.[120] The borrower alleges that Lending Club, which purchases and services loans originated by its bank partners, was the "true lender" and merely used the banks as a "sham" to evade New York usury law.[121] The complaint cites *Madden* for the proposition that Lending Club, a nonbank lender, is unable to issue or service the loans it purchases from its bank partners when those loans have interest rates higher than the rate cap in the borrower's home state.[122] The plaintiff sought to form a class of similarly situated borrowers,[123] but the defendants successfully argued that the case must be sent to arbitration under the terms of the plaintiff's loan.[124]

Bethune raises two different regulatory questions facing marketplace lenders. One is the previously mentioned question about the validity of loans sold by banks to nonbank entities.[125] The other question relates to the "true lender" doctrine, under which the court looks past the statements of the parties to the economic reality of the transaction, in order to determine the actual lender—and therefore what law applies. In *Madden*, there was no dispute that the original lender was a bank that made the loan for its own purposes, retained

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118. The Protecting Consumers' Access to Credit Act of 2016 was introduced by Rep. Patrick McHenry on July 11, 2016. *See* H.R. 5724, 114th Cong. § 2 (2016).

119. *See, e.g.*, H.R. 3299, 115th Cong. (2017); H.R. 3280, 115th Cong. § 925 (2017); H.R. 10, 115th Cong. § 581 (2017); *see also* S. 1642, 115th Cong. (2017) (proposing an identical version of H.R. 3299 in the US Senate). *See generally* Memorandum from Jeb Hensarling, Chairman, Comm. on Fin. Servs., to the Fin. Servs. Comm. Leadership Team 5 (Feb. 6, 2017), https://www.cfpbmonitor.com/wp-content/uploads/sites/5/2017/02/CHOICE.pdf [https://perma.cc/MZ63-U6Q3] (proposing to amend the Financial CHOICE Act with language taken from H.R. 5724).

120. Bethune v. LendingClub Corp., No. 16 CIV. 2578 (NRB), 2017 WL 462287, at *1 (S.D.N.Y. Jan. 30, 2017).

121. Complaint ¶¶ 11–17, *Bethune*, 2017 WL 462287, ECF No. 1.

122. *Id.* ¶ 50.

123. *Id.* ¶¶ 63–73.

124. *Bethune*, 2017 WL 462287, at *1; *see* Robert Loeb et al., *Class Action Against Lending Club and WebBank Headed to Defeat*, ORRICK (Jan. 31, 2017), https://www.orrick.com/Insights/2017/01/Class-Action-Against-Lending-Club-and-WebBank-Headed-to-Defeat [https://perma.cc/R9ZQ-YSDC].

125. *See supra* text accompanying notes 100–22.

the loan and relationship for a period of time, and disposed of the loan only after the loan had ceased to perform.[126] By contrast, the plaintiff in *Bethune* argues that the originating bank was a mere tool of Lending Club, the entity that makes the actual decisions, funds the loans, and owns the relationship.[127]

Disgruntled borrowers are not the only parties raising true lender issues in marketplace lending. For example, regulators in New York[128] and California[129] have begun making inquiries of marketplace lenders. Vermont has passed a law requiring "loan solicitors," which would likely include marketplace lenders, to be licensed and regulated by the state.[130] Additionally, regulators in Colorado have sued two marketplace lenders, arguing that Colorado law applies to the loan—despite the fact it was initially made by a bank—on the grounds that the bank is unable to sell the loan and the marketplace lenders are the true lenders.[131] Identifying the true lender is particularly important for state regulators: if the true lender is a bank, state regulators may be significantly limited by federal preemption; on the other hand, if the true lender is a nonbank entity, state regulators have significantly more authority and flexibility.[132]

Additionally, the CFPB has begun to make interest rate limits a subject of federal regulation. Although Dodd-Frank prohibits the CFPB from imposing an interest rate limit without explicit authorization from Congress,[133] the CFPB has begun to nibble at the edges. In its Proposed Rule on Payday, Vehicle Title, and Certain

126. *See* Madden v. Midland Funding, LLC, 786 F.3d 246, 247–48 (2d Cir. 2015).

127. Complaint, *supra* note 121, ¶¶ 11–17.

128. Suzanne Barlyn, *Exclusive: New York Financial Regulator Gearing Up to Probe Online Lenders*, REUTERS (May 26, 2016, 6:11 PM), http://www.reuters.com/article/us-lending-new-york-probe-exclusive-idUSKCN0YG31O [https://perma.cc/6ND8-4MHL].

129. Consumer Fin. Servs. Grp., *California Launches Marketplace Lending, Merchant Cash Advance Inquiry*, BALLARD SPAHR (Dec. 21, 2015), http://www.ballardspahr.com/alertspublications/legalalerts/2015-12-21-california-launches-marketplace-lending-merchant-cash-advance-inquiry.aspx [https://perma.cc/K8AU-89KM].

130. *Vermont Licenses and Regulates Loan Solicitors Including Lead Generators*, COUNSELORLIBR. (May 5, 2017), https://www.counselorlibrary.net/public/alert.cfm?itemID=2420 [https://perma.cc/2JDR-2UT3].

131. Complaint ¶¶ 29–35, Meade v. Avant of Colo. LLC, No. 17CV30377 (D. Colo. Feb. 15, 2017), https://www.scribd.com/document/344289556/Colorado-v-Avant [https://perma.cc/GST5-JA9L]; Complaint ¶¶ 27–33, Meade v. Marlette Funding LLC, No. 17CV30376 (D. Colo. Feb. 15, 2017), https://www.scribd.com/document/344289584/Colorado-v-Marlette [https://perma.cc/9VRD-YXVG].

132. Douglas, *supra* note 86, at 31–32, 34.

133. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1027, 124 Stat. 1376, 1995 (2010) (codified as amended at 12 U.S.C. § 5517(o) (2012)).

High-Cost Installment Loans (Payday Rule),[134] the CFPB proposed that certain loans with a total annual cost of credit exceeding 36 percent be subject to considerable disclosure and procedural requirements, which would likely render many of those loans infeasible.[135] Such loans include those with which the lender has a lien or "leveraged payment mechanism" that allows the lender to automatically take payment from the borrower's bank account.[136] The Payday Rule, if adopted in its proposed form, could implicate many of the loans made by marketplace lenders because of the lenders' use of the Automated Clearing House (ACH) to "pull" the borrower's payments.

Recently, the CFPB also successfully applied the true lender doctrine to nonbank entities that partner with Native American tribes to issue loans in excess of the borrower's state usury cap, arguing that those loans could violate Dodd-Frank's prohibition on unfair, deceptive, and abusive acts or practices.[137] In *CFPB v. CashCall, Inc.*, the US District Court for the Central District of California granted summary judgment to the CFPB, holding that CashCall, a lender that prefunded and purchased loans issued by Western Sky Financial—a corporation operating under the laws of the Cheyenne River Sioux Tribe (CRST)—was the true lender.[138] The loan contracts contained a choice-of-law provision stipulating that the CRST law would govern the contracts,[139] while Western Sky personnel conducted underwriting and made lending decisions.[140] The court nevertheless found that CashCall was the true lender.[141] It did so by applying a "totality of the circumstances" test.[142]

The court looked at the underlying economics of the transaction and found that CashCall bore the entire risk of the transaction; Western Sky was insulated from the risk that loans would default both contractually and via a prefunded pool of money provided by

134. Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 47864 (proposed July 22, 2016) (to be codified at 12 C.F.R. pt. 1041).

135. *Id.* at 47912–13; *see* Tom Miller, Todd Zwyicki & Brian Knight, Comment Letter on the CFPB's Proposed Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans 11, 13 (Oct. 18, 2016), https://www.regulations.gov/document?D=CFPB-2016-0025-143372 [https://perma.cc/AQ9R-XSZJ].

136. Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. at 47864.

137. CFPB v. CashCall, Inc., No. CV 15-7522-JFW (RAOx), 2016 WL 4820635, at *4, *13 (C.D. Cal. Aug. 31, 2016).

138. *Id.* at *5–6.

139. *Id.* at *3.

140. *Id.*

141. *Id.* at *6.

142. *Id.*

CashCall to cover the next two days' worth of loans.[143] The court then found that the choice-of-law provision in the contract was invalid because the CRST lacked a sufficient connection to the transaction to justify using the tribe's law.[144] Although lending decisions were made on CRST property and the court acknowledged that the law of California (CashCall's home state) could arguably apply, the court held that the law of the borrowers' home state should apply.[145] The court reasoned that the borrowers applied for, paid for, and received the funds from the loans in their home states; therefore, their home states' law should apply because these states had the most important interest in the transaction.[146]

The applicability of the true lender doctrine in the context of marketplace lending is muddled.[147] In determining the true lender's identity, some courts—such as the Central District of California in *CFPB v. CashCall*—look to the totality of the circumstances and seek to determine who has the "predominant economic interest" in the loan at its creation.[148] Other courts look to the legal structure of the arrangement as the guiding principle.[149] One such court cited the concern that making a judgment on the basis of subjective intent instead of legal form is too uncertain and inconsistent with federal banking law's intent to exempt banks from state usury laws.[150] It is unclear how courts will apply the true lender doctrine to marketplace lenders using a bank partnership. Likewise, the CFPB's use of federal law to penalize violations of state usury caps could represent a path to federalization of interest rate regulation, though it too remains unclear how extensively this strategy will be pursued. As they did in

143. *Id.*

144. *Id.* at *7.

145. *Id.* at *9.

146. *Id.* at *8. This analysis appears inconsistent with the Supreme Court's analysis in *Marquette*, where the Court found that the lender's home state should control despite borrowers applying for, receiving, and paying for credit from their home states. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 299–300 (1978).

147. *See* Richard P. Eckman & Ashleigh K. Reibach, *True Lender Issues Cloud the Future of Marketplace Lending*, PEPPER HAMILTON (Dec. 9, 2014), http://www.pepperlaw.com/publications/true-lender-issues-cloud-the-future-of-marketplace-lending-2014-12-09 [https://perma.cc/MG72-4PKZ].

148. *CashCall*, 2016 WL 4820635, at *6, *13; *see* CashCall, Inc. v. Morrisey, No. 12-1274, 2014 W. Va. LEXIS 587, at *41 (W. Va. May 30, 2014); Spitzer v. Cty. Bank of Rehoboth Beach, 846 N.Y.S.2d 436, 439 (App. Div. 2007).

149. *See, e.g.*, Krispin v. May Dep't Stores Co., 218 F.3d 919, 923–24 (8th Cir. 2000); Beechum v. Navient Sols., Inc., No. EDCV 15-8239-JGB-KKx, 2016 WL 5340454, at *7 (C.D. Cal. Sept. 20, 2016); Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1359, 1368–69 (D. Utah 2014); Hudson v. ACE Cash Express, Inc., No. 01-1336-C, 2002 U.S. Dist. LEXIS 11226, at *16 (S.D. Ind. May 30, 2002).

150. *Hudson*, 2002 U.S. Dist. LEXIS 11226, at *16.

reaction to the *Madden* decision, some marketplace lenders with bank partnerships—in an effort to avoid true lender issues—have been changing their arrangements so that the bank's compensation is tied to performance over the life of the loan.[151]

One way around the question of the true lender's identity is to allow marketplace lenders to become "banks" themselves. That possibility has been suggested to the Treasury Department in response to its request for information on marketplace lending.[152] That suggestion was also made to the OCC in response to its white paper *Supporting Responsible Innovation in the Federal Banking System*.[153] The OCC has supported this view and announced it would offer a Special Purpose National Bank charter to fintech firms.[154] Supporters of this approach include those in the financial services industry,[155] policy professionals,[156] and some consumer advocates.[157]

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151. Kevin Wack, *Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges*, AM. BANKER (Feb. 26, 2016, 5:54 PM), https://www.americanbanker.com/news/lending-club-tweaks-business-model-in-effort-to-thwart-legal-challenges [https://perma.cc/HV96-8VWS].

152. Letter from author & Staci Warden, Milken Inst. Ctr. for Fin. Mkts., to Laura Temel, Senior Advisor, U.S. Dep't of Treasury 10–11 (Sept. 28, 2015), https://www.regulations.gov/contentStreamer?documentId=TREAS-DO-2015-0007-0023&attachmentNumber=1&contentType=pdf [https://perma.cc/685L-KQ7E]; Letter from Robert S. Lavet to Laura Temel, *supra* note 90, at 3–5.

153. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE BANK CHARTERS FOR FINTECH COMPANIES 2, 3 n.1 (2016) (citing OFFICE OF THE COMPTROLLER OF THE CURRENCY, SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE (2016)), https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf [https://perma.cc/7RA9-XNKW].

154. *Id.* at 2.

155. Letter from Joan Aristei, Vice President, Opurtun, Inc., to the Office of the Comptroller of the Currency 3 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/oportun-response-to-occ-responsible-innovation.pdf [https://perma.cc/FF4Y-NCK6]; Letter from John A. Beccia, Gen. Counsel, Circle Internet Fin., Inc., to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 5 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-circle-financial.pdf [https://perma.cc/82DY-NBJQ]; Letter from Robert S. Lavet to Laura Temel, *supra* note 90, at 3–5; Letter from Juan Suarez, Counsel, Coinbase Inc., to the Office of the Comptroller of the Currency 4–5 (June 1, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-coinbase-letter.pdf [https://perma.cc/FX5B-SPQM]; Letter from Ryan Zagone, Dir. of Regulatory Relations, Ripple, to the Office of the Comptroller of the Currency 3 (May 30, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-ryan-zagone.pdf [https://perma.cc/6P4V-YXG6].

156. Letter from author, Mercatus Ctr. at George Mason Univ., to the Office of the Comptroller of the Currency 7–8 (May 12, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-brian-knight.pdf [https://perma.cc/J3K4-YVVU]; Letter from Jackson Mueller & Staci Warden, Milken Inst. Ctr. for Fin. Mkts., to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 5–6 (Jan. 15, 2017), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-letter-milken.pdf [https://perma.cc/6PJS-VALQ]; Letter from Peter Van Valkenberg & Jerry Brito, Coin Ctr., to the

The proposed fintech charter has met resistance from the states—which have filed suit to block the OCC[158]—as well as some incumbents[159] and consumer advocates.[160] The OCC has announced that it will offer charters to fintech companies, including marketplace lenders.[161] It remains unclear, however, whether the charter as implemented will be a viable option for many companies.

B. Money Transmission

As with lending, considerable technological innovation has recently occurred in the transmission of money. The Internet, smartphones, and the digitization of money have made it possible to replace traditional intermediaries, such as bank branches or Western Union agents, with (as far as the consumer can tell) direct access without regard for distance between parties. Lower costs of entry have also made providing money transmission services on a large scale more viable, both for new businesses that lack other products to complement or cross-subsidize money transmission (as banks have done in the past) and for the established agent networks traditionally used by companies such as Western Union.

Players in the money transmission space include traditional financial firms,[162] large technology companies that specialize in

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Office of the Comptroller of the Currency 9–10 (May 27, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-coin-center.pdf [https://perma.cc/RK7F-TXHQ].

157. Letter from Jennifer Tescher, Ctr. for Fin. Servs. Innovation, to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 11 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-cfsi.pdf [https://perma.cc/AQB8-4VU2].

158. Complaint, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, No. 1:17-cv-00763, 2017 WL 1488257 (D.D.C. Apr. 26, 2017).

159. Letter from Karen M. Thomas, Senior Exec. Vice President, Indep. Cmty. Bankers of Am., to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 2–3 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-icba.pdf [https://perma.cc/WQ57-Q7Q5].

160. Letter from the Nat'l Consumer Law Ctr., to Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency 7–8 (May 31, 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/comments-fintech-nclc.pdf [https://perma.cc/C9TA-QZ9D].

161. OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 153, at 11.

162. Such firms include traditional credit card networks such as American Express. *See, e.g.*, COMMONWEALTH OF VA. BUREAU OF FIN. INSTS., MONEY TRANSMITTER LICENSEES 1 (2017) [hereinafter MONEY TRANSMITTER LICENSEES], https://www.scc.virginia.gov/bfi/reg_inst/trans.pdf [https://perma.cc/7HFM-EAAL]. They also include networks of banks, as exemplified by Zelle, a payments network ultimately owned by seven large US banks. *See* Sarah Perez, *Zelle, the Real-Time Venmo Competitor Backed by Over 30 U.S. Banks, Arrives this Month*, TECH CRUNCH

moving money,[163] large firms whose interest in money transmission may be incidental or derived from their core businesses,[164] and new insurgent companies.[165] Although many of those firms offer products that leverage existing payment systems, such as credit card networks or the ACH,[166] others use proprietary systems that seek to offer better and faster service. New digital currencies, such as Bitcoin, exist as well. Those currencies also compete in money transmission and introduce unique regulatory issues.[167]

Certain financial technology companies, including PayPal, Google, and Microsoft, have registered with the Department of Treasury's Financial Crimes Enforcement Network (FinCEN) and with some states as money services businesses;[168] others, such as Apple, have not.[169] The determining factor governing FinCEN's registration requirements is whether the service allows the user to

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(June 12, 2017), https://techcrunch.com/2017/06/12/zelle-the-real-time-venmo-competitor-backed-by-over-30-u-s-banks-arrives-this-month [https://perma.cc/JFB7-7266].

163. *See, e.g.*, *Who We Are*, PAYPAL, https://www.paypal.com/us/webapps/mpp/about [https://perma.cc/C4L5-QZ5Q] (last visited Sept. 29, 2017).

164. *See, e.g.*, AMAZON PAY, https://pay.amazon.com/us [https://perma.cc/WN6H-5JLR] (last visited Sept. 29, 2017); APPLE PAY, http://www.apple.com/apple-pay [https://perma.cc/WDR6-UHSR] (last visited Sept. 29, 2017).

165. *See, e.g.*, DWOLLA, https://www.dwolla.com [https://perma.cc/UM5C-YB9G] (last visited Sept. 29, 2017); RIPPLE, https://ripple.com [https://perma.cc/9PHD-EAYW] (last visited Sept. 29, 2017).

166. The ACH is a network that banks use to move funds between accounts. It is frequently used for direct deposits (e.g., a paycheck) or direct payments (e.g., automatic bill pay). For more information, see the network's website at NACHA, https://www.nacha.org/news/what-ach-quick-facts-about-automated-clearing-house-ach-network [https://perma.cc/4P2K-4NWD] (last visited Sept. 29, 2017).

167. *See, e.g.*, BITCOIN, https://bitcoin.org/en [https://perma.cc/73M6-N8LW] (last visited Sept. 29, 2017). This Article focuses on the regulation of money transmitters, not money transmission (e.g., limits on liability for fraudulent transfers).

168. FinCEN's registrant search confirms the registration of these three companies. *See MSB Registrant Search*, FINCEN, https://www.fincen.gov/financial_institutions/msb/msbstateselector.html [https://perma.cc/FDN9-S2U3] (last visited Sept. 29, 2017). With respect to state registration, PayPal and Google are, for example, registered in the Commonwealth of Virginia. *See* MONEY TRANSMITTER LICENSEES, *supra* note 162, at 3. All three companies are also registered in Idaho. *See Money Transmitters*, IDAHO DEP'T OF FIN., http://www.finance.idaho.gov/MoneyTransmitter/MoneyTransmitterLicense.aspx [https://perma.cc/3KTJ-QMCF] (last visited Sept. 29, 2017).

169. Samuel Rubenfeld, *Apple Pay Faces Lighter Compliance Than PayPal, Google*, WALL ST. J.: BLOG (Oct. 20, 2014, 5:45 AM), http://blogs.wsj.com/riskandcompliance/2014/10/20/why-apple-pay-faces-lighter-compliance-than-paypal-google [https://perma.cc/6MYP-G788]. However, Apple has recently announced a peer-to-peer payment functionality that may include Apple holding customer funds, which could require Apple registering. *See* Jason Del Rey, *Apple Just Announced Its Own Venmo Competitor Built Into iMessage*, RECODE (June 5, 2017, 2:18 PM), https://www.recode.net/2017/6/5/15741636/apple-pay-p2p-venmo-competitor-apple-pay-cash-money-transfer [https://perma.cc/Q5LQ-9SR8].

store value or is merely a means of conveying payment credential information.[170] PayPal users, for example, can store money with PayPal as unsecured creditors of PayPal,[171] whereas Apple Pay, at least so far, stores credit card and debit card credentials securely and allows them to be communicated to merchants, but it does not hold customer money.[172]

Money transmission operates in a hybrid regulatory environment governed by both state and federal law. In general, federal regulation is more concerned with preventing money laundering and other criminal abuses of the payments system than it is with consumer protection.[173] By contrast, state laws are more concerned with consumer protection and the safety and soundness of the service provider.[174] However, the federal government, through the CFPB, is expressing increased interest in consumer protection regarding the money transmission context.

How money transmission is regulated depends on who provides the service. State money transmittal statutes,[175] which are otherwise extremely broad,[176] often exempt banks.[177] These laws potentially sweep in a lot of activity beyond traditional money transmission, such as a courier service moving a store of value (for example, a check or cash) between parties.[178] As such, nonbank entities providing money transfer or payments services, which are subject to state-by-state regulation, may find themselves under a different—and much less consistent—regulatory regime than their bank competitors.

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170. Rubenfeld, *supra* note 169.

171. *User Agreement*, PAYPAL, https://www.paypal.com/us/webapps/mpp/ua/useragreement-full?bn_r=o#5 [https://perma.cc/VE6L-7XY9] (last visited Sept. 13, 2017).

172. APPLE PAY, *supra* note 164.

173. Kevin V. Tu, *Regulating the New Cashless World*, 65 ALA. L. REV. 77, 86 (2013).

174. *Id.* at 85–86.

175. *Id.* at 89; *see, e.g.*, TENN. CODE ANN. § 45-7-204 (2017) (exempting from money transmitter regulations only the US government, the State of Tennessee, banks, credit unions, and certain insurance transactions); VA. CODE ANN. § 6.2-1902 (2017) (exempting the US government, other states, agents of the government, banks and credit unions, and private security services businesses that are licensed to transport money).

176. Tu, *supra* note 173, at 87–88.

177. *Id.* at 89; *see, e.g.*, TENN. CODE ANN. § 45-7-204; VA. CODE ANN. § 6.2-1902.

178. Tu, *supra* note 173, at 87–88.

1. State Regulation of Money Transmission

State laws regulating money transmission tend to be broadly applicable[179] with limited exemptions.[180] State regulation of money transmitters has traditionally focused on protecting consumers and ensuring that money transmitters are sufficiently safe and sound to avoid failure.[181] As such, these laws often include provisions that limit who can be a money transmitter on the basis of factors such as criminal history,[182] net worth of licensee,[183] and general character, fitness, and competence.[184] For example, some states require a surety bond or equivalent with the application.[185] Money transmitters are generally charged a licensing fee or periodic assessments by the state.[186] Also, they are generally subject to periodic examination[187] and requirements to file reports with the state regulator—either on a

179. *Id.*; *see, e.g.*, TENN. CODE ANN. § 45-7-202(a); VA. CODE ANN. § 6.2-1901 (requiring a license for anyone engaged in the business of money transmission, regardless of whether the money transmitter has a location in Virginia).

180. TENN. CODE ANN. § 45-7-204 (exempting from money transmitter regulations only the US Government, the state of Tennessee, banks and credit unions, and certain insurance transactions); VA. CODE ANN. § 6.2-1902 (exempting the US government, other states, agents of the government, banks and credit unions, and private security services businesses that are licensed to transport money); Tu, *supra* note 173, at 89–91.

181. Tu, *supra* note 173, at 85–86.

182. *See, e.g.*, TENN. CODE ANN. § 45-7-205(c) (prohibiting issuance of a money transmitter license if certain persons affiliated with the company were convicted of a felony within the past 10 years, subject to the discretion of the Tennessee Commissioner of Financial Institutions); VA. CODE ANN. § 6.2-1906(A)(1) (requiring that the character of the applicant and its control people is such that there is reason to believe the business will be operated fairly).

183. *See, e.g.*, TENN. CODE ANN. § 45-7-205(a) (requiring a $100,000 minimum net worth for the company plus an additional $25,000 per additional location or agent located in Tennessee, up to $500,000); VA. CODE ANN. § 6.2-1906(B) (requiring $200,000 minimum net worth of licensee).

184. *See, e.g.*, VA. CODE ANN. § 6.2-1906(A)(1)–(2) (requiring that a potential licensee be "able to and will perform its obligations" and have the "financial responsibility, character, reputation, experience, and general fitness" to perform its duties).

185. *See, e.g.*, TENN. CODE ANN. § 45-7-208(a) (requiring applications be accompanied by a $50,000 surety bond or equivalent device, with an additional $10,000 per location, up to a maximum of $800,000).

186. *See, e.g.*, *id.* § 45-7-209 (requiring an application fee of between $250 and $500); VA. CODE ANN. § 6.2-1905(A) (stipulating a $750 annual fee); *id.* § 6.2-1905(B) (stipulating annual assessment to defray costs of examination).

187. TENN. CODE ANN. § 45-7-214; VA. CODE ANN. § 6.2-1910(A); CONFERENCE OF STATE BANK SUPERVISORS & MONEY TRANSMITTER REGULATORS ASS'N, THE STATE OF STATE MONEY SERVICES BUSINESSES REGULATION & SUPERVISION 9–10 (2016) [hereinafter STATE BANK REGULATORS REPORT], https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/State%20of%20State%20MSB%20Regulation%20and%20Supervision%202.pdf [https://perma.cc/C6H7-CKHV].

regular basis[188] or in response to certain events[189]—that include information on the money transmitter's financial condition and operations. If the examination or reports indicate that the business is not performing its duties or is in danger of failing, the regulator can mandate corrective action or suspend or revoke the license.[190]

Responding to a call from Congress,[191] the National Conference of Commissioners on Uniform State Laws completed the Uniform Money Services Act in 2000.[192] To date, it has been adopted by only ten states, as well as Puerto Rico and the Virgin Islands.[193] The remaining states[194] maintain their own unique laws with varying substantive requirements.[195]

Although state laws differ, state regulators have made an effort to coordinate their supervision of money transmitters that operate in

188. *See, e.g.*, TENN. CODE ANN. § 45-7-211(d)(1)–(7) (requiring that licenses be renewed yearly and that renewal applications contain a report of the licensee's financial condition, including, *inter alia*, financial statements, list of locations and agents, and notification of any "material litigation or litigation relating to money transmission"); VA. CODE ANN. § 6.2-1905(D) (requiring annual reports, including audited financials).

189. *See, e.g.*, TENN. CODE ANN. § 45-7-212 (requiring a licensed money transmitter to notify the state after certain events, including bankruptcy, felony indictment of certain parties related to the firm, and revocation of the firm's license by any state or governmental authority); VA. CODE ANN. § 6.2-1917 (requiring a money transmitter to notify the state if certain events occur, including material changes to information provided in the firm's application, a filing for bankruptcy, and the indictment of certain parties related to the firm).

190. *See, e.g.*, TENN. CODE ANN. § 45-7-217; VA. CODE ANN. § 6.2-1907; STATE BANK REGULATORS REPORT, *supra* note 187, at 10–11.

191. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(b)(1)–(5), 108 Stat. 2160, 2248 (1994) (codified as amended at 31 U.S.C. § 5311 (2012)).

192. UNIF. MONEY SERVS. ACT (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS, amended 2004), http://www.uniformlaws.org/shared/docs/money%20services/umsa_final04.pdf [https://perma.cc/E47J-P9KR].

193. The ten states that have adopted the Uniform Money Services Act at the time of this writing are Alaska, Arkansas, Hawaii, Iowa, New Mexico, North Carolina, South Carolina, Texas, Vermont, and Washington. *See Enactment Status Map*, UNIF. L. COMM'N, http://uniformlaws.org/Act.aspx?title=Money%20Services%20Act [https://perma.cc/3P6Z-RPKJ] (last visited Sept. 29, 2017).

194. Melanie Baravik, *South Carolina Money Transmitters Now Need Bond*, SURETY BOND INSIDER (June 17, 2016), https://www.suretybonds.com/blog/south-carolina-money-transmitters-now-need-bond/13848 [https://perma.cc/QH5Y-FK2P] (noting that only Montana has yet to regulate money transmitters).

195. Tu, *supra* note 173, at 91, 110. *See generally* THOMAS BROWN, 50-STATE SURVEY: MONEY TRANSMITTER LICENSING REQUIREMENTS, http://abnk.assembly.ca.gov/sites/abnk.assembly.ca.gov/files/50%20State%20Survey%20%20MTL%20Licensing%20Requirements(72986803_4).pdf [https://perma.cc/PCX4-Q336] (cataloguing the licensing and investigation requirements for money transmitters within each state).

multiple states.[196] The Money Transmitter Regulators Association (MTRA) and Conference of State Bank Supervisors (CSBS) have developed multiple frameworks, including the Money Transmitter Regulatory Cooperative Agreement;[197] the MTRA Examination Protocol;[198] the joint CSPS-MTRA Nationwide Cooperative Agreement for MSB Supervision,[199] which has been signed by forty-eight states and territories;[200] and the Protocol for Performing Multi-State Examinations.[201] In 2015, 149 examinations of multistate money services businesses were conducted, of which sixty-eight were administered by a multistate examination team.[202] Twenty-six states participated in the joint examinations.[203]

2. Federal Regulation of Money Transmission

Federal regulation of money transmitters traditionally has been primarily concerned with preventing criminals from using the payments system to facilitate crimes, including laundering illicit proceeds and funding criminal or terrorist activities.[204] The BSA is a

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196. *MTRA Cooperative Agreement*, MONEY TRANSMITTER REGULATORS ASS'N, http://www.mtraweb.org/about/cooperative-agreement [https://perma.cc/2DAZ-HHUB] (last visited Oct. 17, 2017) ("The purpose of this agreement is to promote a nationwide framework for cooperation and coordination among state money transmitter regulators that have concurrent jurisdiction over a regulated entity in a manner that conserves regulatory resources and minimizes the regulatory burden on supervised entities, consistent with each state attaining its supervisory objectives.").

197. *See id.*

198. *See* STATE BANK REGULATORS REPORT, *supra* note 187, at 11.

199. *See* MONEY TRANSMITTER REGULATORS ASS'N, NATIONWIDE COOPERATIVE AGREEMENT FOR MSB SUPERVISION 2 (2012), https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/MSB/MSB-CooperativeAgreement010512clean.pdf [https://perma.cc/8KPH-7MWB].

200. *MSB Ratification Map*, CONFERENCE OF STATE BANK SUPERVISORS (Oct. 24, 2014), https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/MSB/MSB%20Ratification%20Map%2010.24.14.pptx [https://perma.cc/BF25-4UZ3]. The states that have not signed the agreement are Colorado, Maine, Montana, New Mexico, and South Carolina. *See id.*

201. *See* MONEY TRANSMITTER REGULATORS ASS'N, PROTOCOL FOR PERFORMING MULTI-STATE EXAMINATIONS 2 (2012), https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/MSB/MSB-Protocol1010512.pdf [https://perma.cc/X3UW-YTZZ].

202. STATE BANK REGULATORS REPORT, *supra* note 187, at 12.

203. *Id.*

204. Tu, *supra* note 173, at 95; *see also, e.g.*, *Bank Secrecy Act (BSA): Combating Money Laundering and Terrorist Financing*, OFF. COMPTROLLER CURRENCY, https://www.occ.treas.gov/topics/compliance-bsa/bsa/index-bsa.html [https://perma.cc/R7BW-Y5ZA] (last visited Sept. 29, 2017) (detailing the OCC's responsibility to assist law enforcement in deterring and detecting "money laundering, terrorist financing and other criminal acts").

major source of federal regulation of money transmitters.[205] The BSA applies to all "financial institutions," which is defined broadly to include "licensed sender[s] of money or any other person who engages as a business in the transmission of funds."[206] FinCEN, which manages BSA enforcement,[207] made the coverage more explicit in its regulations. FinCEN defines "financial institutions" to include money services businesses,[208] and "money services businesses" to include, *inter alia*, money transmitters.[209] As such, money transmitters are required to comply with the BSA's requirements. Money transmitters are required to register with the Treasury Department within 180 days of founding.[210] Federal anti-money-laundering law requires financial institutions to provide information to the government[211] and to retain information on their customers,[212] which can be a significant burden on the companies.[213] Federal law also imposes criminal penalties on firms and individuals that violate state law by operating money transmission businesses without a state license.[214]

Title X of Dodd-Frank[215] applies to any entity that "engages in offering or providing a consumer financial product or service,"[216] which the CFPB has interpreted in at least two cases to include money transmittal services.[217] Consequently, substantive federal consumer protection law may become a greater part of the regulatory environment for nonbank money transmitters. Recently, the CFPB entered into a consent order with Dwolla,[218] a technology provider that is not a money transmitter but serves as an agent of financial

205. *See* Bank Secrecy Act of 1970, Pub. L. No. 91-508, §§ 201–42, 84 Stat. 1114, 1118–24 (1970) (codified as amended at scattered sections of 12 U.S.C. and 31 U.S.C.); *Bank Secrecy Act*, *supra* note 204.

206. 31 U.S.C § 5312(a)(2)(R) (2012); *Bank Secrecy Act*, *supra* note 204.

207. 31 C.F.R. § 1010.810(a) (2017).

208. *Id.* § 1010.100(t)(3); Tu, *supra* note 173, at 95–96.

209. 31 C.F.R. § 1010.100(ff)(5).

210. 31 U.S.C § 5330(a)(1).

211. *See, e.g.*, 31 C.F.R. § 1010.300–.370.

212. *See, e.g.*, *id.* § 1010.400–.440.

213. Daniel P. Stipano, Opinion, *Time to Bring BSA into this Century*, AM. BANKER (Feb. 21, 2017, 9:30 AM), https://www.americanbanker.com/opinion/time-to-bring-bsa-into-this-century [https://perma.cc/3VUW-DEP2].

214. 18 U.S.C. § 1960 (2012); Brian Klein, *Does 18 U.S.C. § 1960 Create Felony Liability for Bitcoin Businesses?*, COIN CTR. (July 21, 2015), http://coincenter.org/entry/does-18-u-s-c-1960-create-felony-liability-for-bitcoin-businesses [https://perma.cc/FLD8-FX85].

215. Pub. L. No. 111-203, §§ 1001–1100H, 124 Stat. 1376, 1955–2113 (2010) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

216. 12 U.S.C. § 5481(6)(A) (2012).

217. *See, e.g.*, Dwolla, Inc., CFPB No. 2016-CFPB-0007, ¶ 5 (Mar. 2, 2016); Complaint ¶ 9, CFPB v. Intercept Corp., No. 3:16-cv-00144-ARS (D.N.D. June 6, 2016).

218. *See* Dwolla, Inc., CFPB No. 2016-CFPB-0007 (Mar. 2, 2016).

institutions.[219] The CFPB alleged that Dwolla misrepresented the quality of its cybersecurity practices.[220] The CFPB further argued that the misrepresentation was deceptive under Dodd-Frank's prohibition on unfair, deceptive, or abusive acts or practices.[221] Dwolla was ordered to change its procedures to improve security[222] and to pay a civil fine.[223] The CFPB has also sued Intercept Corporation—a payments processing firm that provides services to payday lenders, debt collectors, and other consumer finance companies—as well as some of its officers and owners for violations of Dodd-Frank.[224] The CFPB alleged that Intercept processed numerous payments for transactions that it knew or should have known were illegal because of the high number of returned payments and other "red flags."[225] This argument represents a possible significant expansion of the scope of the CFPB's jurisdiction, given that Intercept did not directly interact with consumers.[226]

Federal banking regulators have also pressured banks to deny services, including money transmission, to certain clients. Operation Choke Point, a project of the Department of Justice and federal banking regulators, targeted banks that provided services to companies in certain high-risk industries, with the justification of seeking to prevent consumer fraud by stopping fraudsters from accessing banking services.[227] The operation focused on numerous industries. While some of these industries were inherently illegal, regulators also targeted legal industries like payday lending and firearms sales, alleging that those industries carried a high risk for fraud.[228] Payday lending in particular was seen as a prime target.[229] Operation Choke Point proved highly controversial, with some critics

219. *About Us*, DWOLLA, https://www.dwolla.com/about?b=footer [https://perma.cc/H83U-4UJ8] (last visited Sept. 3, 2017).

220. Dwolla, Inc., CFPB No. 2016-CFPB-0007, ¶¶ 15, 23 (Mar. 2, 2016).

221. *Id.* ¶ 51 (citing 12 U.S.C. §§ 5531(a), 5536(a)(1)(b) (2012)).

222. *Id.* ¶¶ 52–62.

223. *Id.* ¶ 63.

224. Complaint ¶¶ 8–25, CFPB v. Intercept Corp., No. 3:16-cv-00144-ARS (D.N.D. June 6, 2016). The case against Intercept was dismissed for failure to plead sufficient facts to support the CFPB's claim, though the CFPB may appeal or file a new complaint. *See* Order Granting Defendants' Motion to Dismiss at 10, No. 3:16-cv-00144-RRE-ARS (D.N.D. Mar. 17, 2017).

225. Complaint, *supra* note 224, ¶ 2.

226. *See id.* ¶ 9.

227. STAFF OF H. COMM. ON OVERSIGHT AND GOV. REFORM, *supra* note 70, at 2–3.

228. *Id.* at 5.

229. *Id.* at 1; *see also* Zibel & Kendall, *supra* note 70.

arguing that it led banks to simply avoid industries seen by regulators as high risk, regardless of the legality of the individual company.[230]

Congress has not created a uniform and preemptive federal regulatory regime for money transmitters. However, Congress has acknowledged that greater uniformity of state law governing money service businesses, including money transmitters, would help combat money laundering and protect the payment system.[231] Congress specifically recommended that states create and adopt a model law to address licensing requirements, standards, reporting requirements, disclosures, and federal BSA compliance, and it further recommended that states impose a criminal penalty for operating a money transmitter without the required state license.[232]

C. Virtual Currency

Virtual currencies[233] share many of the issues of traditional fiat money transmission while also posing unique regulatory challenges. Although innovative money transmitters such as PayPal may give rise to regulatory questions, those transmitters have the advantage of operating in traditional fiat currency (legal tender issued by a government). Virtual currencies such as Bitcoin are a "digital representation of value that function[] as a medium of exchange, a unit of account, and/or a store of value, but d[o] not have legal tender status in any jurisdiction."[234] Although there are over a thousand

230. Michael J. Bresnick, Opinion, *How Regulators Can Fight De-Risking*, AM. BANKER (Apr. 7, 2016, 9:30 AM), https://www.americanbanker.com/opinion/how-regulators-can-fight-de-risking [https://perma.cc/9DVD-KLJW] ("Unfortunately, as the [Operation Choke Point] investigations continue, so too have one of the unintended but collateral consequences of such vigilance: mass de-risking. Members of the industry have raised their hands in frustration and simply avoided lines of business typically associated with higher risk.").

231. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(a)(1), 108 Stat. 2160, 2246–48 (1994) (codified as amended at 31 U.S.C. § 5311 (2012)).

232. *Id.* § 407(b)(1)–(5), 108 Stat. at 2248–49.

233. Although terminology is evolving, this Article differentiates between digital currencies, which can include digital representations of fiat currencies (e.g., Paypal's use of "digital" dollars), and virtual currencies that lack legal tender status (e.g., Bitcoin). *See* DONG HE ET AL., VIRTUAL CURRENCIES AND BEYOND: INITIAL CONSIDERATIONS 7–8 (2016), https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf [https://perma.cc/H4EP-ZXTR].

234. Douglas, *supra* note 86, at 39 (citing *In re* Coinflip, Inc., CFTC No. 15–29, at 2 n.2 (Sept. 17, 2015)).

virtual currencies,[235] Bitcoin is by far the most widely used, with a market capitalization of over $70 billion.[236]

Some virtual currencies, including Bitcoin, are decentralized, which means no central administrator controls the system.[237] Instead, the Bitcoin system is administered by a network of computers running a common protocol, which creates a record of transactions on a distributed ledger that is visible to the entire network[238] (Bitcoin's ledger is called the "blockchain").[239] This distributed ledger helps prevent double spending by displaying how each bitcoin is disposed of.[240] The integrity of the system is maintained by computers performing public-key cryptography, for which they are rewarded with bitcoins[241] (of which there is a finite number).[242] That process is called Bitcoin "mining."[243] The Bitcoin network is open to any computer that runs the protocol.[244]

Other virtual currencies are centralized, which means a central party "owns" and ultimately administers the system. For example, Ripple[245] uses a proprietary and permissioned system of computers running a common protocol to record transactions.[246] A fixed number of XRP or "ripples" are premined.[247] Instead of relying on computers mining bitcoins to maintain system integrity, Ripple relies on consensus from trusted computers in the system to validate

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235. Coinmarketcap.com lists market capitalizations for 1,140 of what it calls "crypto-currencies." *See* COINMARKETCAP, https://coinmarketcap.com/all/views/all [https://perma.cc/7238-GDCZ] (last visited Sept. 29, 2017).

236. *Id.*

237. Jerry Brito, Houman Shadab & Andrea Castillo, *Bitcoin Financial Regulation: Securities, Derivatives, Prediction Markets, and Gambling*, 16 COLUM. SCI. & TECH. L. REV. 144, 148 (2014); Douglas, *supra* note 86, at 39.

238. Brito, Shadab & Castillo, *supra* note 237, at 149; Douglas, *supra* note 86, at 39.

239. *See* Brito, Shadab & Castillo, *supra* note 237, at 146.

240. JERRY BRITO & ANDREA CASTILLO, BITCOIN: A PRIMER FOR POLICYMAKERS 6 (2016), https://www.mercatus.org/system/files/GMU_Bitcoin_042516_WEBv2_0.pdf [https://perma.cc/KPT5-SLPE]; Brito, Shadab & Castillo, *supra* note 237, at 149–50.

241. BRITO & CASTILLO, *supra* note 240, at 7–8; Sarah Jane Hughes & Stephen T. Middlebrook, *Advancing a Framework for Regulating Cryptocurrency Payments Intermediaries*, 32 YALE J. REG. 495, 505 (2015).

242. The number is limited to 21 million. *See* BRITO & CASTILLO, *supra* note 240, at 7; Hughes & Middlebrook, *supra* note 241, at 505.

243. *See* BRITO & CASTILLO, *supra* note 240, at 7.

244. Brito, Shadab & Castillo, *supra* note 237, at 146.

245. *See* RIPPLE, *supra* note 165.

246. *Coins Compared: Seven Differences Between Ripple and Bitcoin*, DIGITAL TECH. OBSERVER (Mar. 30, 2016), http://digitaltechobserver.blogspot.com/2016/03/seven-differences-between-ripple-and-bitcoin-cryptocurrencies.html?m=0 [https://perma.cc/N4ZL-8KA7].

247. *Id.*

transactions.[248] Ripples are not designed to be used as money per se, though some merchants accepted them for a brief period.[249] Instead, the Ripple network is designed to help facilitate transactions that require the conversion of different stores of value by providing a common, but not mandatory, medium of exchange.[250] It has been used for currency exchange and intercompany settlements.[251] XRP also serves as a means to defeat attacks on the Ripple protocol. To write to the ledger, Ripple users must purchase and hold XRP.[252] This requirement increases the cost of creating false users, a step that would be necessary to create sufficient consensus to ratify invalid transactions.[253]

Some virtual currencies, including Bitcoin, can be used as a medium of direct value transfer because the token (i.e., the bitcoin) is considered valuable in itself.[254] Some users accept the token as a cash equivalent, but others treat it like a foreign currency that must be exchanged for fiat currency on the Bitcoin market.[255]

Distributed ledgers associated with virtual currencies facilitate efficient communication of information across multiple parties to a transaction and create a relatively permanent and durable record trail. Financial services industries, including currency exchange and remittances,[256] banking,[257] securities,[258] and real estate,[259] have

248. *Id.*; *see* Marcel T. Rosner & Andrew Kang, Note, *Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study*, 114 MICH. L. REV. 649, 658–59 (2016).

249. *Coins Compared*, *supra* note 246.

250. *Id.*; *see* Rosner & Kang, *supra* note 248, at 660.

251. Penny Crosman, *Is Western Union Ready for the Fintech Threat?*, AM. BANKER (May 12, 2016, 2:40 PM), http://www.americanbanker.com/news/bank-technology/is-western-union-ready-for-the-fintech-threat-1080978-1.html [https://perma.cc/4494-532B].

252. Rosner & Kang, *supra* note 248, at 660.

253. *Id.*

254. BRITO & CASTILLO, *supra* note 240, at 6.

255. *See* Jacob Davidson, *No, Big Companies Aren't Really Accepting Bitcoin*, TIME: MONEY (Jan. 9, 2015), http://time.com/money/3658361/dell-microsoft-expedia-bitcoin [https://perma.cc/92PY-VFP5].

256. *See* Pete Rizzo, *Western Union 'Exploring' Pilot Program with Ripple Labs*, COINDESK (Apr. 29, 2015, 10:04 AM), http://www.coindesk.com/western-union-pilot-program-ripple-labs [https://perma.cc/Y7PY-RXCE].

257. *See* Yessi Bello Perez, *8 Banking Giants Embracing Bitcoin and Blockchain Tech*, COINDESK (July 27, 2015, 7:26 PM), http://www.coindesk.com/8-banking-giants-bitcoin-blockchain [https://perma.cc/8JX2-WPD2].

258. *See, e.g.*, Marion Dankers, *Nasdaq Makes First Share Trade Using Blockchain Technology*, TELEGRAPH (Dec. 31, 2015, 11:36 AM), http://www.telegraph.co.uk/finance/markets/12075825/nasdaq-blockchain-share-trade-bitcoin-technology.html [https://perma.cc/X4UT-REGE] ("The Nasdaq stock exchange has used blockchain to transfer shares for the first time in what the US firm said was 'a seminal moment' in the nascent technology."); Stan Higgins, *40 Banks Trial Commercial Paper Trading in Latest R3 Blockchain*

expressed interest in using distributed ledgers to facilitate and record ownership and transfers of assets. In these cases, virtual currencies, or more specifically the distributed ledgers that record virtual currency transactions, compete not with dollars but with traditional databases.[260] However, firms are also considering borrowing certain characteristics from virtual currency-based systems (such as rendering contracts as functions) without adopting all the attributes, such as tokens or a universally distributed ledger.[261]

Some virtual currencies use private closed systems that require participants to take sole responsibility for the system's security.[262] Other virtual currencies use public chains that rely on miners—who are attracted by the possibility of obtaining valuable tokens—to protect the integrity of the system.[263] Using public systems to record data involves the transfer of value (albeit a tiny amount) between the parties, which could potentially trigger money transmission regulations.

Test, COINDESK (Mar. 3, 2016, 1:08 AM), http://www.coindesk.com/r3-consortium-banks-blockchain-solutions [https://perma.cc/C74C-PBTU] ("A consortium of financial institutions led by startup R3CEV has completed a trial of five different blockchain solutions. . . . '[Participants] modeled a financial asset, commercial paper, a short-term debt instrument.'" (alteration in original)); Nathaniel Popper, *Wall Street Clearinghouse to Adopt Bitcoin Technology*, N.Y. TIMES (Jan. 9, 2017), https://www.nytimes.com/2017/01/09/business/dealbook/wall-street-clearing-house-to-adopt-bitcoin-technology.html?_r=0 [https://perma.cc/MK9N-83H8] (describing the Depository & Trust Clearing Corporation's announcement that it will use distributed ledger technology to record credit default swaps).

259. Kim S. Nash, *Blockchain: Real Estate Industry Could See Benefits in 2016*, WALL ST. J.: BLOG (Dec. 22, 2015, 4:44 PM), http://blogs.wsj.com/cio/2015/12/22/blockchain-real-estate-industry-could-see-benefits-in-2016 [https://perma.cc/F4ST-4G3C].

260. *See* Richard Gendal Brown, *On Distributed Databases and Distributed Ledgers*, RICHARD GENDAL BROWN (Nov. 8, 2016), https://gendal.me/2016/11/08/on-distributed-databases-and-distributed-ledgers [https://perma.cc/W2LV-6YTF] (comparing distributed ledgers and distributed databases in the context of business requirements for storing and sharing data across multiple parties).

261. *See, e.g.*, RICHARD GENDAL BROWN, JAMES CARLYLE, IAN GRIGG & MIKE HEARN, CORDA: AN INTRODUCTION 7, 13 (2016), https://www.r3cev.com/s/corda-introductory-whitepaper-final.pdf [https://perma.cc/3RA2-DQQT] (laying out characteristics of a distributed communication system for regulated financial entities that has certain similarities to Bitcoin but lacks a token, mining, and a universally distributed ledger).

262. SWIFT & ACCENTURE, SWIFT ON DISTRIBUTED LEDGER TECHNOLOGIES 11 (2016), http://www.ameda.org.eg/files/SWIFT_DLTs_position_paper_FINAL1804.pdf [https://perma.cc/DLJ9-NRWS].

263. Anna Irrera, *The Public vs Private Debate on Blockchain*, FIN. NEWS (Oct. 1, 2015, 1:00 PM), http://www.efinancialnews.com/story/2015-10-01/blockchain-fintech-the-public-vs-private-debate [https://perma.cc/3WEA-LETM].

1. State Regulation of Virtual Currency

Regulation of virtual currency by the states is muddled. Certain states have found virtual currency to be fully covered by their existing rules.[264] Other states, including Texas and Kansas, have opined that their state money transmitter laws cover virtual currency exchanges that convert virtual currencies into "real" currencies.[265] However, Texas and Kansas also have found that the mere exchange of virtual currency for a good or service is more akin to a sale of goods than to money transmission and, therefore, is not covered by state money transmission laws.[266] Other states have amended[267] their existing money transmission laws to include virtual currencies. Legislators in California have advanced a bill to create a virtual currency-specific regulatory framework, but they have so far been stymied.[268] At the time of this writing, a small minority of states have provided guidance or rulemaking for virtual currencies, and six states have virtual currency legislation passed or pending.[269] Florida regulators tried to bring an enforcement action under existing state

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264. *See, e.g.*, *Bitcoin and Virtual Currency Regulation*, WASH. DEP'T FIN. INSTS., http://www.dfi.wa.gov/bitcoin [https://perma.cc/LPX5-4XU7] (last visited Sept. 29, 2017).

265. PETER VAN VALKENBURGH & JERRY BRITO, STATE DIGITAL CURRENCY PRINCIPLES AND FRAMEWORK 2 (2015) (citing Supervisory Memorandum from Charles G. Cooper, Banking Comm'r, Tex. Dep't of Banking, to All Virtual Currency Companies Operating or Desiring to Operate in Texas (Apr. 3, 2014), http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf [https://perma.cc/LF5W-QCAJ], and KAN. OFFICE OF THE STATE BANK COMM'R, GUIDANCE NO. MT 2014-01, REGULATORY TREATMENT OF VIRTUAL CURRENCIES UNDER THE KANSAS MONEY TRANSMITTER ACT (2014), http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf [https://perma.cc/M79T-JJKA]), https://coincenter.org/wp-content/uploads/2015/04/State-Principles-Framework-V1.31.pdf [https://perma.cc/7ZF3-8UTZ].

266. KAN. OFFICE OF THE STATE BANK COMM'R, GUIDANCE NO. MT 2014-01, REGULATORY TREATMENT OF VIRTUAL CURRENCIES UNDER THE KANSAS MONEY TRANSMITTER ACT 3–4 (2014), http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf [https://perma.cc/2EG8-TD2H]; Supervisory Memorandum from Charles G. Cooper, Banking Comm'r, Tex. Dep't of Banking, to All Virtual Currency Companies Operating or Desiring to Operate in Texas 3 (2014), http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf [https://perma.cc/Q65K-LKZD].

267. Connecticut H.B. 6800 was signed into law on June 19, 2015. It amended Connecticut's money transmitter law to specifically cover virtual currencies. Jeffrey Alberts & Meghan Dwyer, *Another Sweeping State Virtual Currency Law*, LAW360 (July 9, 2015, 10:39 AM), http://www.law360.com/articles/675801/another-sweeping-state-virtual-currency-law [https://perma.cc/7TSG-UPNF].

268. Yessi Bello Perez, *California's Bitcoin Bill Shelved by State Senator*, COINDESK (Sept. 16, 2015, 12:16 PM), http://www.coindesk.com/californias-bitcoin-bill-shelved-by-state-senator [https://perma.cc/ZH8N-GGLK].

269. *State-By-State Regulatory Tracker for Digital Currency Policy*, COIN CTR., https://coincenter.org/page/state-digital-currency-regulatory-tracker [https://perma.cc/LM2M-HWLV] (last updated Aug. 23, 2017).

laws, only to find that those laws do not cover virtual currencies.[270] However, because many state money transmitter laws are broad, regulators in other states may be more successful at bringing cases under existing law.[271]

New York, through its Department of Financial Services (NYDFS), is the first state to create a new stand-alone regulatory framework for virtual currencies.[272] The New York BitLicense[273] requires a license before a person can engage in "virtual currency business activity,"[274] defined as any conduct involving New York or a New York resident:

> (1) receiving Virtual Currency for Transmission or Transmitting Virtual Currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of Virtual Currency;
>
> (2) storing, holding, or maintaining custody or control of Virtual Currency on behalf of others;
>
> (3) buying and selling Virtual Currency as a customer business;
>
> (4) performing Exchange Services as a customer business; or
>
> (5) controlling, administering, or issuing a Virtual Currency.[275]

Importantly, the definition of "virtual currency business activity" does not include the development and dissemination of software or the transfer of virtual currency for a nonfinancial purpose, provided that only a nominal amount of currency is transmitted (such as using the Blockchain to record securities transactions).[276] Likewise, the superintendent of the NYDFS allows New York-chartered banks to engage in virtual currency business activities, and merchants and consumers who exclusively use virtual currency to buy and sell goods need not obtain licenses.[277] However, to participate in virtual currency business activities, banks that do not have a New York charter or approval from the NYDFS need to obtain a BitLicense.[278]

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270. Order Granting Defendant's Motion to Dismiss at 5, State v. Espinoza, No. F14-2923 (Fla. Cir. Ct. July 22, 2016) (finding that the sale of Bitcoin did not constitute money transmission under Florida law).

271. Tu, *supra* note 173, at 87–88.

272. *New York Becomes First State to Finalize Digital Currency Regulatory Framework, BitLicense*, HUNTON & WILLIAMS (June 2015), https://www.hunton.com/images/content/2/1/v2/2177/ny-1st-digital-currency-regs.pdf [https://perma.cc/3XW4-2MTD].

273. N.Y. COMP. CODES R. & REGS. tit. 23, §§ 200.1–.22 (2017).

274. *Id.* § 200.3(a).

275. *Id.* § 200.2(q).

276. *See id.*

277. *Id.* § 200.3(c)(1)–(2).

278. Hughes & Middlebrook, *supra* note 241, at 540.

The BitLicense contains many consumer protection provisions that are similar to those found in traditional money transmitter laws and regulations. For example, the BitLicense requires applicants to provide information about and fingerprints of those in control of the company, as well as information about the company's financial status.[279] The BitLicense specifies minimum capital requirements based on the nature and scope of the licensee's business,[280] requires a surety bond to be maintained for the benefit of the licensee's customers,[281] requires the licensee to maintain books and records that are available for inspection,[282] and mandates that the licensee undergo examination by the NYDFS at least every two years.[283]

While much of the BitLicense is similar to traditional state money transmitter regulation, the BitLicense has certain unique elements. The most striking is that the BitLicense mandates a state-specific anti-money-laundering program in addition to that required by FinCEN.[284] New York mandates reporting of certain transactions not required to be reported to FinCEN.[285] Additionally, compared to FinCEN's risk-based approach, the BitLicense requirements are far more prescriptive.[286] Likewise, the BitLicense's mandatory disclosures are more onerous and prescriptive than those generally found in traditional money transmission laws.[287] The BitLicense also requires licensees to maintain a cybersecurity program[288] and to name a chief information security officer.[289]

The BitLicense has been controversial with virtual currency companies and supporters. A number of market participants have complained that the cost of application and compliance exceeds the value of the New York market.[290] Others object to the lack of an "on-ramp" for smaller businesses to begin operations in New York without having to either comply with the full slate of regulations or go

279. N.Y. COMP. CODES R. & REGS. tit. 23, § 200.4.

280. *Id.* § 200.8.

281. *Id.* § 200.9.

282. *Id.* § 200.12.

283. *Id.* § 200.13.

284. *Id.* § 200.15.

285. *See id.* § 200.15(e)(2)–(3).

286. Hughes & Middlebrook, *supra* note 241, at 542.

287. *Id.* at 544–45.

288. N.Y. COMP. CODES R. & REGS. tit. 23, §200.16.

289. *Id.* § 200.16(c).

290. Daniel Roberts, *Behind the "Exodus" of Bitcoin Startups from New York*, FORTUNE (Aug. 14, 2015), http://fortune.com/2015/08/14/bitcoin-startups-leave-new-york-bitlicense [https://perma.cc/L7N9-XLTE].

through the full application process.[291] Still others take issue with the redundant anti-money-laundering requirements.[292] Those concerns have prompted a number of companies to cease doing business in New York.[293] Meanwhile, as of this writing, only three companies—Circle, Coinbase, and Ripple—have obtained BitLicenses.[294]

Some efforts have been made to create uniform state laws and regulations for virtual currencies. The Uniform Law Commission, for example, formed a drafting committee to create a uniform law to govern virtual currency businesses.[295] The committee produced a bill that was approved by the Commission in July 2017.[296] In September 2015, the CSBS also launched a coordination effort through its Model Regulatory Framework for Virtual Currency Activities.[297] Although these efforts seek to harmonize (at least to a degree) the regulation of virtual currencies at the state level, states seem to be moving in their own directions, albeit in fits and starts.

2. Federal Regulation of Virtual Currency

The federal government currently regulates virtual currency in several ways. FinCEN responded relatively early to the rise of virtual

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291. Tom Jackson, *The Bitcoin Community Reacts to the NY BitLicense*, COINTELEGRAPH (June 4, 2015), https://cointelegraph.com/news/the-bitcoin-community-reacts-to-the-ny-bitlicense [https://perma.cc/3QFB-K6M5] (reproducing the statement of Perianne Boring, the president of the Chamber of Digital Commerce, who claimed the "most worrisome aspect [of the BitLicense] is the lack of a clear on-ramp for digital currency startups").

292. *Id.* (reproducing also the statement of Peter Van Valkenburgh, the director of research at Coin Center, who lamented the BitLicense's "unprecedented and discriminatory state-level anti-money laundering regime").

293. *See* Roberts, *supra* note 290.

294. Grace Caffyn, *Circle Granted First BitLicense by NYDFS*, COINDESK (Sept. 22, 2015, 10:51 AM), https://www.coindesk.com/circle-granted-first-bitlicense-rebrands-as-circle-pay [https://perma.cc/3J5W-SZU2]; Pete Rizzo, *New York Regulators Grant Second BitLicense to Ripple*, COINDESK (June 13, 2016, 6:25 PM), http://www.coindesk.com/new-york-bitlicense-ripple [https://perma.cc/7SL9-WUA5]; Juan Suarez, *Coinbase Obtains the BitLicense*, COINBASE BLOG (Jan. 17, 2017), https://blog.coinbase.com/coinbase-obtains-the-bitlicense-f1c3e35c4d75#.r0cfxw6ev [https://perma.cc/YP4A-BUL8].

295. The drafting committee is called the Committee for the Regulation of Virtual Currency Businesses Act. Its membership and purpose are described on the Uniform Law Commission's website. *Regulation of Virtual Currency Businesses Act*, UNIFORM L. COMM'N, http://www.uniformlaws.org/Committee.aspx?title=Regulation%20of%20Virtual%20Currency%20Businesses%20Act [https://perma.cc/L3L9-QF7U] (last visited Sept. 29, 2017).

296. Press Release, Unif. Law Comm'n, National Law Group Concludes 126th Annual Meeting (July 19, 2017), http://www.uniformlaws.org/NewsDetail.aspx?title=Uniform%20Law%20Commission%20Concludes%20126th%20Annual%20Meeting [https://perma.cc/2X3Z-A89K].

297. CONFERENCE OF STATE BANK SUPERVISORS, STATE REGULATORY REQUIREMENTS FOR VIRTUAL CURRENCY ACTIVITIES: CSBS MODEL REGULATORY FRAMEWORK 1 (2015), https://www.csbs.org/regulatory/ep/pages/framework.aspx [https://perma.cc/KU38-Q6YK].

currency with guidance on what constitutes money transmission.[298] That guidance addressed the use of "convertible virtual currency," which refers to currency that "has an equivalent value in real currency, or acts as a substitute for real currency."[299] FinCEN divided virtual currency actors into three groups: users, administrators, and exchangers.[300] Users are the people who buy things with the currency.[301] Administrators are in the business of putting virtual currency into circulation and have the power to redeem or withdraw currency from circulation.[302] Exchangers are in the business of exchanging virtual currencies for real currency or other virtual currencies.[303] FinCEN advised that administrators and exchangers of virtual currency are money services businesses and are therefore subject to the requirements of the BSA, whereas users of virtual currency are not.[304] FinCEN subsequently clarified that miners[305] and investors in virtual currencies[306] are not considered money services businesses.

As discussed previously, Bitcoin does not have an administrator, but exchanges that facilitate the sale or conversion of Bitcoin into fiat currency or other stores of value are required to register with FinCEN.[307] In fact, FinCEN fined Ripple in 2015 for failing to register and maintain an appropriate anti-money-laundering program.[308]

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298. FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, GUIDANCE NO. FIN-2013-G001, APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (2013).

299. *Id.* at 1.

300. *Id.*

301. *Id.* at 2.

302. *Id.*

303. *Id.*

304. *See id.* at 2–3.

305. FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, GUIDANCE NO. FIN-2014-R001, APPLICATION OF FINCEN'S REGULATIONS TO VIRTUAL CURRENCY MINING OPERATIONS 2 (2014).

306. FIN. CRIMES ENF'T NETWORK, U.S. DEP'T OF THE TREASURY, GUIDANCE NO. FIN-2014-R002, APPLICATION OF FINCEN'S REGULATIONS TO VIRTUAL CURRENCY SOFTWARE DEVELOPMENT AND CERTAIN INVESTMENT ACTIVITY 2 (2014).

307. *See* Brito, Shadab & Castillo, *supra* note 237, at 148; Douglas, *supra* note 86, at 39. Such companies include Coinbase and Kraken, both of which are registered with FinCEN. *See MSB Registrant Search*, FinCEN, https://www.fincen.gov/msb-registrant-search [https://perma.cc/N4NJ-HDEC] (last visited Sept. 29, 2017) (enter "Coinbase" into "legal name" field and click "search," enter "Payward Ventures" into "legal name" field and click "search" for "Kraken").

308. Press Release, Fin. Crimes Enf't Network, U.S. Dep't of the Treasury, FinCEN Fines Ripple Labs Inc. in First Civil Enforcement Action Against a Virtual Currency Exchanger (May

Other federal agencies have begun to regulate, or at least take an interest in, virtual currencies. The Internal Revenue Service (IRS) provided tax guidance for virtual currency in 2014.[309] For tax purposes, virtual currency is to be treated as property,[310] meaning the owner must recognize a gain or loss when the virtual currency is exchanged for a good, a service, or another currency.[311] As Professor Julie Hill points out, this arrangement may lead to some seemingly absurd results where Bitcoin users are technically obligated to perform basis calculations for every purchase (no matter how small) and need to assess which bitcoins they spent to determine appreciation, because the basis in different bitcoins will vary depending on what the user paid for them.[312] Expressing concerns regarding the risk of tax noncompliance that virtual currencies may create, the IRS inspector general has called for the IRS to develop a more coordinated strategy, to provide more guidance on documentation requirements, and to update third-party information-sharing documents to reflect the amounts of virtual currency held.[313] The IRS has also sought records from any user of Coinbase who made a virtual currency transaction between 2013 and 2015.[314]

The Commodity Futures Trading Commission (CFTC) also has expressed an interest in Bitcoin. In a settlement order with Coinflip, a platform "that connects buyers and sellers of standardized Bitcoin options and futures contracts,"[315] the CFTC announced that Bitcoin constitutes a commodity under the Commodity Exchange Act.[316] Additionally, the CFTC has brought an enforcement action against a

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5, 2015), https://www.fincen.gov/news/news-releases/fincen-fines-ripple-labs-inc-first-civil-enforcement-action-against-virtual [https://perma.cc/ANV3-W6C7].

309. INTERNAL REVENUE SERV., IR-2014-21, IRS VIRTUAL CURRENCY GUIDANCE: VIRTUAL CURRENCY IS TREATED AS PROPERTY FOR U.S. FEDERAL TAX PURPOSES; GENERAL RULES FOR PROPERTY TRANSACTIONS APPLY (Mar. 25, 2014).

310. *Id.* at 2.

311. *Id.*; Julie Andersen Hill, *Virtual Currencies & Federal Law*, 18 J. CONSUMER & COM. L. 65, 67 (2014).

312. Hill, *supra* note 311, at 67.

313. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2016-30-083, AS THE USE OF VIRTUAL CURRENCIES IN TAXABLE TRANSACTIONS BECOMES MORE COMMON, ADDITIONAL ACTIONS ARE NEEDED TO ENSURE TAXPAYER COMPLIANCE 3 (2016), https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf [https://perma.cc/MN9G-82C6].

314. Lalita Clozel, *IRS Casts Unusually Wide Net for Bitcoin User Data*, AM. BANKER (Nov. 28, 2016, 1:18 PM), https://www.americanbanker.com/news/irs-casts-unusually-wide-net-for-bitcoin-user-data [https://perma.cc/XKP6-33QT].

315. *In re* Coinflip, Inc., CFTC No. 15-29, at 2 (Sept. 17, 2015).

316. *Id.* at 4; *see* Commodity Exchange Act, ch. 545, §§ 1–13, 49 Stat. 1491, 1491–1501 (1936) (codified as amended at 7 U.S.C. §§ 1–15 (2012)).

swap execution facility, TeraExchange, for facilitating wash trading and prearranged trading of contracts based on the value of Bitcoin.[317] In 2014, the CFTC held an advisory committee meeting on Bitcoin and Blockchain derivatives.[318]

Meanwhile, the SEC established a virtual currencies working group.[319] It also brought enforcement actions involving virtual currency, including actions against unregistered stock exchanges using Bitcoin and other virtual currencies to facilitate securities transactions,[320] and others involving Bitcoin-related Ponzi schemes.[321] In mid-2014, the SEC issued an investor alert "to make investors aware about the potential risks of investments involving Bitcoin and other forms of virtual currency."[322] And in July 2017, the SEC also announced that virtual currency tokens could constitute a security under certain circumstances.[323] Finally, the Federal Trade Commission (FTC) brought an enforcement action against a company that sold computers used for Bitcoin mining to consumers but failed to deliver the computers in a timely manner and used them for the company's own profit without the purchasers' consent.[324]

Bank regulators have also expressed an interest in Bitcoin. The OCC has mentioned virtual currencies as a potential source of risk for banks,[325] as has the Federal Reserve.[326] The CFPB has

317. *In re* TeraExchange LLC, CFTC No. 15-33, at 2 (Sept. 24, 2015).

318. Press Release, Commodity Futures Trading Comm'n, CFTC's Global Markets Advisory Committee to Meet October 9, 2014 (Sept. 25, 2014), http://www.cftc.gov/PressRoom/PressReleases/pr7010-14 [https://perma.cc/V78H-QDE4].

319. Jeffrey Jacobi & Marco A. Santori, *Say Hello to the SEC's Digital Currency Working Group*, PILLSBURY (Jan. 12, 2015), http://www.pillsburylaw.com/publications/secs-digital-currency-working-group [https://perma.cc/4YC6-3JFG].

320. Press Release, SEC, SEC Sanctions Operator of Bitcoin-Related Stock Exchange for Registration Violations (Dec. 8, 2014), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543655716 [https://perma.cc/9UJD-E345].

321. Press Release, SEC, SEC Charges Bitcoin Mining Companies (Dec. 1, 2015), https://www.sec.gov/news/pressrelease/2015-271.html [https://perma.cc/X8UJ-ZVSN]; Press Release, SEC, SEC Charges Texas Man With Running Bitcoin-Denominated Ponzi Scheme (July 23, 2013), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583 [https://perma.cc/XL3U-5YYL].

322. Press Release, SEC, Investor Alert: Bitcoin and Other Virtual Currency-Related Investments (May 7, 2014), https://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html [https://perma.cc/JAV5-K4ML].

323. Press Release, SEC, SEC Issues Investigative Report Concluding DAO Tokens, a Digital Asset, Were Securities (July 25, 2017), https://www.sec.gov/news/press-release/2017-131.

324. Hill, *supra* note 311, at 69; Press Release, Fed. Trade Comm'n, Operators of Bitcoin Mining Operation Butterfly Labs Agree to Settle FTC Charges They Deceived Consumers (Feb. 18, 2016), https://www.ftc.gov/news-events/press-releases/2016/02/operators-bitcoin-mining-operation-butterfly-labs-agree-settle [https://perma.cc/A434-4TCR].

325. Jerry Brito, *The OCC's New Banking Risks Report Mentions "Virtual Currency" Twice*, COIN CTR. (July 13, 2016) (citing OFFICE OF THE COMPTROLLER OF THE CURRENCY,

warned consumers about the risks posed by Bitcoin,[327] especially given that Bitcoin transactions may not be covered by the Truth in Lending Act or the Electronic Funds Transfer Act.[328] Meanwhile, the Federal Reserve has begun to analyze distributed ledger technology in the context of payments systems.[329]

There appears to be a split between federal agencies that view virtual currencies as a form of property, such as the IRS and the CFTC, and those that view it as more akin to a traditional currency, such as FinCEN and the CFPB. FinCEN worries about the illicit use of virtual currency, just as it does in connection with fiat currency.[330] The CFPB highlights virtual currency's risk as compared to fiat currency (e.g., lack of government insurance for balances, volatile exchange rates, and lack of redress for fraudulent transactions as compared to credit and debit transactions).[331] It is too early to tell whether a more coherent and unified federal position will emerge organically or through congressional action. Given that virtual currencies are often more of a means than an end in themselves, it may make sense to keep regulation of the various uses of virtual currency with the underlying market regulators.

D. Securities Offerings

The sale of corporate securities is an important means by which companies access the capital they need to grow, thrive, and create prosperity and opportunity for Americans. Technology has been a major driver of change in the securities market, and technology's ability to cheaply and efficiently provide information to

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SEMIANNUAL RISK PERSPECTIVE 8 (2016), http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2016.pdf [https://perma.cc/3FP6-MK4C]), http://coincenter.org/link/the-occ-s-new-banking-risks-report-mentions-virtual-currency-twice [https://perma.cc/9WF7-TB7B].

326. Wallace Young, *What Community Bankers Should Know About Virtual Currencies*, COMMUNITY BANKING CONNECTIONS (2015), https://www.communitybankingconnections.org/articles/2015/q2/virtual-currencies [https://perma.cc/CJE2-NPCS].

327. CONSUMER FIN. PROT. BUREAU, RISKS TO CONSUMERS POSED BY VIRTUAL CURRENCIES (2014), http://files.consumerfinance.gov/f/201408_cfpb_consumer-advisory_virtual-currencies.pdf [https://perma.cc/4A2Y-WWYS].

328. Hill, *supra* note 311, at 68–69.

329. David Mills et al., *Distributed Ledger Technology in Payments, Clearing, and Settlement* (Bd. of Governors of the Fed. Reserve Sys., Finance and Economics Discussion Series No. 2016-095, 2016), https://doi.org/10.17016/FEDS.2016.095 [https://perma.cc/6MSG-MR7S].

330. *The Present and Future Impact of Virtual Currency: Joint Hearing Before the Subcomm. on Nat'l Sec. and Int'l Trade and Fin., and the Subcomm. on Econ. Policy, of the S. Comm. on Banking, Housing, and Urban Affairs*, 113th Cong. 4–6 (2013) (statement of Jennifer Shasky Calvery, Dir. of the Fin. Crimes Enf't Network, U.S. Dep't of the Treasury).

331. *Id.* at 3–5.

potential investors nationwide has contributed to a tension between state and federal regulators.[332]

This Section focuses on two recent developments that illustrate that tension. First, the amendments to Regulation A[333] made pursuant to the Jumpstart Our Business Startups (JOBS) Act[334] are an example of where the federal government has stepped in to address potentially problematic state regulation. Second, the proposed changes[335] to Rule 147[336] represent a case where the federal government can support capital formation by ceding jurisdiction to the states, which are in the best position to regulate.

The regulation of securities in the United States began as a state project, but as the scope of the economy became more national, the federal government took on a more dominant and preemptive role. The rise of technology that facilitates the scaling of securities transactions is contributing to the increasing pressure placed on preexisting regulatory assumptions about whether the federal government or the states should regulate an area exclusively, concurrently, or at all.

1. State Regulation of Securities Offerings

Regulation of the sale of securities in the United States can be traced back to 1911, when Kansas passed the first state law regulating the sale of corporate securities to the public.[337] This "blue sky" law was soon followed by other state laws, and by 1933, Nevada was the only state without such a law.[338] These laws were generally merit-based—meaning regulators looked both to whether the company

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332. *See* Letter from Jack Herstein, President, N. Am. Sec. Admin'r Ass'n, to A. Nicole Clowers, Fin. Mkt. & Cmty. Inv. Dir., U.S. Gov't Accountability Office (June 26, 2012) ("Current Regulation A was adopted before the internet age and . . . it was not designed for nationwide offerings."), *reprinted in* U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS app. 1 at 23–24 (2012), http://www.gao.gov/products/GAO-12-839 [https://perma.cc/8XZE-XZSN].

333. 17 C.F.R. §§ 230.251–63 (2017).

334. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, §§ 401–02, 126 Stat. 306, 323–25 (2012) (codified as amended at 15 U.S.C. §§ 77c, 77d, 77r (2012)).

335. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 80 Fed. Reg. 69786 (Nov. 10, 2015) (to be codified at 17 C.F.R. pt. 230).

336. Rule 147 serves as a "safe harbor" to companies seeking to do an intrastate securities offering. *See* 17 C.F.R. § 230.147(g). Such offerings are exempt from the requirements of the Securities Act of 1933, Pub. L. No. 112-106, § 3(a)(11), 48 Stat. 74, 75–76 (1933) (codified as amended at 15 U.S.C. § 77c(a)(11) (2012)).

337. THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1:15 (6th ed. 2009).

338. Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 111–12 (2005).

selling securities had fully and properly disclosed the terms of the offer and the company's circumstances and to whether the substantive terms of the offering were appropriate (in the regulators' opinion) for the prospective buyers.[339] Even after the federal government began to take a more active role in securities regulation, the states remained involved in combating fraud and retained responsibility for certain offerings.

2. Federal Regulation of Securities Offerings

The perception of widespread and brazen fraud[340] leading up to the stock market crash of 1929[341] convinced many that state blue sky laws failed to provide adequate protection,[342] and it served as the final impetus for federal securities regulation.[343] Congress subsequently passed the Securities Act of 1933 (Securities Act) to govern the original issuance of securities and the Securities Exchange Act of 1934 (Exchange Act) to govern—among other things—reporting requirements for certain companies, secondary sales of securities, and exchanges.[344] The Exchange Act also created a dedicated federal regulator for securities—the SEC.[345] The federal laws favored mandatory disclosure over merit regulation.[346] As first passed, the federal laws were not particularly preemptive of state power, but instead created a broad realm of concurrent jurisdiction.[347]

This situation changed with the passage of the National Securities Markets Improvement Act of 1996 (NSMIA),[348] which preempted and displaced state regulation for many securities.[349] NSMIA amended the Securities Act to preempt state regulation and

339. HAZEN, *supra* note 337, § 1:15.

340. Chris Brummer, *Disruptive Technology and Securities Regulation*, 84 FORDHAM L. REV. 977, 983 (2015) (discussing the Ivar Krueger and Musica brothers frauds in the 1920s).

341. *Id.* at 983–84; *see* HAZEN, *supra* note 337, § 1:15.

342. Brummer, *supra* note 340, at 983–84; *see* HAZEN, *supra* note 337 § 1:15.

343. HAZEN, *supra* note 337, § 1:15. *But see* PAUL G. MAHONEY, WASTING A CRISIS: WHY SECURITIES REGULATION FAILS 39 (Chris Rhodes & Jillian Tsui eds., 2015) (disputing the argument that widespread fraud significantly contributed to the crash).

344. Hal S. Scott, *Federalism and Financial Regulation*, *in* FEDERAL PREEMPTION: STATES' POWERS, NATIONAL INTERESTS 139, 148 (Richard A. Epstein & Michael S. Greve eds., 2007).

345. HAZEN, *supra* note 337, § 1.18.

346. *See id.*

347. Scott, *supra* note 344, at 148–49; Jones, *supra* note 338, at 111.

348. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

349. HAZEN, *supra* note 337, § 1.24.

registration requirements for "covered securities,"[350] which were defined to include those traded on certain exchanges,[351] sold to "qualified purchasers" (the definition of which could be set by the SEC via rulemaking),[352] or sold under an exemption from registration.[353] NSMIA was passed in response to Congress's view that the dual regulatory system had become "redundant, costly, and ineffective."[354] Congress determined that technology, in particular, had changed capital raising and that changes to the allocation of regulatory authority between the states and federal government were necessary to facilitate effective capital formation.[355]

NSMIA did not completely displace the states. States retained the ability to require notice filings from companies[356] and to enforce state antifraud laws.[357] States also retained their authority over noncovered securities, including intrastate offerings[358] and certain registered securities not traded on national exchanges. Importantly for smaller businesses, offerings made under Rule 506 of Regulation D were covered securities that were nonetheless exempt from state law because they were not considered public offerings.[359] By contrast, Regulation A offerings were not exempt.[360]

Recently, Congress continued its preemption of the states in the JOBS Act,[361] which exempted "crowdfunding" offerings—small offerings for private companies designed to be conducted over the Internet—from state regulation,[362] though the states retained enforcement authority.[363] As discussed below, the JOBS Act also empowered the SEC to expand the definition of "qualified purchaser" under Regulation A.[364]

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350. 15 U.S.C. § 77r(a) (2012).

351. *See id.* § 77r(b)(1).

352. *See id.* § 77r(b)(3).

353. *See id.* § 77r(b)(4).

354. H.R. REP. NO. 104-864, at 39 (1996) (Conf. Rep.).

355. *See id.*

356. 15 U.S.C. § 77r(c)(2).

357. *See id.* § 77r(c)(1).

358. H.R. REP. NO. 104-864, at 40.

359. *See* Securities Act of 1933, Pub. L. No. 104-290, § 4(a)(2), 48 Stat. 74, 77 (1933) (codified as amended at 15 U.S.C. § 77d(a)(2) (2012)).

360. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 2.

361. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 305, 126 Stat. 306, 322 (2012) (codified as amended at 15 U.S.C. §§ 77r, 78o (2012)).

362. *See id.* § 305(c), 15 U.S.C. § 77r(c)(2)(F) (2012).

363. *Id.* § 305(b)–(d), 15 U.S.C. §§ 77r(c), 78o.

364. *Id.* § 305(a), 15 U.S.C. § 77r(b)(4)(D).

3. Regulation A Offerings

Regulation A is a federal securities regulation aimed at helping smaller businesses access capital without having to bear the cost of a full registration.[365] The regulation allows companies to offer freely tradable securities to the general public without going through the full registration process.[366] The SEC originally promulgated Regulation A pursuant to its authority under Section 3(b) of the Securities Act, which allows the SEC to exempt certain offerings if registration is "not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."[367]

Although Regulation A exempted companies from full registration, companies had to submit offering statements to the SEC for review and respond to the SEC's comments.[368] Once the company's disclosures were sufficient for the SEC, the offering was considered "qualified" and could be offered to potential investors.[369] The firm was required to provide investors with the qualified disclosure circular.[370] Additionally, Regulation A offerings were generally not exempt from state regulation,[371] which meant the issuing company had to comply with each relevant state's registration process in addition to the SEC's.

Unlike the SEC, which focused on the adequacy and accuracy of the company's disclosure,[372] the majority of states employed "merit review."[373] Merit review consists of a substantial evaluation of the merits of the offering to determine whether the offering is "fair."[374] State standards often differ substantively,[375] which means issuers (or their counsel) need to (1) research the specific requirements for each state in which they plan to offer securities, (2) comply with each state's requirements, and (3) address comments from each state's

365. Rutheford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital"*, 31 DEL. J. CORP. L. 77, 79–80 (2006); *see* U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 1–2.

366. Campbell, *supra* note 365, at 80.

367. 15 U.S.C. § 77c(b)(1); *see also* Campbell, *supra* note 365, at 99–100.

368. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839 *supra* note 332, at 11–12.

369. *See id.* at 10–12.

370. *See id.*

371. *See id.* at 2.

372. *See id.* at 11.

373. *Id.* at 13.

374. *Id.* at 8.

375. *Id.* at 14; *see* Campbell, *supra* note 365, at 109–10.

regulators.[376] In some cases, companies warned by counsel of a state's compliance burdens will simply avoid that state.[377]

According to the Government Accountability Office (GAO), most companies opted not to rely on Regulation A at all.[378] Use of Regulation A declined from a peak of 116 initial offerings in 1997 to nineteen in 2011.[379] Qualified offerings also declined from fifty-seven in 1998 to a single offering in 2011.[380] Possible reasons for the decline included the time required to comply with the SEC's requirements,[381] the burden of complying with the differing state requirements,[382] and an offering limit that was perceived to be too low to justify the costs.[383] These factors came together in the growing preference among companies seeking capital for Regulation D[384] (specifically, Rule 506)[385] offerings. These offerings were more cost-effective because state law was largely preempted, the SEC required only notice of the offering (provided that the offer was made only to accredited investors), and there was no offering limit.[386]

The decline in Regulation A offerings prompted Congress to increase the offering limit from $5 million to $50 million as part of the JOBS Act.[387] Early versions of Title IV of the JOBS Act explicitly preempted state law for Regulation A offerings, but such provisions were withdrawn after some members of Congress expressed concerns about the risk of fraud.[388] Ultimately, Congress amended NSMIA to

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376. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 17–18.

377. *See id.* at 18.

378. *See id.* at 8–9.

379. *Id.* at 9.

380. *Id.*

381. *See id.* at 16–17.

382. *See id.* at 17–18; *see* Campbell, *supra* note 365, at 106–10; *see also* Rutheford B. Campbell, Jr., *Regulation A and the JOBS Act: A Failure to Resuscitate*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 317, 322–23 (2012).

383. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 19.

384. 17 C.F.R. §§ 230.501–.508 (2017); Campbell, *supra* note 382, at 321–22; *see* David Burton, *Offering and Disclosure Reform*, *in* RETHINKING FINANCIAL REGULATION, *supra* note 30, at 277, 278.

385. 17 C.F.R. § 230.506.

386. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 19; *see* Campbell, *supra* note 382, at 323.

387. Pub. L. No. 112-106, § 401(a), 126 Stat. 306, 323 (2012) (codified as amended at 15 U.S.C. § 77c(b) (2012)); *see also* U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 19–20 (identifying the $5 million offering ceiling as a reason for the decline in Regulation A offerings).

388. *See* Lindeen v. SEC, 825 F.3d 646, 651 n.8 (D.C. Cir. 2016) (citing 157 CONG. REC. H7231 (daily ed. Nov. 2, 2011) (statement of Rep. Gary Peters) ("Regulation A securities can be high-risk offerings that may also be susceptible to fraud, making protections provided by the State regulators an essential [feature]."), and H.R. REP. NO. 112-206, 13 (2011) (minority view)

permit preemption if the Regulation A securities were sold to a qualified purchaser[389] as defined by the SEC.[390] Congress also directed the GAO to assess the impact of state regulation on Regulation A offerings.[391] The GAO study identified the burden of complying with state regulations as a possible deterrent to issuers using Regulation A.[392]

Reacting to the ease with which small businesses reach potential investors nationwide through the Internet, the states have acknowledged the need for greater uniformity in their registration.[393] However, they also argue that the state regulatory process is important for consumer protection and that consumers have suffered as a result of preemption for Rule 506 offerings.[394] The states further argue that assessing the effects of state regulation and extending preemption are premature, given the changes to Regulation A and technological changes. Moreover, creating a more coordinated review system would remove the need for preemption.[395]

In response to the JOBS Act, the SEC proposed amendments to Regulation A[396] in January 2014.[397] So-called Regulation A+ created two tiers of offerings. Tier 1 offerings were limited to $5 million[398] (later increased to $20 million in the final rule)[399] and remained subject to concurrent state regulation. Tier 2 offerings were limited to $50 million;[400] were subject to continuing mandatory disclosure, including annual reports;[401] and were effectively exempt from state registration because all purchasers of Tier 2 offerings were deemed to be qualified purchasers.[402] To use either tier of offering, a company

("Regulation A securities are sometimes high-risk offerings that may be susceptible to fraud, making the protections provided by state review essential.")).

389. JOBS Act § 401(b), 15 U.S.C. § 77r(b)(4)(D) (2012) (amending 15 U.S.C. § 77r(b)(4) (1996)).

390. National Securities Markets Improvement Act, Pub. L. No. 104-290, § 102(b)(3), 110 Stat. 3416, 3418 (1996) (codified as amended at 15 U.S.C. § 77r (2012)).

391. JOBS Act § 402.

392. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, *supra* note 332, at 20.

393. Letter from Jack Herstein to A. Nicole Clowers, *supra* note 332, at 23.

394. *See id.* at 24.

395. *See id.* at 23.

396. *See* Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3926 (proposed Jan. 23, 2014) (to be codified at 17 C.F.R. pt. 230) [hereinafter Proposed Rule Amendments].

397. *See id.* at 3925.

398. *Id.* at 4000.

399. 17 C.F.R. § 230.251 (2017).

400. Proposed Rule Amendments, *supra* note 396, at 4000.

401. *Id.* at 4004.

402. 15 U.S.C. § 77r(b)(3) (2012).

needed to submit an offering statement to the SEC containing a significant amount of information about the company and its offering.[403]

Unsurprisingly, this preemption of the states was highly controversial. Numerous state regulators,[404] consumer advocates,[405] members of Congress,[406] and at least one company[407] wrote to oppose Tier 2 preemption on the grounds that it would harm investors and represent an inappropriate power grab by the SEC. The states also pointed to the development of a coordinated review process for existing Regulation A offerings they believed would mitigate the costs of state regulation.[408] However, the majority of commenters,[409] including businesses,[410] business advocates,[411] members of Congress,[412] think

403. Proposed Rule Amendments, *supra* note 396, at 4000; *see also id.* at 4008–41 (providing a template for Form 1-A).

404. *See, e.g.*, Letter from William M. Beatty, Sec. Adm'r, Wash. Dep't of Fin. Insts., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author); Letter from Irving L. Faught, Adm'r, Okla. Dep't of Sec., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author); Letter from William F. Galvin, Sec'y, Commonwealth of Mass., to SEC Comm'rs (Mar. 24, 2014) (on file with author); Letter from Andrew M. Hartnett, Mo. Comm'r of Sec., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author); Letter from Chad Johnson, Bureau Chief, Inv'r Prot. Bureau, N.Y. State Attorney Gen.'s Office, to Mary Jo White, Chair, SEC (May 7, 2014) (on file with author); Letter from Andrea Seidt, President, N. Am. Sec. Adm'rs Assoc., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014) (on file with author).

405. *See* Letter from Barbara Roper, Dir. of Inv'r Prot., Consumer Fed'n of Am., to Elizabeth M. Murphy, Sec'y, SEC (Feb. 11, 2015) (on file with author).

406. *See* Letter from Edward Markey et al., Members of Cong., to Mary Jo White, Chair, SEC (Aug. 1, 2014), https://www.sec.gov/comments/s7-11-13/s71113-123.pdf [https://perma.cc/ZXV8-JFRS].

407. *See* Letter from Nick Bhargava, Exec. Vice President, Groundfloor Fin. Inc., to Mary Jo White, Chair, SEC (Nov. 18, 2014), https://www.sec.gov/comments/s7-11-13/s71113-139.pdf [https://perma.cc/LZX4-5ZD6].

408. *See* Letter from William Beatty, President and Wash. Sec. Dir., N. Am. Sec. Adm'rs Ass'n, to Brent J. Fields, Sec'y, SEC (Feb. 11, 2015), https://www.sec.gov/comments/s7-11-13/s71113-144.pdf [https://perma.cc/2657-KGVK].

409. *See* Lindeen v. SEC, 825 F.3d 646, 652 (D.C. Cir. 2016).

410. *See* Letter from William Klehm, Chairman and CEO, Fallbrook Techs., Inc., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 22, 2014), https://www.sec.gov/comments/s7-11-13/s71113-54.pdf [https://perma.cc/PR86-Y9SE]; Letter from John Rodenrys, Exec. Dir. R&D, Leading BioSciences, Inc., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 24, 2014), https://www.sec.gov/comments/s7-11-13/s71113-58.pdf [https://perma.cc/W53M-BGA9].

411. *See* Letter from Kim Wales, Exec. Bd. Member, CrowdFund Intermediary Regulatory Advocates, to Kevin M. O'Neill, Deputy Sec'y, SEC (May 14, 2014), https://www.sec.gov/comments/s7-11-13/s71113-109.pdf [https://perma.cc/B56G-RDAG].

412. *See* Letter from Patrick McHenry et al., Members of Cong., to Mary Jo White, Chair, SEC (Sept. 25, 2014), https://www.sec.gov/comments/s7-11-13/s71113-129.pdf [https://perma.cc/P2MX-LDF8].

tanks,[413] and academics,[414] argued in favor of preemption as necessary to make Regulation A cost-effective.

The preemption provision remained in the final rule,[415] prompting a lawsuit by the state securities regulators of Montana and Massachusetts.[416] The state regulators challenged the legality of the SEC's designation of all Tier 2 purchasers as "qualified purchasers,"[417] in part because the SEC did not adequately consider investor protection in making the designation.[418] The court rejected those arguments.[419]

The new Regulation A went into effect on June 19, 2015.[420] Online securities platforms[421] that facilitate corporate offerings and individual companies have used Regulation A+ to offer securities directly to the public.[422] As of October 31, 2016, 147 new Regulation A+ offerings had been filed with the SEC.[423] Of these, eighty-one had been reviewed by the SEC and found to have sufficiently complete disclosures to be offered for sale.[424] Although total offerings were fairly evenly split between Tier 1 and Tier 2 (49 percent to 52 percent, respectively), 61 percent of qualified offerings were Tier 2.[425] Tier 2

413. *See* Letter from Daniel Gorfine & Staci Warden, Dirs. of Ctr. for Fin. Mkts., Milken Inst., to Elizabeth M. Murphy, Sec'y, SEC (Mar. 19, 2014), https://www.sec.gov/comments/s7-11-13/s71113-45.pdf [https://perma.cc/ZS7D-BLDS].

414. *See* Campbell, *supra* note 382, at 329–32; Letter from Rutheford B. Campbell, Jr., Spears-Gilbert Professor of Law, Univ. of Ky., to Elizabeth M. Murphy, Sec'y, SEC 2 (Mar. 5, 2014), https://www.sec.gov/comments/s7-11-13/s71113-36.pdf [https://perma.cc/ASS7-YAG8] (arguing that the SEC did not go far enough).

415. *See* 17 C.F.R. § 230.256 (2017).

416. *See* Lindeen v. SEC, 825 F.3d 646, 646 (D.C. Cir. 2016).

417. *See id.* at 653.

418. *See id.* at 654.

419. *See id.* at 656.

420. *SEC Final Rules*, SEC, https://www.sec.gov/rules/final/finalarchive/finalarchive2015.shtml [https://perma.cc/2NTW-6A52] (last visited Sept. 30, 2017).

421. See, for example, new firms such as SEEDINVEST, https://www.seedinvest.com [https://perma.cc/KD44-45ES] (last visited Sept. 30, 2017), and STARTENGINE, https://www.startengine.com [https://perma.cc/Q3L3-AUCG] (last visited Sept. 30, 2017), as well as traditional broker-dealers such as *A+ Offerings: JOBS Act Changes to Regulation A*, WR HAMBRECHT & CO., https://wrhambrecht.com/regulation-a-ipo-offering [https://perma.cc/BP3W-2VCU] (last visited Sept. 30, 2017).

422. See, for example, THRILLCORP, http://www.thrillcorp.com [https://perma.cc/FHD5-ZCEH] (last visited Aug. 2, 2016), a builder of theme parks that offers securities (at the time of this writing) directly on its website.

423. *See* ANZHELA KNYAZEVA, SEC, REGULATION A+: WHAT DO WE KNOW SO FAR? 1 (2016), https://www.sec.gov/dera/staff-papers/white-papers/18nov16_knyazeva_regulation-a-plus-what-do-we-know-so-far.html [https://perma.cc/BU9R-4Z9D].

424. *Id.*

425. *See id.* at 7 tbl.1.

offerings are on average larger[426] and solicit investment from more states.[427] A greater percentage of Tier 2 offerings are made for the maximum amount allowed, as compared to Tier 1 offerings, though the majority of offerings in both tiers are made for less than the cap.[428] The use of intermediaries (for example, a broker-dealer) is "significantly higher" for Tier 2 offerings, consistent with nationwide solicitation and higher investor search costs.[429]

The relative use of Tier 1 versus Tier 2 offerings indicates that firms seeking to cast a wider net for investors value preemption. Although the different limits for the tiers also likely play a role in selection, the fact that a significant number of firms use Tier 2 for offerings at or under $20 million—but solicit in many more states than firms using Tier 1 offerings—indicates that preemption becomes more valuable as the number of states increases, even if Tier 1 is an option.

4. Rule 147 Offerings

While Regulation A represents a case of technology helping to move the transactions to a national level, Rule 147 presents the opposite problem—transactions that are truly intrastate in nature but that may technically qualify as interstate because of the limits (or lack thereof) of technology. This dynamic leads to the risk that the federal government will needlessly regulate in an environment where the states are better suited—practically and politically.

Rule 147 is a safe harbor provision for offerings that are exempt from registration under Section 3(a)(11) of the Securities Act for intrastate securities offerings.[430] That section originally exempted securities offered only to residents of the state in which the issuer is incorporated and does business.[431] Rule 147 provides a set of criteria that insulate a compliant issuer from the risk that its Section 3(a)(11)

426. Among all offerings, Tier 1 offerings average $10 million requested compared to $26 million for Tier 2; for qualified offerings, the average sought for Tier 1 offerings is $7 million compared to $26 million for Tier 2. *See id.* The median offering amount for Tier 1 offerings is $6 million ($5 million for qualified offerings), compared to $20 million for Tier 2 offerings (both general and qualified). *See id.*

427. The median number of states in which a firm using Tier 1 would solicit investors is four (eight among qualified offerings), compared to a median of fifty states for Tier 2 offerings (both general and qualified). *Id.* at 8–9.

428. Among all Tier 1 offerings, 26 percent are made at the tier limit, though this figure declines to 6 percent for qualified offerings. *Id.* at 7 tbl.1. For all Tier 2 offerings, meanwhile, 32 percent are made at the tier limit, with a slight increase to 33 percent for qualified offerings. *Id.*

429. *Id.* at 25.

430. 17 C.F.R. § 230.147 (2017).

431. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 81 Fed. Reg. 83494, 83498–99 (Nov. 21, 2016) (to be codified at 17 C.F.R. pt. 200).

offering would be deemed an unregistered sale of securities subject to potential sanction.[432]

Recently, numerous states have adopted or expanded intrastate "crowdfunding" laws to make it easier for companies to raise money from their local communities.[433] Compliance with Rule 147 was traditionally a prerequisite under state securities law for local offerings.[434] However, the requirements of Rule 147 may have presented an impediment to companies using the new intrastate crowdfunding laws. For example, the SEC's Advisory Committee on Small and Emerging Companies identified several potential problems, including the concern that using the Internet to advertise an offering would be impermissible under Rule 147 because people outside of the state could see the offering.[435]

In response to these concerns, the SEC proposed changes to Rule 147,[436] including allowing issuers to engage in general solicitation.[437] Under the proposal, issuers may use the web to advertise their offerings—provided that they comply with other requirements, including notifying potential purchasers that the offer is only for residents of a single state.[438] The proposed rule also would simplify the test for an issuer to show that its principal place of business is within the state in which it is making its offering.[439] These requirements would effectively ensure that the issuer has an exclusive relationship to the state of the offering.[440]

Importantly, the SEC proposed the changes to Rule 147 using its general authority under Section 28 of the Securities Act, as opposed to Section 3(a)(11).[441] Doing so enabled the SEC to introduce

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432. *Id.* at 83494–95.

433. Letter from Judith M. Shaw, President, N. Am. Sec. Adm'rs Ass'n, to Brent J. Fields, Sec'y, SEC 2 (Jan. 11, 2016), https://www.sec.gov/comments/s7-22-15/s72215-22.pdf [https://perma.cc/UU3N-SNZK].

434. *Id.*

435. *See* Exemptions to Facilitate Intrastate and Regional Securities Offerings, 80 Fed. Reg. 69786, 69788–89 (proposed Nov. 10, 2015) (to be codified at 17 C.F.R. pt. 230) [hereinafter Exemptions to Facilitate Offerings]; Letter from Stephen M. Graham & M. Christine Jacobs, Co-Chairs, Advisory Comm. on Small and Emerging Cos., to Mary Jo White, Chair, SEC (Sept. 23, 2015), https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-modernize-rule-147.pdf [https://perma.cc/533K-35FA].

436. *See* Exemptions to Facilitate Offerings, *supra* note 435, at 69786.

437. *See id.* at 69788.

438. *Id.* at 69828.

439. *Id.* at 69830.

440. Letter from author & Staci Warden, Milken Inst. Ctr. for Fin. Mkts., to Brent J. Fields, Sec'y, SEC 6 (Jan. 11, 2016), https://www.sec.gov/comments/s7-22-15/s72215-26.pdf [https://perma.cc/TJ6W-NB22].

441. *See* Exemptions to Facilitate Offerings, *supra* note 435, at 69789.

substantive requirements on the nature of the offering. Those requirements included a $5 million annual limit on offerings made under Rule 147.[442] The proposal also required that the relevant state place limits on the amount certain investors could purchase.[443] The SEC acknowledged that moving Rule 147 away from Section 3(a)(11) to Section 28 meant the rule would no longer function as a safe harbor for offerings made under Section 3(a)(11), but the SEC stated that the Section 3(a)(11) exemption would remain an option for issuers.[444]

The SEC's proposal was met with skepticism from commenters, including legal practitioners,[445] industry advocates,[446] think tanks,[447] and state securities regulators.[448] Commenters noted that moving Rule 147 from Section 3(a)(11) would jeopardize state securities laws that require Rule 147 compliance.[449] Commenters also pointed out that imposing substantive federal requirements would prevent the states from creating the securities offerings that best suited their residents' needs.[450] A comment letter this Author coauthored with Staci Warden argued that even though use of the Internet—which inevitably connects issuers with residents of other states—likely gives the federal government jurisdiction as a constitutional matter, the federal government should nevertheless refrain from imposing substantive regulation.[451] Offerings made under Rule 147 are true intrastate offerings. Commenters argued that when all the parties to a transaction are in one state, they can influence the state's policy. Thus, the state is likely to be, on average, more nimble and

442. *Id.* at 69788–89.

443. *Id.*

444. *Id.* at 69789.

445. *See* Letter from Sara Hanks, CEO, CrowdCheck, Inc., to Brent J. Fields, Assistant Sec'y, SEC 2 (Jan. 2, 2016), https://www.sec.gov/comments/s7-22-15/s72215-9.pdf [https://perma.cc/2Z6V-JLF8]; Letter from David Lynn, Chair of Fed. Regulation of Sec. Comm., Am. Bar Assoc., to Brent J. Fields, Sec'y, SEC (Apr. 8, 2016), https://www.sec.gov/comments/s7-22-15/s72215-29.pdf [https://perma.cc/H5UP-2947].

446. *See* Letter from Kim Wales, Exec. Bd. Member, CrowdFund Intermediary Regulatory Advocates, to Brent J. Fields, Assistant Sec'y, SEC (Jan. 10, 2016), https://www.sec.gov/comments/s7-22-15/s72215-17.pdf [https://perma.cc/V64F-ABEP].

447. *See* Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 2.

448. *See* Letter from Judith M. Shaw to Brent J. Fields, *supra* note 433, at 2–9.

449. *See id.*; *see also* Letter from Sara Hanks to Brent J. Fields, *supra* note 445, at 1; Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 4.

450. *See* Letter from Sara Hanks to Brent J. Fields, *supra* note 445, at 2; Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6–7; Letter from Judith M. Shaw to Brent J. Fields, *supra* note 433, at 3–4.

451. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6–7.

responsive, rendering it the appropriate actor to regulate the offerings.[452]

On October 26, 2016, the SEC finally amended Rule 147.[453] The SEC also created a new Rule 147A for offerings made by companies that are incorporated under the laws of a state different from their primary place of business and that use general solicitation to offer their securities.[454] Rule 147A sales are limited to residents of the state that is the company's primary place of business.[455] The SEC concurred with commenters that it was "appropriate that the resident investor protections in intrastate offerings primarily flow from the requirements of state securities law."[456] The SEC declined to move forward with the federally imposed limits on offering and investment size.[457] It noted that most states already limit relevant offerings to less than $5 million per year and limit how much individuals can invest.[458] In light of the policy motivating Section 3(a)(11)—to facilitate companies financing themselves from local investors[459]—and the fact that states were engaged in providing consumer protection, the SEC deferred to the states on whether such limits are appropriate.[460] Under the new rules, Rule 147 and 147A offerings are subject to the antifraud and civil liability provisions of federal securities law.[461]

IV. WHO SHOULD REGULATE?

Under the current expansive reading of the Interstate Commerce Clause[462]—which grants Congress the ability to regulate the channels and instrumentalities of interstate commerce, persons or things in interstate commerce, and anything that has a substantial effect on interstate commerce[463]—Congress can regulate and displace state regulation of fintech. But just because Congress *can* regulate

452. *Id.*

453. *See* Press Release, SEC, SEC Adopts Final Rules to Facilitate Intrastate and Regional Securities Offerings (Oct. 26, 2016), https://www.sec.gov/news/pressrelease/2016-226.html [https://perma.cc/5ZQS-H8YY].

454. *Id.*

455. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 81 Fed. Reg. 83494, 83500 (Nov. 21, 2016) (to be codified at 17 C.F.R. pt. 200).

456. *Id.* at 83509.

457. *Id.*

458. *Id.*

459. *Id.* at 83495.

460. *Id.*

461. *Id.* at 83509.

462. U.S. CONST. art. I, § 8, cl. 3.

463. Gonzales v. Raich, 545 U.S. 1, 16–17 (2005).

does not necessarily mean it *should*. Instead, Congress should have a compelling reason to intervene. The circumstances described herein highlight three such reasons that could justify intervention: efficiency, competitive equity among market participants, and political equity among the residents of the various states. However, the case of Rule 147 presents a counterexample: although Congress and, by extension, the SEC have the authority to regulate, they should refrain from doing so.

A. Efficiency

Commentators who likely disagree significantly on what the substance of the law should be nevertheless recognize the value of efficiency provided by consistent national rules.[464] Whether efficiency is best served by federalism or federalization is a case-by-case question. For example, Professor Barry Weingast describes "market-preserving federalism," in which a federalist structure encourages competition among governments in the regulation of markets and thus discourages rent-seeking and contributes to greater prosperity.[465] If a market met those criteria, federalization would be unnecessary, if not harmful.

Unfortunately, the regulation of nonbank lenders, money transmitters, and pre-reform Regulation A offerings should not qualify as market-preserving federalism. The missing element is what Weingast calls a "common market" that would prevent states from creating trade barriers to the products of other states.[466] Instead, the states are able to impose state-specific conditions on market entry, including licensing requirements and limits on product offerings and service offerings.[467] Consumers and market participants suffer under

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464. *Compare* Bar-Gill & Warren, *supra* note 32, at 83 ("The erosion of state power in itself need not be problematic from a consumer protection perspective. In an era of interstate banking, uniform regulation of consumer credit products at the federal level may well be more efficient than a litany of consumer protection rules that vary from state to state. *The problem is not in the federal preemption; it is in the failure of federal law to offer a suitable alternative to the preempted state law.*" (emphasis added)), *with* Joseph R. Mason, Robert Kulick & Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 787–88 (2010) (citing Bar-Gill & Warren, *supra* note 32, at 83) ("A deeper examination of the economics of preemption reveals that Professor Warren had it right in her law review article: preemption has been a force for increasing the efficiency of the banking sector.").

465. Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 5–6 (1995).

466. *Id.* at 4.

467. *See, e.g.*, *supra* Parts III.A.1, III.B, and III.B.2.

redundant and contradictory regulation rather than reaping the benefits of market-preserving federalism.

Having to research and comply with multiple regulations or having to pay for multiple licenses is inefficient, time consuming, and costly for companies, especially new firms with limited resources. This lack of competition imposes a direct cost on consumers and benefits incumbents who are able to capture the surplus that would otherwise be competed away. An example from lending is the credit card market in the 1980s, which was primarily intrastate at the beginning and shifted to interstate competition over time.[468] Christopher Knittel and Victor Stango show that state usury limits served as a "focal point for tacit collusion" among banks that clustered their rates at the upper limit of what they could charge under state law.[469] Over time, as the credit card market became subject to interstate competitive pressures in the wake of the *Marquette* decision, DIDA, and other reforms, the ability for in-state firms to collude declined, resulting in decreased costs to consumers.[470] Similar tacit collusion may also exist in payday loans, an industry subject primarily to state-by-state regulation.[471]

State-by-state regulation also contributes to regulatory uncertainty. As Professor Kevin Tu points out in the context of money transmission, the state-by-state regulatory picture dramatically increases "search costs" for firms, as those firms constantly need to assess just what the law is.[472] That burden is likely to fall hardest on younger and smaller firms that lack industry experience and the resources to hire large legal teams.[473] These are the very firms most likely to introduce new, innovative products.[474]

The search cost problem is compounded by the fact that it is not a one-time expense. Even if states all agree to a uniform law and

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468. Christopher R. Knittel & Victor Stango, *Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards*, 93 AM. ECON. REV. 1703, 1707–08 (2003).

469. *See id.* at 1719.

470. *Id.* at 1721–22.

471. Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* 2 (Fed. Reserve Bank of Kansas City, Research Working Paper No. 09-07, 2009), https://www.kansascityfed.org/publicat/reswkpap/pdf/rwp09-07.pdf [https://perma.cc/X5ED-QY56].

472. Tu, *supra* note 173, at 112.

473. *Id.* at 112–13.

474. *See, e.g.*, William J. Baumol, *Education for Innovation: Entrepreneurial Breakthroughs Versus Corporate Incremental Improvements* (Nat'l Bureau of Econ. Research, Working Paper No. 10578, 2004), *in* 5 INNOVATION POLICY AND THE ECONOMY 33, 54 (Adam B. Jaffe et al. eds., 2005), http://www.nber.org/chapters/c10806.pdf [https://perma.cc/Y7UM-5GH6] (finding that startups and entrepreneurs are more likely to create breakthrough innovations and that established firms are more likely to create incremental improvements of existing products and services).

the law remains uniform as enacted, there is always the risk that some states will change their laws or their statutory and regulatory interpretations.[475] Preemption limits the scope of necessary monitoring and provides greater stability and certainty.

Pre-reform Regulation A illustrates the way redundant and contradictory regulation can interfere with the functioning of a national market. The inability of firms to use Regulation A because of the costs of working with multiple regulators harmed businesses and their would-be employees and customers, and it reduced economic growth. Providing a consistent legal environment can facilitate greater access and opportunity, as shown by the increase in usage of Regulation A, which went from one qualified offering in 2011 to eighty-one as of October 2016, the majority of which used the preemptive features of Tier 2.

The inconsistent treatment of nonbank loans by the courts provides another example. With regard to interest rates and the definition of what constitutes interest, it is clear that state law will control.[476] What is unclear, however, is *which* state's law should control and what role the federal government should play in ensuring respect for the proper state's law. Opponents of bank partnerships view an agreement made over the Internet between a lender in State *A* and a borrower in State *B* as an example of the lender coming to the borrower, which means State *B*'s law should control. However, one could as easily argue that State *A*'s laws should control because the borrower came to the lender to take advantage of the products available under the lender's state laws. In the latter case, an effort by State *B* to reach into State *A* to prevent State *B*'s residents from conducting a transaction in State *A* would likely be viewed as an unconstitutionally extraterritorial statute.[477]

This tension was noted in *Marquette* in the context of determining the location of the bank. The court found that the

475. This drift away from uniformity has been seen in other contexts, including the Uniform Commercial Code (UCC). *See generally* John C. Minahan, Jr., *The Eroding Uniformity of the Uniform Commercial Code*, 65 KY. L.J. 799 (1976) (discussing how factors including amendments, subsequent state laws, and judicial decisions had reduced the degree of similarity between all states that nominally enacted the UCC).

476. *See supra* Part III.A.2 (discussing how federal law looks to underlying state law for regulation of interest rates).

477. *See* Healy v. Beer Inst., 491 U.S. 324, 332 (1989) ("[S]tate law that has the 'practical effect' of regulating commerce occurring wholly outside that State's borders is invalid under the Commerce Clause."); Edgar v. Mite Corp., 457 U.S. 624, 642–43 (1982) ("The Commerce Clause also precludes the application of a state statute to commerce that takes place wholly outside of the State's borders, whether or not the commerce has effects within the State."); Cotto Waxo Co. v. Williams, 46 F.3d 790, 794 (8th Cir. 1995) ("[A] statute has extraterritorial reach when it necessarily requires out-of-state commerce to be conducted according to in-state terms.").

location of the lender should be controlling, in part because the lender's state bore the deepest and most consistent relationship to every transaction.[478] The NBA's solution to this quandary is akin to a choice-of-law provision that resolves the question in favor of the state law that the lender and borrower agreed to.[479] The NBA thus facilitates interstate contracts.[480] Contrast this experience with the experience of marketplace lenders post-*Madden*, where uncertainty about the legality of loans has crippled access to lending for certain borrowers.[481]

State-by-state regulation may also impede the securitization markets. As Mason, Kulick, and Singer point out, inconsistency in allowable interest rates, finance charges, and terms can hamper securitization of loans.[482] Securitization can be an important source of funds for loans,[483] especially for small businesses. However, inconsistencies in loan terms (often driven by regulatory requirements) have kept the loan securitization markets for small businesses relatively underdeveloped.[484]

Finally, the lack of consistent regulation may require more complex financial engineering to make products compliant. The change in structure of loans by marketplace lenders provides an example. Banks are restructuring their products to retain an interest for the purposes of regulatory protection rather than economic efficiency.[485] This change is not driven by competitive pressure or customer-oriented innovation, but rather to avoid regulatory uncertainty. The result is greater complexity and higher costs, with the additional cost being passed on to borrowers and investors.

B. Competitive Equity

There is much wisdom to Senator Dale Bumpers's (D-AR) reaffirmation of the principle that "institutions offering similar

478. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 310–11 (1978).

479. Smith, *supra* note 51, at 1672.

480. *Id.*

481. *See* TREASURY REPORT, *supra* note 72, at 25.

482. Mason, Kulick & Singer, *supra* note 464, at 797–98.

483. *Id.* at 798.

484. DAVID BROWN & EMILY LINER, TO GROW NEW BUSINESSES, IMPROVE ACCESS TO CREDIT 18–19 (2016), http://s3.amazonaws.com/content.thirdway.org/publishing/documents/pdfs/000/002/037/to-grow-new-businesses-improve-access-to-credit.pdf?1474321861 [https://perma.cc/4ABB-VZYL].

485. Smith, *supra* note 51, at 1677–80.

products should be subject to similar rules."[486] In the realm of fintech, that is often not the case. Instead, competing institutions offering similar products on a nationwide basis are often subject to different regulations, depending on whether they are a bank.[487]

Marketplace lending presents an obvious, but not exclusive, example. Marketplace lenders offering bank-like loan products compete with banks. Although they are governed by many of the same consumer protection laws as banks, marketplace lenders lack banks' interest export capability.[488] Banks are able to offer a consistent product nationwide, but marketplace lenders are subject to state-by-state rules.[489] Some lenders have sought to minimize this competitive disadvantage by partnering with banks, but those partnerships are under legal threat.

Policymakers should ask if it should matter whether a loan is made by a bank or a nonbank lender. Perhaps, instead, the characteristics of the loan and the facts surrounding the negotiation and agreement to its entry should be determinative. The plaintiff's argument in *Bethune* is striking in how much it relies on technicalities.[490] The plaintiff does not allege that Lending Club misled him as to the terms of the loan, hid fees, or coerced him. Indeed, he appears to have gotten exactly the type of loan he expected. Despite the lack of fraud or coercion, the plaintiff alleges that because Lending Club was the true lender, and the bank only a sham lender, the loan was illegal under New York law.[491]

Although the *Bethune* plaintiff points to the more regulated status of banks as a justification for their exemption from usury laws, he does not explain which regulations serve to justify the exemption

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486. 126 CONG. REC. 6907 (1980) (statement of Sen. Bumper).

487. *See, e.g.*, *supra* Parts III.A.3 (discussing differences in ability to export laws governing interest between banks and nonbank lenders), III.B.1 (discussing general exemption from money transmission licensing requirements for banks).

488. *See supra* Part III.A.3.

489. *See, e.g.*, Telis Demos, *Venture Capitalists Get Radical and Invest in a . . . Bank*, WALL ST. J. (Nov. 1, 2016, 8:53 AM), http://www.wsj.com/articles/the-new-banking-approach-for-silicon-valley-is-a-bank-1478004624 [https://perma.cc/32MZ-GPAQ] ("Cross River uses its position as a chartered and Federal Deposit Insurance Corp.-member bank to do things that are tougher for nonbank firms under U.S. rules. That includes originating loans in any state and moving funds over the banking system's rails on behalf of its partners or customers."); *see also* Wack, *supra* note 2 ("Banks that are getting into the online lending business have one additional edge over the startups—greater regulatory certainty. Firms like Lending Club and Prosper issue their loans through partner banks in a somewhat byzantine effort, which has attracted judicial scrutiny, to get around state-by-state interest rate caps.").

490. *See supra* notes 120–24 and accompanying text.

491. Bethune v. LendingClub Corp., No. 16 CIV. 2578 (NRB), 2017 WL 462287, at *1 (S.D.N.Y. Jan. 30, 2017).

that do not apply to marketplace lenders.[492] Marketplace lenders are subject to consumer protection laws—including the Equal Credit Opportunity Act,[493] the Fair Housing Act,[494] the Truth in Lending Act,[495] Dodd-Frank's prohibition on unfair, deceptive, or abusive acts or practices,[496] and the Gramm-Leach-Bliley Act[497]—that are similar to those governing banks.[498] Additionally, marketplace lenders that work with banks are "regulated" by their bank partners.[499] Further, under the Bank Service Company Act, these lenders may fall under the direct regulation of the federal regulator of their partner banks for the services they perform for those banks (including loan servicing and lead generation).[500] As such, it is unclear what regulatory discrepancy justifies prohibiting a marketplace lender from making a loan that a bank can make. This question is important for borrowers. Rules that place certain providers at a competitive disadvantage—by depriving them of the regulatory consistency enjoyed by banks—limit competition and innovation. As seen in the history of interest rate regulation, this limitation can favor incumbents at the expense of

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492. *Id.*

493. Equal Credit Opportunity Act, Pub. L. No. 93-495, §§ 501–03, 88 Stat. 1500, 1521 (1974) (codified as amended at 15 U.S.C. §§ 1691–91f (2012)).

494. Fair Housing Act, Pub. L. No. 90-284, §§ 801–19, 82 Stat. 73, 81–89 (1968) (codified as amended at 42 U.S.C. §§ 3601–19 (2012)).

495. Truth in Lending Act of 1968, Pub. L. No. 90-321, §§ 101–45, 82 Stat. 146, 146–59 (1968) (codified as amended at 15 U.S.C. §§ 1601–67f (2012)).

496. Consumer Financial Protection Act, Pub. L. No. 111-203, § 1031, 124 Stat. 1376, 2005–06 (2010) (codified as amended at 12 U.S.C. § 5531 (2012)). The CFPB also collects consumer complaints about marketplace lenders. *See* Press Release, Consumer Fin. Prot. Bureau, CFPB Now Accepting Complaints on Consumer Loans from Online Marketplace Lender (Mar. 7, 2016), http://www.consumerfinance.gov/about-us/newsroom/cfpb-now-accepting-complaints-on-consumer-loans-from-online-marketplace-lender [https://perma.cc/3QZA-JS5M].

497. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C.). Note, however, that the exact scope of the rules may differ somewhat.

498. TREASURY REPORT, *supra* note 72, at 10.

499. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. NO. 2013-29, RISK MANAGEMENT GUIDANCE (2013), https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html [https://perma.cc/HF4H-B96S]; FED. DEPOSIT INS. CORP., FIL-44-2008, GUIDANCE FOR MANAGING THIRD-PARTY RISK (2008), https://www.fdic.gov/news/news/financial/2008/fil08044.html [https://perma.cc/H856-PWUA]. *See also* FED. DEPOSIT INS. CORP., FIL-50-2016, FDIC SEEKING COMMENT ON PROPOSED GUIDANCE FOR THIRD-PARTY LENDING (2016), https://www.fdic.gov/news/news/financial/2016/fil16050.html [https://perma.cc/X4HL-38VF].

500. *See* Bank Service Company Act, Pub. L. No. 104-208, § 2613, 110 Stat. 3009, 3485–87 (codified as amended at 12 U.S.C. §§ 1861, 1867(c) (2012)); Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1359, 1368 (D. Utah 2014).

higher-than-necessary prices and unnecessarily limited access for consumers.[501]

Regulation should follow the risk created, and similar products should be regulated similarly. Although it is true that banks have regulatory requirements not shared by marketplace lenders, such as obligations under the Community Reinvestment Act and safety-and-soundness inspection to protect the federal deposit insurance fund, those requirements are tied to aspects of banks' business—such as deposit taking—that marketplace lenders do not share.[502] Hence, differential regulation may be justified. To the extent that marketplace lenders present the same risks as banks, however, they should be regulated similarly; on the other hand, regulation should be adjusted according to the extent to which models present different or lesser risks. Regulating marketplace lenders similarly to banks would equalize the rulebook for market participants and encourage competition from new players, which would ultimately benefit consumers.

C. Political Equity Between Citizens of the Several States

It is a well-worn saying from Justice Brandeis that "a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments."[503] Professors Samuel Issacharoff and Catherine Sharkey wryly note: "While Justice Brandeis's aphorism . . . is oft repeated, the tail end of his claim tends to get lost."[504] In full, his saying reads: "[A] single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments *without risk to the rest of the country*."[505] There is always the risk that the state as laboratory will have an accident or that it will create a policy that benefits itself but sends pollutants downstream[506] (often called a "spillover").[507] This risk is

501. *See supra* notes 33, 34, 42, 468, 469, and 471, and accompanying text.

502. *See* Letter from John W. Ryan, President and CEO, Conference of State Bank Supervisors, to Thomas Curry, Comptroller of the Currency, Office of the Comptroller (Apr. 13, 2017), https://www.csbs.org/regulatory/resources/Documents/Attached%20Exhibits%20-%200CC%20Complaint.pdf [https://perma.cc/CJ2C-E44D] (listing areas of federal banking law that only apply to FDIC-insured deposit-taking banks).

503. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

504. Issacharoff & Sharkey, *supra* note 13, at 1355.

505. *New State*, 285 U.S. at 311 (Brandeis, J., dissenting) (emphasis added).

506. A clear example is product liability regulation, where, as Issacharoff and Sharkey note: "Products liability law raises the specter of spillover effects, whereby a state uses its liability regime to benefit in-state residents with larger compensation payments, or exports the costs of its regulation to out-of-state manufacturers and product consumers in the rest of the nation." Issacharoff & Sharkey, *supra* note 13, at 1386.

particularly acute in national markets that are regulated on a state-by-state basis.[508] Many innovative fintech markets, including lending and money transmission, fall into the category of national markets regulated state by state.

Although the courts and many scholars view the need to prevent or at least minimize encroachments by one state's citizens on another's to be a core component of American federalism,[509] others have a more sanguine view of spillovers. Professors Heather K. Gerken and Ari Holtzblatt, for example, argue that in some cases—especially those where an issue has high political salience among the public—benefits to spillovers also exist, including increasing political engagement and forcing reform.[510] To Gerken and Holtzblatt, federalism is not an end in itself but rather a means to encourage a "well-functioning democracy"[511] and to push the political process to a national consensus[512] which, while it can include disuniformity, is driven by a national "choice, not an accident."[513] This view also does not consider some states effectively controlling other states as a positive good. The point is not to have California's boot on Wyoming's throat for all time, but to push the public and politicians into engagement and compromise.[514]

Many of the spillovers arising from inconsistent state-by-state regulation discussed in this Section likely fall into the quadrant of high economic cost but low political salience, as envisioned by Gerken

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507. Heather K. Gerken & Ari Holtzblatt, *The Political Safeguards of Horizontal Federalism*, 113 MICH L. REV. 57, 61–62 (2014).

508. Issacharoff & Sharkey, *supra* note 13, at 1359.

509. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 422 (2003) ("A basic principle of federalism is that each State may make its own reasoned judgment about what conduct is permitted or proscribed within its borders."); BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 571–73 (1996); Healy v. Beer Inst., 491 U.S. 324, 335–36 (1989) ("The principles guiding this assessment . . . reflect the Constitution's special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and with the autonomy of the individual States within their respective spheres." (footnotes omitted)); *see also* Katherine Florey, *State Courts, State Territory, State Power: Reflections on the Extraterritoriality Principle in Choice of Law and Legislation*, 84 NOTRE DAME L. REV. 1057, 1115 (2009) ("[T]he idea that states are entitled to some autonomous sphere in which to make policy free of interference from other sovereigns [is an 'ideological principle[]' of federalism]."); Michael S. Greve, *Choice and the Constitution* 7 (Am. Enter. Inst., Federalist Outlook No. 16, 2003), https://www.aei.org/publication/choice-and-the-constitution [https://perma.cc/53D2-PZ47] ("States must govern themselves, not one another.").

510. Gerken & Holtzblatt, *supra* note 507, at 62–63.

511. *Id.* at 67–68.

512. *Id.* at 86.

513. *Id.* at 98.

514. *Id.* at 63.

and Holtzblatt.[515] After all, the specifics of how much capital money transmitters must retain or what forms a company must file to make a securities offering, though ultimately important to questions of access and opportunity, are unlikely to motivate people to march in the streets. Regulation A provides such an example, where the issue was important to businesses seeking capital and had subsidiary effects on workers and local economies but never prompted mass political movements. Federalizing interventions to address those problems of high cost and low salience are likely justified given the economic burden that they impose compared to the minimal benefits of maintaining inconsistency.[516]

Some of the issues discussed in this Article, however, may have relatively high political salience, such as interest rate and (potentially) virtual currency regulation (see Table 1 below). Even if one subscribes to Gerken and Holtzblatt's view of spillovers as not anathema per se, in most of the examples discussed here, moving to a national consensus is appropriate.

515. *Id.* at 83.

516. *Id.* at 85 ("We think the case for regulating low-salience, economically costly spillovers . . . is easy. The democratic benefits are small, and the economic costs are high.").

Table 1. High Economic Cost and High vs. Low Political Salience of Fintech Issues Discussed[517]

	High political salience	**Low political salience**
High economic cost	Interest rate regulation Virtual currency regulation (potentially)	Intrastate securities offerings Regulation A securities offerings Money-transmitter regulation

An example of this move toward a national consensus is the regulation of the interest banks can charge. Critics often point to the interest rate export provisions as unconstitutional[518] "sister-state preemption"[519] that gives "Delaware or South Dakota supremacy over [other states]."[520] That criticism ignores that the extension of interest rate export to both state-chartered and nationally chartered banks was in furtherance of a federal policy and done under federal law. The NBA represents a "federal law [that] completely defines what constitutes the taking of usury by a national bank, referring to the state law only to determine the maximum permitted rate."[521] Likewise, DIDA represents a national decision to extend competitive parity to state-chartered banks.[522] Congress, a body that draws membership from all states, provided a venue for citizens to come to a national consensus,[523] which includes some amount of intentional disunity. To the extent that citizens change their views, they have a

517. This Table follows the pattern of the table created by Gerken & Holtzblatt, *supra* note 507, at 61–62. However, given the relatively high economic costs of all the topics, it contains only a high economic cost row.

518. Irwin v. Citibank (S.D.), N.A., No. 2557, 1993 WL 837921, at *2 (Pa. Com. Pl. Dec. 9, 1993).

519. *See, e.g.*, Yolanda D. McGill & Kathleen E. Keest, Comment on Petition for Rule-Making to Permit Preemption of State Laws with Respect to the Interstate Activities of State Banks (May 16, 2005), https://www.fdic.gov/news/conferences/agency/public_mcgill_test.html [https://perma.cc/RQ62-JS7D].

520. *Id.*

521. Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 10 (2003) (quoting Evans v. Nat'l Bank of Savannah, 251 U.S. 108, 114 (1919)).

522. *See* Greenwood Tr. Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992).

523. *See* Gerken & Holtzblatt, *supra* note 507, at 108.

mechanism to pressure their representatives in Congress to change the law.

Contrast this with much of the state-by-state regulation described previously.[524] One state's regulations can distort the entire national market, especially if the state is large and economically important. For example, given New York's important position within the financial sector, the inherent power of the NYDFS, and the broad scope of New York's BitLicense,[525] it is unclear whether Bitcoin companies actually could avoid New York jurisdiction and remain competitive. Even if the scope of the law is uncertain, companies will have a strong incentive to comply to avoid being the target of the NYDFS testing its authority. A court battle with the NYDFS over its authority—even if successful—could bankrupt a small company. A consumer in a state where a product would be legal, but is de facto banned because of New York, has no recourse in Albany or with the NYDFS. Thus, Americans everywhere may have their options constrained by New York (or California, or Texas) because either certain products may not be offered (if one large state prohibits them) or state compliance costs will be passed on to customers nationwide, requiring products that *are* offered to cost more.

State legislators and regulators have incentives and obligations to create policy that they believe benefits their state without much regard for its effect on others.[526] Policies that internalize benefits and export costs are a likely consequence.[527] For example, New York's BitLicense is designed to respond to the internal policy preferences and political bargains that affect New York, its citizens, and its policymakers.[528] The NYDFS did not wait for other states to come to a general agreement, nor did it adopt any of the previous paths used by states to that point (ignoring virtual currencies, fitting them under existing regulations, or modifying existing regulations). Of course, New York is not unique in this respect: each state reacts in its own way on the basis of political and policy preferences within the state. Such reactions, however, can result in a muddle—multiple conflicting regimes effectively regulate people without providing them with any meaningful recourse.[529] Contrast this situation with federal

524. *See supra* Parts III.A.1, III.A.3, III.B.2, III.C.1, and III.D.3.

525. *See* Hughes & Middlebrook, *supra* note 241, at 511–12.

526. *Cf.* Int'l Paper Co. v. Ouellette, 479 U.S. 481, 494–95 (1987) (contrasting the cost-benefit analysis that a federal regulator, the state where an activity occurs, and a state downstream are likely to perform in the context of regulating water pollution).

527. Issacharoff & Sharkey, *supra* note 13, at 1387–88.

528. *See* N.Y. COMP. CODES R. & REGS. tit. 23, §§ 200.1–.22 (2017); Hughes & Middlebrook, *supra* note 241, at 542.

529. Issacharoff & Sharkey, *supra* note 13, at 1355.

regulation, which gives far more people at least the opportunity to participate in the decision-making, even if the ultimate outcome is not what everyone desires.[530]

Thus, even in cases of high political salience, federal action to address spillovers can be appropriate. Such action allows for democratic input from, and accountability to, all the citizens who have their autonomy limited by the regulation. Federal regulation is also not per se deregulatory, because it will likely reflect a compromise between citizens of more restrictive states and those of less restrictive states, resulting in a rule that is too restrictive for some states and not restrictive enough for others.[531] Furthermore, although costs and benefits may not be spread exactly evenly because state economies differ, it will not be as simple for policymakers to export the costs of regulations to outsiders. Better, more responsive policy will likely result, however, because the country is not held hostage by a handful of states that are effectively avoiding the full costs of their regulations.

Critics of laws that allow a company to export its home state's law, such as laws governing interest rates, worry about a "race to the bottom."[532] That concern is also commonly cited in discussions of state corporate chartering, with a long line of scholars worrying that states (most notably Delaware) race to the bottom of investor protection to attract corporations and the fees that come with them.[533] Other scholars believe that competitive federalism in corporate charters is a race to the top, leading to more efficient corporate law.[534]

When considering the risk of a race to the bottom, one must remember that consumers are not powerless and can choose to avoid bad products. Consumer choice gives companies an incentive to (1) seek out legislation that is attractive enough to the customers and investors they want to do business with, and (2) avoid exploiting such legislation to disadvantage consumers. Likewise, states have an incentive to pass laws that attract customers and to avoid passing laws seen as undesirable. States also have an incentive to avoid laws that are seen as so exploitive that they mobilize the public or interest

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530. *See supra* notes 510–16 and accompanying text.

531. Issacharoff & Sharkey, *supra* note 13, at 1373.

532. Lalita Clozel, *State Regulators Balk at OCC Fintech Charter*, AM. BANKER (Aug. 19, 2016, 5:08 PM), https://www.americanbanker.com/news/state-regulators-balk-at-occ-fintech-charter [https://perma.cc/SK7Z-3SVK] ("Massachusetts Commissioner of Banks David Cotney also said a federal charter [which would grant interest rate and money transmission home-state export] could trump state consumer protection and licensing rules, which would be 'the beginning of a race to the bottom.'").

533. *See, e.g.*, Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 594–95 (2003) (describing the "race to the bottom" theory).

534. *Id.* at 596 (describing the "race to the top" theory).

groups to appeal to the federal government for preemption. By contrast, in a world where certain states de facto regulate a national market and prevent products with certain characteristics from being viable, consumers have their choices limited without their input or consent.

States have strong competitive incentives to create good laws, and they also have strong incentives to avoid creating bad laws that prompt federal intervention. The threat of federal preemption can be a powerful check on any potential race to the bottom. As Professor Mark Roe points out in the context of state chartering of corporations, corporate law is a product not only of the states but also of the federal government.[535] As Roe says, "all corporate law could be federal law."[536] This means state action, especially for a dominant state like Delaware, is done with the threat of federal intervention in mind.[537] In the corporate context, the federal government has intervened through direct action[538] and through threat of action.[539] It is not that states cannot compete; rather, (1) the bounds placed by the federal government, or by the areas in which it hesitates to enter, limit the scope of competition[540] and (2) that competition can end in federal displacement of state law if things go awry.[541]

Concerns about a race to the bottom in fintech can be answered in a similar way. Creating a regime akin to that found in bank interest rate export requires a consensus at the federal level, and if such a regime is more harmful than helpful, the federal government can either displace the problematic state laws or remove the exporting capability.[542] States, for their part, have an incentive to avoid becoming too aggressive for fear they will lose their ability to regulate (and collect the attendant fees). The expansion of the CFPB into the interest rate debate, in the context of both the *CashCall* case and the Payday Rule, indicates federal policing of consumer issues is a very

535. *Id.* at 598.

536. *Id.* at 597.

537. *Id.* at 598, 639–40.

538. *Id.* at 610, 633 (discussing various direct federal interventions into corporate governance).

539. *Id.* at 601–07 (discussing incidents where the threat of federal action affected Delaware's positions). A clear example provided by Professor Roe is the debate around Delaware's 1988 anti-corporate takeover law. *Id.* at 605. Roe points to comments by the head of the Delaware State Bar Association's corporate law committee arguing for a law that was not maximally restrictive (which would be best for incumbent corporations) because such a law might risk federalization of the issue. *Id.*

540. *Id.* at 639.

541. *Id.* at 624 (discussing the preemptive effect of NSMIA).

542. *See* discussion *supra* Part III.A.2.

real possibility in the long term, making the threat of federal intervention credible.

D. Let's Not (Always) Make a Federal Case out of It

Many of the circumstances previously discussed involve companies operating at a national level while dealing with state regulation. The proposed changes to Rule 147 reflected the opposite concern. Rule 147 offerings are, by their nature, intrastate,[543] but the SEC considered imposing substantive regulations on those offerings.[544] The SEC's regulatory hook was issuers' use of an instrumentality of interstate commerce—the Internet.[545] That hook is likely sufficient under current jurisprudence,[546] but the SEC ultimately chose (wisely) not to use its authority to impose substantive requirements, instead deferring to the states.[547] Unlike the other examples—as this Section explains—efficiency, competitive equity, and political equity could not support federal regulation.

Intrastate offerings are inherently limited to a single state, use of the Internet notwithstanding. Hence, conflicting state laws are consistent with efficiency. The costs of monitoring legislative and regulatory developments are limited because there is only one state with jurisdiction over a particular issuer. Ironically, the injection of substantive federal regulation would decrease efficiency by increasing the number of applicable rule sets and the number of regulators that need to be monitored. Also important, adding the SEC to the regulatory mix could delay regulatory adaptation because the federal government is likely to be less responsive to local concerns than the states would be.[548] Likewise, intrastate offerings do not need federal regulation to provide competitive equity because every company conducting a Rule 147 offering in a given state will be regulated by that state.[549]

Finally, political equity would not justify federal regulation because Rule 147 offerings are, by their terms, limited to cases where the company is effectively linked to the state and the investors are residents of the same state. All the parties affected by the regulation have some amount of democratic access and means of promoting

543. *See supra* note 430–34 and accompanying text.

544. *See supra* notes 442–43 and accompanying text.

545. *See supra* note 435 and accompanying text.

546. *See supra* note 463 and accompanying text.

547. *See supra* notes 456–60 and accompanying text.

548. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6.

549. *See supra* note 452 and accompanying text.

accountability.[550] Accordingly, the relevant state legislature and regulators have a strong incentive to create properly balanced regulations and enforcement because both the costs and the benefits will be felt within the state.[551]

One question that Rule 147 does present concerns the resales of securities initially offered under Rule 147 by the original purchaser to out-of-state parties.[552] Such resales reintroduce an interstate element to the transaction. Thus, it is appropriate that federal rules govern the resale. First, under Rule 147, the securities cannot be sold across state lines for the first six months after the initial purchase.[553] After that period, if the offering were public under the state's laws, the securities would presumptively be eligible to use the resale exemption found in Section 4(a)(1) of the Securities Act of 1933.[554] Private securities resales can rely on the provisions of Rule 144.[555] Although the exemption found in Section 4(a)(1) is broad, it represents a choice made at the federal level to exempt such offerings. If public policy needs dictated, Congress could change the rule.

Given the above considerations, although the federal government *can* impose substantive requirements on Rule 147 initial offerings or on other intrastate transactions with similar characteristics, it should not. The mere presence of an instrumentality of interstate commerce does not overcome the fact that the economic and political realities of the transactions place them within the individual states without the "leaking"[556] found in the other cited markets.

V. WHAT SHOULD BE DONE?

As this Article demonstrates, the allocation of regulation for certain fintech transactions is frequently harmful to efficiency, competition, and political equity. What should be done to mitigate these issues and create greater regulatory consistency? Change can come from federal regulators, Congress, the states themselves, or the courts, although these routes may vary in their effectiveness.

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550. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6.

551. *Id.*

552. The Author is indebted to an anonymous reviewer who raised this question.

553. 17 C.F.R. § 230.147(e) (2017).

554. 15 U.S.C. § 77d(a)(1) (2012).

555. *See* 17 C.F.R. § 230.144 (allowing the public resale of restricted securities in some cases); *see also Rule 144: Selling Restricted and Control Securities*, SEC (Jan. 16, 2013), https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html [https://perma.cc/95N5-PWWC].

556. Letter from author & Staci Warden to Brent J. Fields, *supra* note 440, at 6.

A. Who Should Write the Rules?

Who writes the rules, and to whom the writers are answerable, are the core questions posed by the previous examples and by many fintech issues more broadly. Rules can come from numerous sources and can conflict, complement one another, or exist on parallel tracks. Among the parties that may write rules are federal regulators, Congress, and the states themselves. All have a potential role to play in providing more consistent and equitable regulation, though they may not all have the same chance of success.

Federal regulators already possess considerable power to impact fintech regulation. For example, consider a special-purpose bank charter for fintech firms, such as the one being pursued by the OCC.[557] This charter, though not without controversy,[558] could help address the competitive disadvantage fintech faces. It is unclear, however, whether the charter will help anyone but the largest fintech firms that focus on affluent customers. If the OCC's charter simply applies regulations built for universal banks to much more limited companies, or if it otherwise imposes significant costs,[559] it may be of little value to new entrants that lack the resources to manage the associated regulatory burden. Likewise, if the OCC regulates fintech firms, which rely on speed and nimbleness to survive, in the same way that it regulates banks, the fintech firms—especially newer, smaller firms that are still finding their way—may not remain viable. Given that many fintech lenders offer higher-interest products, the informal regulatory pressure against high rates may make the charter unworkable. Even if the charter is viable only for larger players that serve prime customers, it would allow those firms to compete on a more even playing field. In that case, the charter would benefit some

557. OFFICE OF THE COMPTROLLER OF THE CURRENCY, SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE 2 (2016).

558. *See, e.g.*, Letter from Sens. Sherrod Brown & Jeffrey A. Merkley, to Thomas Curry, Comptroller of the Currency, Office of the Comptroller (Jan. 9, 2017), http://brown.senate.gov/download/occ-fintech [https://perma.cc/ETV2-PNBV] (expressing concern over the special-purpose bank charter and questioning the OCC's legal authority to offer one); Letter from John W. Ryan to Thomas Curry, *supra* note 502 (opposing the special-purpose bank charter and raising questions as to whether the OCC has the necessary statutory authority to issue a "fintech" charter).

559. For example, the OCC is considering imposing enhanced capital requirements and CRA-like obligations, and potentially requiring more onerous small-business borrower "protections" as a condition of granting a fintech charter. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE NATIONAL BANK CHARTERS FOR FINTECH COMPANIES 12 (2016), https://www.occ.gov/topics/bank-operations/innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf [https://perma.cc/QDW2-Y2XH].

consumers, but it nevertheless would miss an opportunity to serve a broader population.

The bank regulators could also seek to address the harm and uncertainty done by the *Madden* decision to marketplace lending[560] via regulation.[561] Promulgating a rule holding that under federal law a valid loan made by a bank does not become invalid once sold to a nonbank would preempt state laws to the contrary[562] and be consistent with the OCC's previously stated position on the power of banks.[563] Such a rule could also potentially address the "true lender" question[564] if it holds that a bank is not required to retain a "predominant economic interest" in a loan in order to exercise its power to lend. Such a rule would no doubt be controversial, and it would only treat a symptom caused by the unfair and inefficient regulatory system currently facing fintech firms—rather than the underlying cause—but it would help address at least some of the practical harms to credit access caused by inapt state regulation.

Congress has even more flexibility. Congress could create a regime that provides consistency, avoids unnecessary duplication, and is accessible to new firms that may not be large enough to benefit from a bank charter. Hughes and Middlebrook advocate a bifurcation of responsibility between the states and federal government.[565] This division would be based on which level of government has the most experience regulating the different aspects of a cryptocurrency transaction (for example, anti-money-laundering issues would be left to the federal government and payment execution regulation to the states).[566] Similarly, Congress could federalize certain aspects of regulation in which state-by-state differences are most harmful, while leaving other aspects to the states, such as allowing a state lending or money transmission license to serve as a passport between states. That approach would be similar to the regulation of state banks, for which federal action permits interest rate export, but much of the rest

560. *See supra* notes 100–22 and accompanying text.

561. BRIAN KNIGHT, MERCATUS ON POLICY: RISKS TO INNOVATIVE CREDIT POSED BY EMERGIN REGULATORY AND LITIGATION TRENDS 4 (2017) https://www.mercatus.org/system/files/knight-risks-innovative-credit-mop-v1.pdf [https://perma.cc/GV45-2SBV]; Brian Knight, Comment Letter on Examination Guidance for Third-Party Lending 2 (Oct. 17, 2016), https://www.mercatus.org/system/files/mercatus-fdic-guidance-third-party-lending.pdf [https://perma.cc/MX2Y-9BLU]; *see also* Alan S. Kaplinsky, *OCC Must Stand up for Preemption*, AM. BANKER (Mar. 20, 2017, 12:00 PM), https://www.americanbanker.com/opinion/occ-must-stand-up-for-preemption [https://perma.cc/MXR9-4S37].

562. *See* Smiley v. Citibank (S.D.), N.A., 517 U.S. 735, 744 (1996).

563. *See supra* notes 112–13 and accompanying text.

564. *See supra* notes 147–51 and accompanying text.

565. Hughes & Middlebrook, *supra* note 241, at 549.

566. *Id.*

of the regulation remains at the state level.[567] The challenge is determining which functions or criteria should be federalized and which should remain under state control.

The states themselves can also harmonize their requirements, as they have done with Article 4A of the Uniform Commercial Code, which governs the transfer of funds.[568] It is unclear whether any of the fintech-related model laws discussed here will ultimately matter, however. Those laws not only need to gain sufficient traction to be widely adopted, but they must remain sufficiently consistent over time. Only then can fintech firms have confidence in their regulatory environment and avoid expensive monitoring costs. Experience to date suggests that success is unlikely. The states have not harmonized their lending and money transmission laws, even ignoring Congress's call to harmonize such laws.[569] Future harmonization is unlikely without federal government action.

Another option, advocated by Professor J.W. Verret, would be to allow for home-state charter recognition akin to how states respect the corporate law of other states.[570] There is a long history of state corporate charter recognition,[571] but the same tradition of political comity does not exist for financial firm charters.[572] States are unable to compete with one another to offer the best legal regime because firms need to comply with every state's law. As Verret acknowledges, somewhat akin to state banks, it is likely the federal government will need to compel that recognition if it is to occur at all.[573]

It may make sense to allow companies to opt into federal fintech regulation that overlaps with state law. Companies that operate in only a single state or a few states may be able to comply with those state laws more efficiently than with an overarching federal regime, and providing opt-in will allow companies to avoid regulatory regimes that are inefficient or that put them at a competitive disadvantage. That approach would ensure regulatory

567. *See supra* note 60 and accompanying text.

568. Hughes & Middlebrook, *supra* note 241, at 519; *see also* Gerken & Holtzblatt, *supra* note 507, at 94 (citing the UCC as an example of an effective solution to inconsistent laws among states).

569. *See supra* notes 191–95 and accompanying text.

570. Verret, *supra* note 11, at 35–36.

571. *Id.* at 13–14.

572. *Id.* at 36.

573. *Id.* at 36–37. The current dual banking system is considered by some to encourage this sort of salutary regulatory competition. *See, e.g.*, Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 32 (1977). *But see* Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 683–93 (1988) (arguing that the dual banking system does not encourage competition so much as rent splitting between federal and state governments).

coverage, but it would allow companies that operate only in a single state or a few states to avoid a federal regime that may not be appropriate for them. The opt-in method might encourage competition between the states and federal government. However, it is possible an opt-in regime could negate the benefits of a federal system if state regulation created sufficiently costly spillovers for which the companies did not pay, giving companies insufficient incentive to move to the federal system.[574]

Policymakers may also consider whether hybrid regulation, in which the states' and federal government's regulatory regimes overlap or coexist, is appropriate. Even in areas of significant federal preemption, states are able to enforce laws that are not explicitly preempted.[575] It may make sense to explicitly federalize only those elements of regulation where the state-by-state model impinges on efficiency, competitive equity, and political equity, while leaving other issues to the states. Determining which is which, however, would be the challenge.

Hybrid regulation can also include coextensive regulation, which may be more problematic. For example, Section 1041 of Dodd-Frank precludes preemption of state laws that offer "greater" consumer protection.[576] As a result, states that embrace "greater" consumer protection are able to set policy for themselves and potentially for other states. Other states that favor less "protective" rules (as defined by the CFPB) are precluded from exercising sovereignty.[577] This arrangement denies certain states political equality without providing offsetting efficiency benefits. As Professor Michael Greve points out, hybrid regulation, in which the federal government sets a floor but not a ceiling, does not create consistency, but rather can serve as a jumping-off point for further idiosyncratic state regulation.[578] Although commentators have raised concerns that preempting state law will weaken consumer protections,[579] the better

574. The Author is grateful to one of the anonymous peer-reviewers for raising this concern.

575. *See, e.g.*, 12 U.S.C. § 25b (2012) (narrowing the scope of federal preemption of state consumer financial laws).

576. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1041(a)(2), 124 Stat. 1376, 2011–12 (2010) (codified as amended at 12 U.S.C. § 5551(a)(2) (2012)).

577. *Id.* (deeming that Dodd-Frank only preempts state law to the degree it is inconsistent, but that state "statutes, regulations, orders, or interpretations" that provide consumers with "greater" protection, as determined by the Bureau, is not inconsistent).

578. Michael S. Greve, *Business, the States, and Federalism's Political Economy*, 25 HARV. J.L. & PUB. POL'Y 895, 903 (2005).

579. *See, e.g.*, Bar-Gill & Warren, *supra* note 32, at 81–82.

answer may be to create uniform rules adequate to provide appropriate protection to govern the national market.[580]

B. Who Should Enforce the Rules?

The previous Section focused on the rules to which market actors are subject. However, the question of who enforces those rules—or threatens to enforce them—is also important. The question can arise in cases where state laws or rules are so broad that they may allow a regulator to bring enforcement actions against companies that have weak or tangential ties, and in cases where there is a common rule but multiple regulators share jurisdiction—situations that can lead to a consistent rule in theory becoming an inconsistent rule in practice.

The enforcers of regulations, such as the states' attorneys general and banking commissioners, are not immune to the temptation to capture benefits while exporting costs.[581] Although attorneys general and commissioners may be sensitive to the political preferences of their state, they are less concerned with the perception of out-of-state residents, who lack a direct means of applying political pressure to check the enforcers' actions.[582] That situation might encourage regulators to stretch their authority over companies without political means of redress.

For example, given the scope of the BitLicense,[583] the NYDFS could use its virtual currency regulations to bring an enforcement action against a company that may have only tangential or incidental ties to New York (if any at all). The NYDFS may wish to bring an action because it feels it is justified on the basis of a company's conduct, but it may also be motivated by political factors such as wishing to appear tough or making an example of a foreign firm to change licensed firms' behavior. The NYDFS may also be motivated to pursue foreign firms because those firms lack the means of political response that domestic firms possess. The threat of litigation could chill activity outside New York for fear of an enforcement action that could bankrupt a company even if that company successfully resisted.[584]

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580. *See supra* note 464 and accompanying text.

581. PAUL NOLETTE, FEDERALISM ON TRIAL 210–11 (2015) (looking at the impact of state attorneys general and their litigation on national markets).

582. *Id.* at 211.

583. *See supra* note 275 and accompanying text.

584. A related example, albeit one with limited chance of bankruptcy, is the New York Attorney General's use of New York's Martin Act, N.Y. GEN. BUS. LAW §§ 352–353 (McKinney 2017), a law that empowers the New York Attorney General to launch sweeping investigations

Even in areas with robust federalization, such as bank regulation, the states are not completely excluded.[585] In fact, Dodd-Frank goes even further in Section 1042,[586] which empowers state attorneys general and regulators to bring civil suits to enforce Dodd-Frank's consumer protection provisions (though they are limited to enforcing CFPB regulations against banks).[587] That provision places state regulators in a position to enforce not only their states' non-preempted laws, but also federal law. Arguably, this nonexclusive approach to enforcement invites disparate treatment, depending on how the various attorneys general interpret the law. The approach risks creating fifty or more different interpretations of the same law. It could, in turn, lead to inefficient inconsistency, usurpation of authority by states with aggressive attorneys general, and the imposition of externalities on other states without democratic redress.[588]

Considering the unpredictability of state-by-state regulations for particularly sensitive transactional elements, federal enforcement should provide more consistency and allow real—albeit imperfect—redress to those affected. This is not to say that federal enforcement is guaranteed to be good enforcement.[589] However, federal enforcement may be able to provide consistent application of the rules nationwide, as well as among competitors, and may be subject to broad political accountability. These attributes recommend it for cases where the true nature of a transaction is interstate.

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into possible financial fraud, to investigate ExxonMobil for failing to write down the value of its oil reserves as a means to facilitate an investigation driven by concerns about climate change, rather than securities fraud. *See, e.g.*, Christopher M. Matthews, *New York AG Employs Powerful Law in Exxon Probe*, WALL ST. J. (Sept. 16, 2016, 5:38 PM), https://www.wsj.com/articles/new-york-ag-employs-powerful-law-in-exxon-probe-1474061881 [https://perma.cc/5JXS-C72G].

585. *See, e.g.*, Cuomo v. Clearing House Ass'n, LLC, 557 U.S. 519, 536 (2009) (holding that federal banking regulations did not preempt a state's ability to enforce state lending law).

586. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1042(a)(1), 124 Stat. 1376, 2012 (2010) (codified as amended at 12 U.S.C. § 5552(a)(1) (2012)).

587. *Id.* § 5552(a)(2).

588. NOLETTE, *supra* note 581, at 211.

589. Examples of flawed enforcement abound. For those on the right, Operation Choke Point and the FDIC's treatments of financial institutions that offered refund-anticipation loans are examples of federal regulatory abuse. *See supra* notes 70, 224–27 and accompanying text. For those on the left, the perceived capture of financial regulators in the run-up to the 2007–2009 financial crisis shows how federal regulators can fall down on the job. Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 2049 (2014) ("While the financial regulatory system [pre-2008 crisis] was undoubtedly outdated in many ways, it is hard to deny that capture [of financial regulators by regulated entities] played some role, if not the leading role, in the crisis.").

Determining who should enforce is difficult given the variables and trade-offs that encumber every example. In many of the areas previously discussed, the interests of efficiency, competitive equity, and political equity argue for more federalization of enforcement, though the states are likely in the best position in cases of intrastate transactions.

C. What About the Courts?

Finally, the courts have a role to play. As the jumble that is "true lender" law demonstrates, uncertainty imposed by litigation can harm efficiency and competition, and it can privilege some citizens over others. Providing clarity on who has the right to write the rules—and consistency on questions such as whether a lending contract applies—will help both market participants and citizens, who, to the extent that they are displeased with the courts' consensus, can lobby Congress to make a change.

VI. CONCLUSION

Financial technology is changing how people access financial services and who provides those services. The dramatic and rapid changes are placing significant stress on the regulatory and legal framework for financial services, including the balance of authority between the federal government and the states. Often, the current allocation leads to harmful inefficiency and a lack of competitive and political parity. In those cases, federal policymakers should consider federalizing fintech regulation and displacing state-by-state rules to an appropriate degree. However, in cases where the transaction is truly intrastate, the federal government should defer to the states, even if the Constitution would allow federalization. Harmonizing the level at which the markets are regulated with their economic, competitive, and political reality will lead to a more competitive, efficient, and just result. Such harmonization will help consumers, market participants, and the country as a whole flourish.

Appendix 2

MERCATUS ON POLICY

Modernizing Financial Technology Regulations to Facilitate a National Market

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July 2017

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CURRENT TECHNOLOGY ALLOWS NONBANK

financial service providers to compete on a national scale with banks more effectively in areas including lending and money transmission.[1] While these firms may be able to offer services at lower cost[2] and lower risk[3] while improving access to underserved customers,[4] they also face challenges from the existing regulatory structure. If these challenges are not successfully addressed, they risk denying consumers the benefits of innovation and competition that financial technology (fintech) can provide.

The inadequacy of the existing regulatory structure is particularly evident in the allocation of regulatory responsibility between the states and the federal government. Banks frequently are subject, via federal law and state comity, to relatively uniform legal rules in important areas like licensing[5] and the laws governing interest on a loan.[6] Conversely, nonbank fintech firms providing lending or money transmission services are generally subject to inconsistent state-by-state regulation.[7] Nonbank fintech providers thus operate at a disadvantage compared with banks, and the unequal treatment of banks and nonbank firms causes both inefficiency and inequity in the financial marketplace. Table 1 illustrates the differences in regulatory treatment for certain issues between national banks, state banks, and nonbank financial institutions.

PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

The choice between federalization and state regulation is a continuum, not a binary decision, Banks, despite the uniformity owing to federal preemption that they enjoy in many areas, are still subject to significant state regulation in certain cases. The current regime of burdensome state regulation for nonbank

Table 1. Select Regulatory Differences between Banks and Nonbanks

REGULATORY BARRIER	NATIONAL BANK	INSURED STATE BANK	NONBANK FINANCIAL INSTITUTION
Laws governing interest on loans	exportation of home state law[a]	exportation of home state law[b]	law of borrower's state applies[c]
State lender licensing	exempt[d]	generally exempt[e]	state license required[f]
Money transmission licensing	exempt[g]	generally exempt[h]	state license required[i]

Notes: [a]*National Bank Act, 12 U.S.C. § 85 (2015); see also Marquette Nat. Bank v. First of Omaha Corp., 439 U.S. 299 (1978); 12 C.F.R. § 7.4001(a)(1997) (allowing banks to use their home state's definition of what constitutes interest nationwide); Smiley v. Citibank (S.D.), N.A., 517 U.S. 735 (1996) (upholding same).*

[b]*The Depository Institutions Deregulation Act of 1980 (12 U.S.C. § 1831d(a) (2015)) (granting the same power to state-chartered, federally insured banks); FDIC, General Counsel's Opinion No. 10: Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998) citing 12 C.F.R. § 7.4001(a) (1997) and 12 C.F.R. § 560.110(a)(1997) (allowing banks to use their home state's definition of what constitutes interest nationwide); Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992) ("The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act in pari materia. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way.").*

[c]*John L. Douglas, "New Wine into Old Bottles: Fintech Meets the Bank Regulatory World," North Carolina Banking Institute Journal 20, no. 1 (2016): 17, 31–32; letter from Manuel P. Alvarez, chief compliance officer for Affirm, Inc., to US Treasury, September 30, 2015, 7; letter from Sam Hodges, managing director for Funding Circle, and Conor French, general counsel, to US Treasury, September 30, 2015, 27; letter from Mitria Wilson for Oportun to US Treasury, September 30, 2015, 11–14; letter from Robert Lavet, chief legal officer for Social Finance, Inc., to US Treasury, September 30, 2015, 3–5.*

[d]*US Department of the Treasury,* Opportunities and Challenges in Online Marketplace Lending, *May 10, 2016, 6; Douglas, "New Wine into Old Bottles," 34.*

[e]*Department of the Treasury,* Opportunities and Challenges, *6; Douglas, "New Wine into Old Bottles," 34.*

[f]*Department of the Treasury,* Opportunities and Challenges, *5; Douglas, "New Wine into Old Bottles," 32.*

[g]*Kevin V. Tu, "Regulating the New Cashless World,"* Alabama Law Review *65, no. 1 (2013): 77, 89. See also Bryan Cave LLP. "The Latest in Money Transmitter Licensing," February, 19, 2015, slide 20.*

[h]*Tu, "Regulating the New Cashless World," 69; Bryan Cave LLP, "The Latest in Money Transmitter Licensing."*

[i]*Tu, "Regulating the New Cashless World," 86–89.*

fintech firms creates three separate but interrelated problems: (1) it harms consumers by forcing fintech firms into an inefficient regulatory environment; (2) it damages competitive equity by differently regulating firms that offer similar services; and (3) it risks violating political equity among citizens of different states because some states de facto regulate the national market. Fortunately, there are ways to address these problems, which will be discussed below.

Inefficiency

Being forced to obtain licenses from each state in which a nonbank firm wishes to do business can be costly and time consuming.[8] In addition to the cost and delay of obtaining licenses, different states impose different substantive requirements regarding licensing[9] and what products or services licensed firms can provide.[10] This inconsistency can also impose significant ongoing "search costs" on firms as they need to constantly monitor each state for changes in the law.[11] This inefficiency can make it hard for firms to offer products, which has led many firms, especially in the lending space, to partner with banks to take advantage of the banks' federally granted preemption.[12]

The bank-partnership model addresses the inefficiencies of state-by-state regulation, but it does so at a cost. The direct costs include the banks' compensation for their participation and the added complexity required to structure the transaction. But there are also indirect costs, including uncertainty about enforceability, which has been exacerbated by recent litigation and state regulatory action.

These actions include the recent *Madden v. Midland Funding, LLC* decision,[13] in which the United States Court of Appeals for the Second Circuit held that a loan originally valid when made by a bank could subsequently become usurious and invalid once sold to a nonbank. While this decision does not directly involve innovative nonbank lenders, it does strike at

While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help.

the heart of the bank-partnership model, which relies on banks selling loans to nonbanks for servicing.

The *Madden* court's reasoning has affected the nonbank lending market. Loan volume for borrowers with relatively low credit scores seeking to use innovative lenders has declined significantly in 2016 relative to 2015 in the areas covered by the Second Circuit, while it has increased outside the Second Circuit.[14] Additionally, other parties have adopted the reasoning of *Madden* to directly attack the bank-partnership model, arguing that even if a loan is valid when made by a bank, it can become invalid when sold to a nonbank firm. For example, Colorado's Uniform Consumer Credit Code administrator has sued two marketplace lenders alleging that the loans made by their bank partners were invalid, in part based on the claim that once the loans were sold to the nonbank lender, the loans lost the benefit of exporting the bank's home state law.[15]

In addition to the issue of loans that were valid when made, the issue of who is the true lender in a bank partnership—and whether it should matter—also calls the validity of the bank-partnership model into question. Some courts have held that the contractual relationship between the borrower and the bank controls[16] because looking beyond the contract would intrude on the powers provided to banks by federal law.[17] Other courts have held that the party with the "predominant economic interest" in the loan (i.e., the most to gain or lose based on the loan's performance) is the true lender and that the laws that apply to that entity govern the loan.[18] Concerns about true lender issues have caused firms and their bank partners to distort their contractual relationships in ways that seek to avoid invalidation of the loan but do not provide greater efficiency or benefit to customers.[19]

Competitive Equity

Nonbank fintech firms turn to banks to avoid the inefficiencies of state-by-state regulation, indicating that banks enjoy a competitive advantage, despite the similarity of the products and services being offered. For example, the loans that Colorado is attacking would be unquestionably legal if made by a bank. The disparate treatment makes even less sense when one considers that nonbank lenders are governed by the same federal consumer protection laws as banks.[20] Likewise, nonbank money transmitters are subject to federal consumer protection and anti-money-laundering law[21] similarly to banks.

This disparate treatment of similar products runs contrary to "the principle that institutions offering similar products should be subject to similar rules."[22] Senator Dale Bumpers made this statement in the context of the debate about whether competitive fairness demanded that interest rate exportation be provided to state banks on the same terms as it was provided to federal banks.[23] A similar dynamic exists today between banks and nonbank fintech firms, where the differences in regulation are not driven by differences in risks generated by the firms' activity but by the charter or license status of the firms.

Political Equity

Competitive equity isn't the only type of fairness imperiled by state-by-state regulation of fintech firms. There is also the risk that a state, especially a state that represents a large share of the market, will end up de facto regulating the national market. The New York Department of Financial Services (NYDFS) acknowledged as much in its complaint

against the Office of the Comptroller of the Currency (OCC) when NYDFS sought to stop the OCC's fintech bank charter (discussed below).[24] NYDFS's statement that "New York is a global financial center and, as a result, [NY]DFS is effectively a global financial regulator"[25] is not inaccurate, but it highlights the problem. While NYDFS may have global reach, it does not have global political accountability. The citizens of other states have no means of democratic redress against the NYDFS (or the regulators of other large and systemically important states).

This dynamic presents a problem for fintech firms because they will face significant economic and regulatory pressure to limit their national product offering to conform to state specific rules. For example, New York's licensing regime for virtual currencies—the "BitLicense"—claims a sweeping jurisdiction, including any virtual currency transaction (as defined by the rule) that involves New York or a New York resident.[26] Given New York's importance to the financial system, it is questionable whether a firm seeking to establish a viable business could elect to avoid New York. Given the breadth of New York's rules, firms would rightly be concerned that even if they intended to avoid New York, the NYDFS would consider them covered by New York law. Even if a firm were to successfully defend an enforcement action on the grounds that the NYDFS lacked jurisdiction, the diversion of resources away from competition to litigation could fatally cripple a company.

If firms must change their national products to comply with a specific state's rules, then the residents of other states must also bear with their choices being limited by rules they have no control over. State regulators and legislators have an incentive to act in the best interests of their state (or the most powerful political factions therein), even if this means imposing costs on other states.[27] Conversely, federal law and regulation is driven ultimately by the laws Congress passes, and Congress is accountable to the country as a whole.

WAYS TO ADDRESS THE PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help modernize and streamline fintech regulation and make it more efficient and equitable.

Federal Regulators

Federal regulators—in particular the OCC, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve (Fed)—can address at least some of the problems facing fintech lenders and money transmitters.

- *Address "valid when made" and "true lender" issues via regulation.* The United States solicitor general and the OCC have correctly taken the position that the Second Circuit's Madden decision is incorrect as a matter of existing law and that a national bank's power to lend includes the power to sell the loan and have it remain valid.[28] The Federal Deposit Insurance Act[29] should be interpreted in parallel[30] to convey the same power to state banks. Therefore, regulators could clarify via rulemaking that a bank may sell a loan without undermining the loan's validity. Additionally, bank regulators should clarify that the power of a bank to make a loan it plans to sell does not hinge on which party maintains the "predominant economic interest" in the loan.
- *Provide a viable bank charter option for non-depository firms.* The OCC has announced its intention to offer a special-purpose national bank charter for nondepository fintech firms.[31] The OCC should continue to move this project forward and should structure the charter so that it is a viable option for smaller entities, omitting needlessly onerous

or restrictive requirements. The OCC should also vigorously defend its effort against the lawsuits brought by the NYDFS[32] and the Conference of State Bank Supervisors.[33] The Fed should support the inclusion of special-purpose national banks into the Federal Reserve system as needed.

Additionally, the FDIC should clarify that the definition of "deposit" for the purpose of federal law does not include money provided to fintech banks for the purposes of money transmission.[34] The FDIC and the Fed should also support efforts by state banking regulators to pursue innovative charter structures comparable to the OCC's effort, including supporting any necessary changes to federal law.

The States

The States could still play a major and productive role in improving fintech regulation. While they are making some efforts already,[35] those efforts revolve around making it easier for firms to apply for multiple licenses and deal with multistate supervision.[36] They do not address the core problems posed by the requirement for multiple licenses and the inconsistency of state law. Truly effective reform likely will require collaboration with the federal government.

- *Harmonization and reciprocity.* The states do not need the federal government's help to make their laws more uniform and grant reciprocity for licensed entities. However, the history of state regulation in this space is not heartening. For example, Congress called on the states to harmonize their money transmission laws in 1994,[37] but to date only seven states have adopted the Uniform Money Services Act established by the Uniform Law Commission for that purpose.[38] The states could work with Congress to pass legislation that would allow for reciprocity for state-regulated nonbank financial services companies or for the exporting of certain legal provisions (for example, provisions governing interest), akin to the powers granted to state-chartered banks. States would remain the primary regulator, but it would be easier for state-licensed entities to compete on a national scale.
- *Innovative chartering and licensure.* Rather than opposing the OCC's efforts at innovation, the states should emulate (and possibly surpass) those efforts by creating new chartering options for nondepository institutions. To the extent such efforts are inhibited by existing federal law,[39] the states should work with Congress to remove those impediments to facilitate salutary competition between national banks and state-chartered or state-licensed financial institutions.

Congress

Given the interstate nature of the commerce in question, Congress has the broadest authority to address the issues posed by inapt state regulation of fintech.[40] As discussed above, there are several areas where Congress may be needed to help state-licensed entities compete at the national level. Additionally, there are other areas of federal law that can be clarified or improved to help rationalize the regulation of fintech firms.

- *Codify "valid when made" and clarify "true lender."* Congress could provide regulatory certainty by explicitly codifying the long-standing common-law rule of "valid when made"[41] and making clear that a firm does not need to maintain a "predominant economic interest" in a loan to be considered the true lender. This clarification would assist in protecting existing powers held by national and state banks.
- *Change the law to help state-based innovation.* Congress could change federal law to allow state-licensed or -chartered entities to export key provisions of their home state's law (for example, provisions governing interest) and

mandate reciprocity for certain licensed activities (for example, money transmission licensing). Congress also could amend the Federal Deposit Insurance Act and other laws to allow state-chartered nondepository banks to enjoy the relevant powers of a bank granted to insured depositories.

- *Modernize tools to resolve uninsured nondepository banks.* As Acting Comptroller Keith Noreika recently testified, the power of the OCC to place a noninsured bank in receivership relies on law going back to the passage of the National Bank Act and needs to be modernized.[42]

Additionally, Congress could amend the bankruptcy code to expand its application beyond noninsured state banks that are members of the Federal Reserve system to include, at a minimum, nondepository national banks.[43] In cases where receivership is unlikely to be necessary to protect customers, failing firms should go through bankruptcy.

CONCLUSION

There are many virtues to the United States' federal system, but as the Founders understood when they granted Congress the power to regulate interstate commerce,[44] there are times when the patchwork of inconsistent state regulations is counterproductive or even pernicious. The regulation of nonbank fintech lenders and money transmitters presents one such case, with inconsistent state regulation harming efficiency, competitive equity, and political equity. Both the federal government and the states themselves have options available to help address these problems and their underlying causes. They should consider exercising those options.

NOTES

1. Brian R. Knight, "Federalism and Federalization on the Fintech Frontier" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2017). An updated version is forthcoming at Brian R. Knight, "Federalism and Federalization on the Fintech Frontier," *Vanderbilt Journal of Entertainment & Technology Law* (forthcoming).
2. Yuliya Demyanyk and Daniel Kolliner, "Peer-to-Peer Lending is Poised to Grow," Federal Reserve Bank of Cleveland, August 14, 2014.
3. "Ripple eliminates the risk that payments will not reach the targeted payee once the payer initiates the transaction. . . . Either the entire transaction happens or none of the steps happen at all." Marcel T. Rosner and Andrew Kang, "Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study," *Michigan Law Review* 114 (2016): 661.
4. Usman Ahmed et al., "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises," *Innovations: Technology, Governance & Globalization* 10, no. 3–4 (2015).
5. Kevin V. Tu, "Regulating the New Cashless World," *Alabama Law Review* 65, no. 1 (2013): 77, 89. Note, however, that not all states exempt other state banks from licensing. Bryan Cave LLP, "The Latest in Money Transmitter Licensing," February, 19, 2015, slide 20.
6. The National Bank Act, 12 U.S.C. § 85 (2015), allows national banks to charge the amount of interest under their home state's laws nationwide. The Depository Institutions Deregulation Act of 1980, 12 U.S.C. § 1831d(a) (2015), grants the same power to state-chartered, federally insured banks. See also Marquette Nat. Bank v. First of Omaha Corp., 439 U.S. 299 (1978); 12 C.F.R. § 7.4001(a) (1996); 12 C.F.R. § 560.110(a) (1997) (allowing banks and federal savings associations to use their home state's definition of what constitutes interest nationwide); Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735 (1996) (upholding same); FDIC, General Counsel's Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act 63 Fed. Reg. 74 (1998) (citing 12 C.F.R. § 7.4001(a)(1997) and 12 C.F.R. § 560.110(a)(1997)).
7. John L. Douglas, "New Wine into Old Bottles: Fintech Meets the Bank Regulatory World," *North Carolina Banking Institute Journal* 20, no. 1 (2016): 17, 32; letter from Manuel P. Alvarez, chief compliance officer for Affirm, Inc., to US Treasury, September 30, 2015, 7; letter from Sam Hodges, managing director for Funding Circle, and Conor French, general counsel, to US Treasury, September 30, 2015, 27; letter from Mitria Wilson for Oportun to US Treasury, September 30, 2015, 11–14; letter from Robert Lavet, chief legal officer for Social Finance, Inc., to US Treasury, September 30, 2015, 3–5; Tu, "Regulating the New Cashless World," 87–88.
8. Obtaining licenses and maintaining compliance can cost over $1 million and take more than two years. Douglas, "New Wine into Old Bottles," 46.
9. Douglas, "New Wine into Old Bottles," 32–34; Tu, "Regulating the New Cashless World," 91.
10. Thomas W. Miller Jr. and Harold A. Black, "Examining Arguments Made by Interest Rate Cap Advocates," in *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*, ed. Hester Peirce and Benjamin Klutsey (Arlington, VA: Mercatus Center at George Mason University, 2016), 346–50 (listing different state law requirements governing interest charged on loans).
11. Tu, "Regulating the New Cashless World," 112.
12. For example, Lending Club, Prosper, and PayPal all originate loans through WebBank, a state-chartered Utah industrial bank. Square partners with Celtic Bank, also a state-chartered Utah industrial bank.

and Intuit partners with Cross River Bank, a state-chartered New Jersey bank.

13. Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).

14. Colleen Honigsberg, Robert J. Jackson Jr., and Richard Squire, "What Happens When Loans Become Legally Void? Evidence from a Natural Experiment" (Columbia Business School Research Paper No. 16-38, Columbia University, New York, December 2, 2016), 28–29.

15. Amended Complaint, Julie Ann Meade, Administrator, Uniform Consumer Credit Code v. Avant of Colorado LLC d/b/a Avant, and Avant Inc., No. 17CV30377 (D. Colo. Mar. 9, 2017); Amended Complaint, Julie Ann Meade, Administrator, Uniform Consumer Credit Code v. Marlette Funding LLC d/b/a Best Egg, No. 17CV30376 (D. Colo. Feb. 15, 2017).

16. See, for example, Krispin v. May Dept. Stores Co., 218 F.3d 919 (8th Cir. 2000); Sawyer v. Bill Me Later, Inc., No. 2:11-cv-00988, 2014 U.S. Dist. LEXIS 71261 (D. Utah May 23, 2014); Hudson v. ACE Cash Express, Inc., No. 01-1336-C, 2002 U.S.Dist. LEXIS 11226, at *4, *16 (S.D. Ind. May 30, 2002); Beechum v. Navient Solutions, Inc., No. 2:15-cv-08239-JGB-KK (C.D. Cal. Sept. 20, 2016).

17. See, for example, *Hudson* at *16 ("[the plaintiff] invites the courts to draw boundaries between federal and state bank regulation depending on the subjective purpose of those engaged in the transaction and/or the precise extent of financial risk accepted by the national bank. The court sees no basis for drawing jurisdictional boundaries in such an uncertain and unpredictable way.").

18. See, for example, CashCall, Inc., v. Morrisey, No. 12-1274, 2013 W. Va. LEXIS 587, at *18 (W. Va. May 30, 2014); Spitzer v. County Bank of Rehoboth Beach, 846 N.Y.S.2d 436 (N.Y. App. Div. 2007); Kane v. Think Finance, Inc., No. 14-cv-7139, 2016 WL 183289 (E.D. Pa. 2016) (refusing to grant a motion to dismiss a complaint of conspiracy to avoid Pennsylvania usury law. The defendant was a nonbank lender who partnered with a bank and a Native American tribe.); Consumer Financial Protection Bureau v. CashCall, Inc., CV 15-7522-JFW (RAOx) (C.D. Cal. 2016) (summary judgment was granted to CFPB on August 31, 2016).

19. Kevin Wack, "Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges," *American Banker*, February 26, 2016.

20. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, 10.

21. Knight, "Federalism and Federalization," 32–33.

22. 126 Cong. Rec. 6,907 (1980) (statement of Sen. Dale Bumpers).

23. Knight, "Federalism and Federalization," 13–14.

24. Complaint for Declaratory and Injunctive Relief, Maria T. Vullo v. Office of the Comptroller of the Currency, 1:17-cv-03574-NRB (S.D.N.Y. May 12, 2017).

25. Ibid., ¶10.

26. Knight, "Federalism and Federalization," 39–40.

27. Samuel Issacharoff and Catherine Sharkey, "Backdoor Federalization," *UCLA Law Review* 53, no. 6 (2006): 1353, 1387–88; Paul Nolette, *Federalism on Trial: State Attorneys General and National Policymaking in Contemporary America* (Lawrence, KS: University Press of Kansas, 2015); Knight, "Federalism and Federalization," 72, 82–83.

28. Brief for the United States as Amicus Curiae Supporting Petitioners, Midland Funding, LLC v. Madden, No. 15-610 (U.S. May 24, 2016).

29. Codified at 12 U.S.C. § 1831d(a) (2014).

30. "The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act *in pari materia*. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way." Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992). See also FDIC, General Counsel's Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998).

31. Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016.

32. Complaint for Declaratory and Injunctive Relief, Maria T. Vullo v. Office of the Comptroller of the Currency, 1:17-cv-03574-NRB (S.D.N.Y. May 12, 2017).

33. Complaint for Declaratory and Injunctive Relief, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, 1:17-cv-00763-JEB (D.D.C. Apr. 26, 2017).

34. Lawrence D. Kaplan et al., "The OCC's Proposed Fintech Charter: If It Walks Like a Bank and Quacks Like a Bank, It's a Bank," Paul Hastings LLP, December 13, 2016 (acknowledging that funds provided to a bank for money transmission purposes may potentially constitute deposits under the Federal Deposit Insurance Act (12 U.S.C. § 1813(l)).

35. Conference of State Bank Supervisors, "CSBS Announces Vision 2020 for Fintech and Non-Bank Regulation," news release, May 10, 2017.

36. Ibid.

37. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(b)(1-5) (1994).

38. Uniform Law Commission, "Money Services Act," Enactment Status Map, accessed June 30, 2017.

39. For example, the Federal Deposit Insurance Act defines "State Bank" as a bank "engaged in the business of receiving deposits" (12 U.S.C. § 1813(a)(2)(A)) and limits the ability to export home-state interest rates to "State-chartered depository institutions" (12 U.S.C. § 1831d(a) (2015).

40. Knight, "Federalism and Federalization," 60–61.

41. Section 581 of the Financial CHOICE Act, H.R. 10, 115th Cong. (2017), Section 925 of the House Financial Services Appropriations Bill for FY 2018, H.R. 3280, 115th Cong. (2017), and the Protecting Consumers' Access to Credit Act of 2017, H.R. 3299, 115th Cong. (2017) seek to address this issue; see also Protecting Consumers' Access to Credit Act of 2017, 115th Cong. (2017).

42. Testimony of Keith A. Noreika, Acting Comptroller of the Currency, before the US Senate Committee on Banking, Housing, and Urban Affairs, June 22, 2017, 35–36.

43. 11 U.S.C. §§ 109(b)(2) and (d) (2006) preclude almost all banks from utilizing bankruptcy. See also Richard M. Hynes and Steven D. Walt, "Why Banks are Not Allowed in Bankruptcy," *Washington and Lee Law Review* 67, no. 3 (2010): 985, 986–87.

44. 44 U.S. Const. art. I, § 8, cl. 3.

About the Authors

Brian Knight is a senior research fellow for the Financial Markets Working Group at the Mercatus Center at George Mason University. He most recently worked for the Milken Institute, where he headed the FinTech and Capital Access programs. Knight has experience working for a broker-dealer with a focus on the emerging online private-placement market and was the co-founder of CrowdCheck, a company providing due-diligence and disclosure services to companies and intermediaries engaged in online private o erings. He has also served as an attorney for the federal government. He received his law degree from the University of Virginia and his bachelor's degree from the College of William and Mary.

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TESTIMONY OF EVERETT K. SANDS TO THE HOUSE FINANCIAL SERVICES COMMITTEE'S TASK FORCE ON FINANCIAL TECHNOLOGY

License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age

September 29, 2020

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Task Force Chair Lynch, Task Force Ranking Member Emmer, Chairwoman Waters, Ranking Member McHenry, and distinguished members of the Task Force, it is an honor for me to appear before you today. My name is Everett Sands, and I appreciate the Committee's interest in financial technology, and this opportunity to provide insights and information from my perspective of more than 20 years in lending, including the past five years focusing on responsible lending to underserved small businesses by leveraging financial technology.

My testimony will address several of the Task Force's areas of interest, with a focus on lending generally and on small business lending, though many of my comments are also applicable to other areas of lending, as they are closely tied in terms of the credit parameters from a consumer perspective and origination activity from financial technology ("Fintech") lenders. The single, unifying perspective that ties together my testimony is this: in lending, there are good and responsible actors and there are bad and unscrupulous actors, and it is my belief and experience that the best protection against bad actors is to take actions designed to incentivize more good actors to come into the field, making their offerings more available and crowding out the bad actors. Fintechs can have a constructive role in lending if their rates and product offerings are responsible.

And as my testimony concludes, the stakes for expanding responsible lending are enormous and the urgent need for action in this regard cannot be overstated. Small businesses and consequently the United States, are in crisis. Every day is a fight to remain open and continue doing their parts for their owners, their employees, their communities and the economy. That makes it all the more vital that there is financing available and accessible to business owners with ideas for how to pivot and for entrepreneurs with vision for new businesses for this new environment. Now more than ever, grit, plans and dreams need capital.

I. Introduction

I have more than 20 years of experience in the banking and lending fields. Prior to starting Lendistry, I worked in both national and community banking. I have served as a Board Member and an Executive for two minority deposit institutions; as a sales team leader for a national bank on both the East and West coasts; as a member of committees focused on compliance, rate-risk, and commercial lending; and as a manager of credit and operations departments. As a banker I typically served in a change agent capacity, being called in to turn around a unit of a bank, and as such, units I have led typically recorded annual growth rates of between 300% and 600%. I have closed more than $3 billion in transactions. During my career, businesses I have led have been regulated by the Federal Deposit Insurance Corporation, Federal Housing Administration, Federal Housing Finance Agency, Federal Home Loan Bank of San Francisco, Office of Comptroller of Currency, Office of Thrift Supervision, Small Business Administration, Veterans Administration and various state regulators.

Lendistry is a minority-owned and technology-enabled Community Development Financial Institution (CDFI). In fact, Lendistry is the only fintech CDFI. Our proprietary technology and online application portal enable a faster and more widely accessible lending process for small business borrowers. As a CDFI, Lendistry is dedicated to providing economic opportunities and progressive growth for underserved urban and rural small business borrowers and their communities. Lendistry also offers business coaching, financial education, and technical assistance through its nonprofit partner organization, The Center. Lendistry is a proud signatory of the Small Business Borrowers' Bill of Rights, guidelines set by The Responsible Business Lending Coalition.

I recruited a team to start Lendistry with me because I saw that consolidation trends in the community banking and regional banking segments were leaving an expanding gap in the small business lending market. Small businesses that were ready to graduate beyond financing themselves through credit cards and home equity were finding far fewer community banks available to help them take the next step in their growth so that they eventually could become large

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enough for a large regional or national bank to serve them. (The dual trends of dwindling numbers of community banks and larger banks withdrawing from the smaller end of the small business market due to operational efficiency considerations has continued and become so pronounced that I believe the definition of "underserved small business borrower" should be expanded to include a loan size threshold, and loan size has become a larger and more significant barrier to capital access for small businesses than all other traditional criteria combined.) Into this credit vacuum for small businesses, predatory lenders have proliferated and thrived.

This adverse capital availability environment for small businesses was, and continues to be, compounded for entrepreneurs with historically weaker ties to traditional banks, including women and minorities, as well as entrepreneurs based in rural areas with fewer banking options. I believed technology could play a significant role in the solution, and by approaching fintech from my banking background rather than from a technology background, I believed I could bring a somewhat differentiated lens to the market.

Since launching in 2015, Lendistry has sought to use fintech—and partnerships with financial institutions, non-profits and government organizations—to help solve the problem of disparities in access to capital, to open doors that were previously closed to small businesses owned by minorities, women, and veterans, businesses located in rural areas, or businesses whose financing needs to take the next step in their development are just too small for traditional banks.

As a hybrid of a fintech lender and community bank, and with roots in traditional banking as mentioned above, Lendistry combines the best of fintech—efficiency, scalability, and seamless user experience—with the best of traditional lending—low cost of acquisition, low cost of funds, and strong risk management—and all with an unwavering commitment to responsible credit culture and expanding access to small business funding.

Today Lendistry ranks second nationwide in SBA Community Advantage lending, a pilot program spearheaded in 2011 to increase SBA-guaranteed loans to small businesses in underserved areas. Community Advantage loans range in size between $50,000 and $250,000, and it is the only category of SBA loan in which Black and Latinx borrowers, combined, account for more than 10% of annual loan volume.

With our reach, technology, and operational and capital capacity, Lendistry has both the ability and interest to serve a much larger geographic footprint and broader market than we do today and fill the lending gaps left by mainstream finance.

As the only fintech CDFI, we believe we have a unique perspective on the ways in which fintech can expand access to underserved small businesses, and the regulatory actions that would make the greatest positive impact on bridging the substantial funding gap for small businesses, and particularly those owned by minorities, women, veterans and those in rural areas.

II. Lendistry and COVID-19 Small Business Recovery Effort

In response to the COVID-19 crisis, Lendistry has stepped up to provide desperately needed capital to small businesses struggling amid the pandemic, both as a lender and as an administrator of state and local grant programs made possible by the Coronavirus Relief Fund under the CARES Act.

The urgent need among small businesses-and particularly very small businesses and those owned by historically disadvantaged people, which data show have minimal reserve resources to withstand a prolonged downturn-has been a challenge that we at Lendistry believed from the beginning we were built to take on. The business owners we are mission-bound to serve have been suffering a crisis of financial liquidity, and we knew we possessed the relationships to

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connect with them, the technology to serve them, the experience to meet them where they are, and the technical assistance to help guide them.

What we never had before, however, were access to a very large amount of capital to deploy, and access to geographic territories outside of California. Once Lendistry was selected by Goldman Sachs' 10,000 Small Businesses Initiative to have access to $175 million in capital to deploy for PPP loans, and was granted authorization by the SBA to expand our footprint – not to all states, unfortunately, but to 12 states with large populations, diverse populations, and significant rural areas - the true power of our platform and our organization was unleashed.

During the four-month span of our PPP offering, Lendistry originated, processed and approved more than $180 million in PPP loans to more than 3,500 small businesses – which was nearly twice the loan dollar volume we funded during the preceding four years since our founding.

The major learning of PPP for Lendistry, and we believe for policymakers, is that lack of access to capital and territory were significant limiting factors to the impact that Lendistry had been able to make prior to PPP – despite the fact that Lendisty is a CDFI, a CDE and a member of the Federal Home Loan Bank of San Francisco.

Lendistry's contribution to the small business recovery effort amid the COVID-19 pandemic has not been limited to PPP, however. Another feature of the CARES Act that has gotten much less attention than PPP is the $150 billion Coronavirus Relief Fund, which allocated funds to states and large counties to deploy on a discretionary basis with certain broad parameters. Many states and counties have elected to use a portion of their allotments of Coronavirus Relief Fund dollars for small business grant programs. Because administering such a program-including designing the grant application, building an engine to process a high volume of applications according to criteria specified by the state or local authority, processing the applications, verifying information, complying with applicable federal requirements, reporting on the status, and ultimately funding the businesses approved for grants-requires very similar capabilities as were demanded of lenders by the PPP program, and because Lendistry is a CDFI and excels in partnering, the state of Pennsylvania and its network of 17 local CDFIs selected Lendistry as their administrative and technology partner for their $190 million small business grant program. Lendistry processed more than 50,000 grant applications in two weeks and will fund approximately 10,000 applicants. Through Lendistry's work with Pennsylvania's statewide small business grant program, we also were chosen as the administrative partner to four additional county programs in the state.

III. Lending Responsibly as a Fintech: How Lendistry Does It

Lendistry takes a straightforward path to lending responsibly, consisting of four key components.

First, we set a maximum interest rate. No loan we originate can have an APR exceeding 18%, and in many of our products the maximum rate is considerably lower. If a loan has a risk profile such that we would need to charge a higher rate in order to be compensated for taking the risk, it's a loan we should not or will not make, and in all likelihood it's not a loan that the borrower should be taking on, for their own sake.

Second, we manage our costs, and we do that in three ways: with low cost of funds, with strong risk management, and by keeping our customer acquisition costs far lower than most fintechs. Lendistry's access to government programs-SBA, Federal Home Loan Bank, and others-are critical to our ability to keep our costs of funds low, and they also contribute to our strong risk management by providing guarantees to a very high percentage of our loan portfolio. Lendistry's loss rate is less than 1% versus an acceptable industry standard of 5%.

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The third component of our approach to responsible lending is the technical support we make sure our borrowers have access to, whether provided directly by Lendistry or by our non-profit affiliate, The Center for Strategic Economic Studies and Institutional Development. The support our borrowers receive helps make them smarter users of credit, helps them be more effective in operating and developing their businesses, and helps them manage their loan so that it remains in good standing and so that they remain in a strong position to modify or replace their loan as their needs and market conditions warrant.

The final component of Lendistry's responsible lending approach is our ongoing efforts to partner with other financial institutions. Our partnerships can take many forms, but among the most powerful is with larger banking institutions that recognize that there are segments of their footprint that they are not serving or that they are underserving, and that the most efficient way for them to bridge that gap is by partnering with Lendistry, enabling us to use their capital to do what we do best. Alternatively, Lendistry can effectively operate a portion of a bank's lending business on a white-label basis.

IV. Acting to Incentivize and Expand Responsible Lending is the Best Protection Against Predatory Lending

The federal government already possesses systems and authorities that can and should be both empowered and harnessed to create compelling incentives for fintechs to choose to operate within a regulated framework and conduct lending activities in a responsible manner. By increasing borrowers' access to responsible sources of financing, the competitive environment for unscrupulous lenders will become more difficult, which in turn would be expected to make them less attractive vehicles for the investors who capitalize them.

Compare the incentives of the lender who is federally regulated with the ability to borrow from, for example, the Federal Reserve and obtain capital equal to many times the amount of its equity, with those of the unregulated lender who, with the same amount of equity, can only borrow a far smaller amount from a private funder. For the purposes of this comparison, assume each lender begins with $10 million in equity, and the federally regulated entity able to leverage its equity into $100 million in capital while the unregulated entity's $10 million only can be leveraged to $40 million.

With a much larger amount of capital available, the regulated lender can operate on a volume model, pricing its loans to be highly attractive to generate a high volume of originations. By contrast, the unregulated lender with less capital available due to less leverage must price its loans many multiples higher, on average, in order to achieve the same return on the initial $10 million in equity, because the unregulated lender's pricing not only must compensate for the lower amount available to lend but also must compensate for the higher default rate it can expect to incur by lending to borrowers unable to obtain loans at lower rates from the regulated entity.

<u>Possible solution: CDFI Fund in an Empowered Gatekeeper and Oversight Role</u>
Non-depository fintech lenders are by now a fixture within the financial services landscape, and while some may elect to pursue charters enabling them to accept deposits, it is important for the protection of borrowers and for the availability of financing on a responsible basis that due consideration be given to using existing systems more effectively with respect to fintech lenders. An incentives-oriented mindset is important for promoting innovation while tilting the competitive landscape against unscrupulous participants.

One such incentives-oriented solution for expanding responsible lending (and thereby narrowing the market opportunity for predatory lenders and, in turn, reducing the incentive for investors to capitalize them) begins with **the CDFI Fund**:

1. Create compelling incentives to be a CDFI, including all of the following:
    - Automatic approval to offer all SBA products

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    - Pathway/clear criteria for gaining nationwide territory approval
    - Benefit from new requirement placed on the SBA for a certain percentage of SBA loans to be made to underserved borrowers (thereby incentivizing the SBA to approve CDFIs to lend nationwide)
- Member of Federal Reserve
    - Pathway/clear criteria for directly accessing its borrowing facilities
    - Benefit from new requirement placed on Federal Reserve for a certain percentage of funds borrowed from it to be deployed to underserved borrowers (thereby incentivizing the Federal Reserve to approve CDFIs to have access to its facilities)
- Ability to lend nationally
- Benefit from new incentives to be provided to banks (e.g., triple CRA credit, additional Tier 1 capital credit) for providing capital to CDFIs
    - For CDFIs not yet approved by Federal Reserve to access its facilities, this incentive to banks would create a valuable source of capital
    - For CDFIs that become approved by the Federal Reserve to access its facilities, banks effectively would be in competition with the Federal Reserve as providers of capital meaning, in effect, banks would need to provide something else of value to CDFIs beyond capital (allows for flexibility, e.g., one CDFI might want a partnership for customer acquisition to help keep costs down, another may want access to a technology, etc.)

2. Raise the bar for qualifying to be a CDFI, so that in addition to at least 60% of loan volume going to low- and moderate-income people, designated investment areas or other targeted populations (historically disadvantaged people), additional requirements would include:
    - An interest rate ceiling of 36% APR
    - Collect no more than two payments per month
    - Standardized payment cycles
    - Additional disclosure (including allowing interest rate monitoring, detailed demographic reporting on loan recipients, organizational DEI)
    - Accountability (board of directors and executive leadership)

3. Empower and fund the CDFI Fund to monitor compliance with #2 above

Based on widely published average loan size data for fintech lenders as a group and for several of larger fintech lenders individually, we believe that most major fintech lenders already serve a significant percentage of underserved borrowers, making it readily achievable for them to meet the CDFI 60% requirement.

<u>*Madden vs. Midland Funding LLC* and related pending rule-making</u>
In a similar way as described above, a positive, incentive-based approach to expanding responsible consumer lending could function to blunt the potential adverse effects stemming from the possible adoption of the OCC/FDIC rules crafted in response to the Second Circuit's *Madden vs. Midland Funding LLC* decision.

<u>OCC Special Charters</u>
Though we believe an enhanced role for the CDFI Fund in a more highly incentivized CDFI designation, as discussed above, is a preferable solution, it could be adapted for the OCC if the OCC prevails in its appeal of the district court's decision in favor of NYDFS with regard to whether non-depository lenders can be granted special charters. OCC's historical capabilities in overseeing payments and transfer activity are less applicable and relevant to the lending context, in our view. We also believe lending and payments each require a significant adjustment in regulation, and we

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would suggest the OCC focus on payments first as new technology entrants like bitcoin, blockchain and cryptocurrency gain traction.

Industrial Loan Charters

While it is clear that ILCs can be a threat to the banking system if the unregulated parent company has a financial misfortune, history has shown that the mixing of banking and commerce have not had a negative impact on the consumer and the deposit insurance fund. Likewise, the decisions being examined and considered by this committee and your Task Force today are quite similar to those that came before Congress when the ILC was instituted in the early 1900s. We think ILCs are a viable solution for granting access into the deposit insurance fund; however, in our view the parent company should be subject to the Bank Holding Company Act. We also believe ILCs represent an opportunity for the banking system to benefit from capitalization by non-financial corporate businesses, which we believe would be an important benefit as we enter the COVID-19 recovery.

Annual Oversight

In the context of either the CDFI Fund proposal, the OCC Special Charter or Industrial Loan Charter path, the evolution and speed of the fintech industry demands that the regulatory authority be empowered and mandated to conduct an annual review of the requirements, in order to ensure accountability and transparency. Currently, although the CDFI Fund conducts such reviews on an annual basis, OCC's reviews are conducted only once every three years, which is not an appropriate frequency for the pace of change within financial technology.

V. Partnerships between Banks and Non-Banks/Fintechs

Though I recognize the Task Force's intent in raising this topic is to examine the issue of so-called "rent-a-charters" (and to that point I again refer to the discussion above in section IV), I believe it's important for the Task Force to be aware of the many positive forms of partnership that can and do take place between banks and fintechs.

Lendistry's technology and processing capability, combined with our familiarity with small business borrowers, are seen by many banks as an operational efficiency solution for them. Partnerships between banks and fintechs also are effective in delivering the benefit of specialized expertise – such as cybersecurity and mobile payments – in an affordable way; this is especially beneficial for areas that undergo rapid development and enhancement, enabling banks to remain state-of-the-art.

VI. The Crisis for Underserved Small Businesses and the Urgency to Expand Capital Access

As my testimony declared from the beginning, the stakes for expanding responsible lending are enormous and the urgent need for action in this regard cannot be overstated. It is critical that incentives are created and barriers are removed to increase the supply of responsible capital resources and offerings available to empower and fund not only small businesses trying to stay open or re-open, but also those seeking to launch or grow. The challenge in front of us today will require every responsible lender possible to help with the restoration and repair of our small businesses nationwide.

Data collected, assembled and analyzed by Harvard University Economics Professor and American Economic Association Clark Medal winner Raj Chetty and his team at Opportunity Insights show that the employment rate among workers who had been making below $27,000 per year as of January 2020 was still **16.1%** below January levels as of the end of July.[1]

[1] https://tracktherecovery.org/

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As of September 13, 2020, the number of small businesses open **decreased by 23.6%** compared to January 2020, and total small business revenue had **decreased by 20.6%** over the same period.[2]

Not surprisingly, the economic devastation has only widened historic disparities by disproportionately impacting minorities, and particularly Black and Latinx people and communities. The underbanked small business owners and their communities we serve already were in a financially precarious position before the start of COVID-19. The state of African American and Latino-owned business is in month six of an all-out crisis, as these horrific statistics reveal:

- As of May, over 41% of African American small businesses and 32% of Hispanic/Latino small businesses had stopped operating, according to an analysis of government data by Stanford Institute for Economic Policy Research leveraging University of California, Santa Cruz professor Robert Fairlie's research[3].

- Moreover, research by the New York Federal Reserve[4] found that in the eight states with the largest numbers of Black business owners, despite a leveling off in closure rates in May data, all but two of these eight states experienced a net decline in Black business ownership between February and June, with the net numbers of business closures most acute in Ohio (-59.3%) and New York (-56.0%).

- The same Stanford/U of California study found the number of working business owners plummeted from 15.0 million in February to 11.7 million in April, the largest drop ever.

- The devastating impact on these businesses is mirrored in African American and Latinx unemployment rates. Whereas overall unemployment was 8.4% in August, African American unemployment was 13.0% (vs. 6.7% for March) and Latinx unemployment was 10.5% (vs. 6.0% in March). Moreover, African American employment recovery is lagging behind the national average, with the gap between African American and white unemployment widening in August for the fourth straight month.

- On a market-by-market basis, small businesses in major cities like Boston, Chicago, Dallas, Houston, Miami, Los Angeles, San Francisco are suffering[5]. And in "majority minority" cities of Atlanta, Baltimore, Detroit and Philadelphia the conditions are worse.

Data says small business lender resources during the crisis have been insufficient for the need; projections say the need for capital will grow enormously.

- A report last month by the New York Federal Reserve[6] found that "racial disparities in bank relationships prior to COVID-19...raise structural questions about the presence of banks and access to credit in communities of color, questions that have heightened significance when banks are relied on to administer federal, taxpayer-supported relief programs, as is the case with PPP." While 54% of healthy or stable white employers report having an existing banking relationship over the five-year period prior to COVID-19, just 33% of healthy or stable Black employers do.

[2] https://tracktherecovery.org/
[3] https://siepr.stanford.edu/sites/default/files/publications/20-022.pdf
[4] https://www.newyorkfed.org/medialibrary/media/smallbusiness/DoubleJeopardy_COVID19andBlackOwnedBusinesses
[5] https://www.nytimes.com/interactive/2020/06/18/us/coronavirus-black-owned-small-business.html
[6] https://www.newyorkfed.org/medialibrary/media/smallbusiness/DoubleJeopardy_COVID19andBlackOwnedBusinesses

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- There also is the issue, discovered in Washington, D.C., but presumably applicable broadly, of unequal treatment by banks based on race and gender, as experienced by comparably-qualified applicants at 13 out of 17 branches of banks tested, ranging from community banks to large institutions.[7]

We know that in neighborhoods and communities comprised disproportionately of African Americans and Latinx, with the loss of locally-owned employers and independent businesspeople, who provide jobs both directly and indirectly, come compounding negative effects. Reversing these dynamics only becomes more difficult the longer their cause persists.

Lendistry's team, technology and partners equip us to make a positive and rapid impact, and we are prepared to do as much as we are permitted. We believe every responsible and willing lender is needed urgently at this critical juncture, and that it must be a priority for policymakers to take actions to incentivize, and remove barriers that delay, that outcome.

Thank you for the opportunity to testify.

[7] https://ncrc.org/despite-gaping-holes-in-government-data-tests-show-ppp-borrowers-faced-discrimination/

HEARING ON "LICENSE TO BANK: EXAMINING THE LEGAL FRAMEWORK GOVERNING WHO CAN LEND AND PROCESS PAYMENTS IN THE FINTECH AGE," SEPTEMBER 29, 2020, BEFORE THE TASK FORCE ON FINANCIAL TECHNOLOGY, COMMITTEE ON FINANCIAL SERVICES, U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY OF ARTHUR E. WILMARTH, JR.
Professor Emeritus of Law, George Washington University Law School
Washington, D.C.

Thank you for inviting me to participate in this very important hearing. My testimony today criticizes recent attempts by the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) to confer banking powers and privileges on nonbanks and commercial firms without requiring those companies to comply with the regulations that govern banks and bank holding companies. For the reasons stated below, I believe that the OCC's and FDIC's initiatives are unlawful and contrary to the public interest. They represent a dangerous form of regulatory arbitrage because they allow nonbanks and commercial firms to evade fundamental principles incorporated in our federal statutory framework for banking institutions. I urge Congress to use its legislative and oversight powers to block OCC's and FDIC's initiatives or persuade the agencies to rescind them.

In July 2018, the OCC announced its intention to approve national bank charters for nondepository fintech firms that provide lending or payment services but do not accept deposits. The New York Department of Financial Services (NYDFS) promptly filed a lawsuit to challenge the OCC's action. In May 2019, a federal district court held that the OCC lacked authority to

grant national bank charters to financial institutions that do not accept deposits. The OCC has appealed that decision to the U.S. Court of Appeals for the Second Circuit.[1]

Despite the district court's decision, Acting Comptroller of the Currency Brian Brooks stated in August 2020 that the OCC was ready to "start processing applications for [national bank] charters from payments companies . . . . These could include financial technology firms like PayPal or cryptocurrency exchanges like Coinbase, his former employer." Big technology firms responded with great enthusiasm to the OCC's willingness to approve national bank charters for nondepository providers of payment services. For example, "Financial Innovation Now – a group that represents Amazon, Apple, Google, Intuit, PayPal, Square and Stripe – praised Brooks' 'leadership and vision' in a statement."[2]

In March 2020, the FDIC issued a proposed rule that would allow all types of commercial firms – including the largest technology firms – to acquire FDIC-insured industrial banks and industrial loan companies (collectively "ILCs").[3] If implemented, that rule could have an even greater impact than the OCC's nondepository fintech national bank charter and could transform our financial system and economy. Unlike the OCC's nondepository fintech charter, the FDIC's proposed ILC rule would permit Big Tech giants and other commercial firms to own FDIC-

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[1] *Vullo v. OCC*, 378 F.Supp.3d 271 (S.D.N.Y. 2019), *appeal pending sub nom. Lacewell v. OCC*, No. 19-4271-cv (2d Cir.). Morgan Ricks, Lev Menand, Joseph Sommer, and I served as the drafting committee for an amicus brief filed by 33 banking law scholars in the Second Circuit in support of the NYDFS and in opposition to the OCC. Parts I(A), I(B), and I(C) of my testimony are adapted from that brief, which is available at https://justmoney.org/wp-content/uploads/2020/08/19-4271-Amicus-Brief-of-Banking-Law-Scholars.pdf.

[2] Victoria Guida, "Top regulator pushes ahead with plan to reshape banking, sparking clash with states," *Politico* (Aug. 31, 2020), available at https://www.politico.com/news/2020/08/31/currency-comptroller-reshape-banking-406393 (summarizing Brooks' statement and quoting Financial Innovation Now's statement).

[3] FDIC notice of proposed rulemaking, "Parent Companies of Industrial Banks and Industrial Loan Companies," 85 Fed. Reg. 17771 (Mar. 31, 2020) [hereinafter "FDIC Proposed ILC Rule"]. On April 10, 2020, I filed a comment letter (available at https://www.fdic.gov/regulations/laws/federal/2020/2020-parent-companies-of-industrial-banks-3064-af31-c-002.pdf) opposing the FDIC's proposed rule. I subsequently published an article based on that comment letter. Arthur E. Wilmarth, Jr., "The FDIC Should Not Permit Commercial Firms to Acquire Industrial Banks," 39 *Banking & Financial Services Policy Report* No. 5 (May 2020, at 1-17, available at http://ssrn.com/abstract=3613022 [hereinafter Wilmarth, "Industrial Banks"].

insured, deposit-taking institutions. The proposed ILC rule would also enable commercial owners of ILCs to avoid the limitations and obligations that apply to parent companies of FDIC-insured banks under the Bank Holding Company Act.

In addition, FDIC-insured ILCs have presumptive access to discount window loans, payment and settlement services, and other facilities and benefits offered by the Federal Reserve System (Fed) to depository institutions. In contrast, as discussed below in Part I(B), it is doubtful whether the OCC's nondepository fintech national banks could gain access to the Fed's services and facilities.

The OCC has made two attempts to confer the privileges of national banks on nonbank firms. In June 2020, the OCC adopted a rule declaring that national banks may transfer their federal preemptive immunity from state usury laws to nonbanks that are purchasers, assignees, or transferees of their loans. The OCC's usury preemption transfer rule will shield nonbank purchasers, assignees, and other transferees from all state usury laws except for the laws of the state where the national bank that transferred the loans is "located."[4] Most national banks "locate" their lending operations in states that have few or no usury limits. Accordingly, the OCC's rule effectively provides blanket immunity from state usury laws to all persons who acquire loans from national banks.

In July 2020, the OCC issued a proposed rule that would (1) allow national banks to form lending "partnerships" with nonbank lenders, (2) treat national banks as the "true lenders" for loans produced such "partnerships" if the banks are named as the lenders in the loan agreements

[4] OCC final rule, "Permissible Interest on Loans That Are Sold, Assigned or Otherwise Transferred," 85 Fed. Reg. 33530 (June 2, 2020) [hereinafter OCC Usury Preemption Transfer Rule]. The OCC's rule provides parallel treatment for loans that are sold, assigned or transferred by federal savings associations to nonbanks. I filed a comment letter opposing that rule as proposed in November 2019. Arthur E. Wilmarth, Jr., Comment Letter in Opposition to the OCC's Proposed Valid-When-Made Rule" (Jan. 17, 2020), available at http://ssrn.com/abstract=3523939 [hereinafter Wilmarth Usury Preemption Transfer Comment Letter].

or fund the loans, and (3) permit national banks to maintain their status as "true lenders" even if the banks sell their entire interest in loans to their nonbank "partners" *one day after the loans are made*. The OCC's proposed "true lender" rule would allow national banks to establish "rent-a-charter" schemes with predatory nonbank lenders. Under "rent-a-charter" schemes, banks earn fees by transferring their federal preemptive immunity from state usury laws and other state laws to their nonbank "partners," while the nonbank "partners" assume all or virtually all of the economic benefits and risks of the loans originated through those schemes.[5]

In July 2020, the FDIC adopted a rule allowing FDIC-insured state banks to transfer their federal preemptive immunity from state usury laws to purchasers, assignees, and transferees of their loans. The FDIC's rule is intended to give FDIC-insured state banks the same ability to transfer their preemptive immunity from state usury laws that national banks possess under the OCC's usury preemption transfer rule.[6] The FDIC has not yet proposed a regulation similar to the OCC's "true lender" rule.

Part I of this testimony shows that the OCC's nondepository fintech national bank charter and the FDIC's proposed ILC rule are contrary to federal statutes and policies governing banks and bank holding companies. Part II demonstrates that the OCC's and FDIC's attempts to confer on nonbanks the benefits that banks receive through federal preemption violate federal laws and undermine important public policies. I urge Congress to exercise its legislative and oversight

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[5] OCC notice of proposed rulemaking, "National Banks and Federal Savings Associations as Lenders," 85 Fed. Reg. 44223 (July 22, 2020) [hereinafter OCC Proposed "True Lender" Rule]. The OCC's proposed rule would provide parallel treatment for federal savings associations that form lending "partnerships" with nonbanks. On August 11, 2020, I filed a comment letter opposing the OCC's proposed rule. Arthur E. Wilmarth, Jr., Comment Letter in Opposition to the OCC's "True Lender" Rule (Aug. 11, 2020), available at http://ssrn.com/abstract=3673421 [hereinafter Wilmarth "True Lender" Comment Letter].

[6] FDIC final rule, "Federal Interest Rate Authority," 85 Fed. Reg. 44146 (July 22, 2020) [hereinafter FDIC Usury Preemption Transfer Rule]. On January 17, 2020, I filed a comment letter (available at https://www.fdic.gov/regulations/laws/federal/2019/2019-federal-interest-rate-authority-3064-af21-c-008.pdf) opposing that rule as proposed in November 2019.

powers to overturn the OCC's and FDIC's unauthorized and misguided actions or to persuade the agencies to rescind them.

I. The OCC's Nondepository Fintech Charter and the FDIC's Proposed ILC Rule Violate Federal Laws and Undermine the Separation of Banking and Commerce

As shown below, several federal banking laws prohibit the OCC from granting national bank charters to financial institutions that do not accept deposits. In addition, the OCC's nondepository fintech national bank charter and the FDIC's proposed ILC rule undermine fundamental policies established by federal banking statutes, including the separation of banking and commerce, the avoidance of undue risks to financial stability, the prevention of serious threats to competition, and the protection of consumers and communities.

A. The National Bank Act Requires National Banks to Accept Deposits in Order to Conduct the "Business of Banking"

Congress passed the National Bank Act of 1864 (NBA) to establish a uniform national currency in the form of bank notes issued by national banks.[7] The NBA also helped the federal government to finance the Civil War by requiring national banks to purchase and hold government bonds as liquidity reserves for their liabilities created by bank notes and deposits.[8] The NBA required each national bank to hold federal government bonds and other "lawful money of the United States" in an amount equal to a specified percentage of "its notes in circulation and its deposits."[9]

Since 1864, deposit-taking has been an essential part of the "business of banking" conducted by national banks. Since 1864, the NBA has authorized the OCC to issue national

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[7] *See* Bray Hammond, *Banks and Politics in America, from the Revolution to the Civil War* 723-27 (1957); Edward L. Symons, Jr., "The Business of Banking in Historical Perspective," 51 *George Washington Law Review* 676, 699 (1983).

[8] Hammond, *supra* note 7, at 724, 731-32; Symons, *supra* note 7, at 699.

[9] Act of June 3, 1864, ch. 106, § 31, 13 Stat. 108; *see also id.* § 16, 13 Stat. 104 (requiring each national bank to deposit a minimum amount of federal government bonds with the U.S. Treasury).

bank charters only if the OCC determines that each proposed national bank "is lawfully entitled to commence the business of banking."[10] Since 1864, the NBA has defined "the business of banking" to include the activities of "receiving deposits," making loans, paying ("discounting") negotiable instruments and other evidences of debt, buying and selling "bullion" and foreign exchange, and obtaining and issuing circulating bank notes, along with "all such incidental powers as shall be necessary to carry on the business of banking."[11] Since 1864, the NBA has required every national bank to identify in its organization certificate "[t]he place where its operations of discount and deposit are to be carried on."[12]

The NBA's designation of deposit-taking as a crucial aspect of "the business of banking" reflects the fundamental role of bank deposits in our monetary system and economy. Banks increase our nation's money supply by issuing deposits. Banks use deposits as a funding device for extending loans and purchasing investment securities.[13] Bank customers use deposits as a vehicle for savings and for making payments to others. Under federal law, only banks and other chartered depository institutions are allowed to issue deposits.[14]

Thus, banks perform essential functions through their issuance of deposits. Bank deposits expand our money supply and support our economy by funding loans and investments, promoting savings, and facilitating payments by businesses and consumers to other persons.[15]

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[10] 12 U.S.C. § 27(a) (derived from § 18 of the NBA of 1864, 13 Stat. 104-05).
[11] 12 U.S.C. § 24 (Seventh) (derived from § 8 of the NBA of 1864, 13 Stat. 101-02). As discussed below in Part I(B), the function of issuing a national currency in the form of circulating notes was transferred from national banks to the Federal Reserve System after 1913.
[12] 12 U.S.C. § 22 (Second) (derived from §6 (Second) of the NBA of 1864, 13 Stat. 101).
[13] *United States v. Philadelphia National Bank*, 374 U.S. 321, 326 (1963) ("Commercial banks are unique among financial institutions in that they alone are permitted by law to accept demand deposits. This distinctive power gives commercial banking a key role in the national economy. For banks do not merely deal in but are actually a source of, money and credit; when a bank makes a loan by crediting the borrower's demand deposit account, it augments the Nation's credit supply."); *see also* Milton Friedman, "The Euro-Dollar Market: Some First Principles," 7 *Review* 16 (Fed. Res. Bank of St. Louis, July 1971).
[14] 12 U.S.C. § 378(a).
[15] *See* E. Gerald Corrigan, "Are Banks Special? A Revisitation" (Fed. Res. Bank of Minneapolis, Mar. 1, 2000), available at https://www.minneapolisfed.org/article/2000/are-banks-special; John L. Douglas, "The Role of a

Federal courts have repeatedly identified deposit-taking as an "essential" element of the "business of banking" authorized by the NBA and other federal statutes.[16] The power to accept deposits is a special privilege conferred by federal and state governments on banks and other depository institutions through a demanding chartering process. That special privilege also warrants the comprehensive regime of regulation and supervision that federal and state governments impose on banks and other depository institutions.[17]

In 1975, the OCC took an unprecedented step by approving a national bank charter for a special-purpose trust company. That trust company that did not accept deposits other than trust funds and did not exercise any other non-fiduciary powers. A district court invalidated the OCC's special-purpose trust charter, holding that it violated the NBA's requirement that all national banks must engage in the "business of banking."[18] In response to that court decision, Congress amended Section 27(a) of the NBA in 1978. That 1978 amendment allowed the OCC

Banking System in Nation-Building," 60 *Maine Law Review* 511, 513-19 (2008); *see also* Morgan Ricks, "Money as Infrastructure," 2018 *Columbia Business Law Review* 757, 758-72 (describing the "competing paradigms" that view banks as "monetary institutions" or as "financial intermediaries," and explaining why those paradigms are "not strictly incompatible" and "coexist in uneasy tension").

[16] *Mercantile National Bank v. New York*, 121 U.S. 138, 156 (1887) (The "business of banking" under the NBA includes "receiving deposits payable on demand"); *In re Prudence Co.*, 79 F.2d 77, 79 (2d Cir.), *cert. denied*, 296 U.S. 646 (1935) ("[T]he power to receive deposits . . . is generally recognized as the essential characteristic of a banking business."); *Gamble v. Daniel*, 39 F.2d 447, 450 (8th Cit. 1930) (In 1910, Congress recognized that "the ordinary conception of a bank was of a business which was based primarily on the receipt of deposits (general or special), which deposits were used by the bank for loans, discounts, buying and selling commercial paper, and other business purposes.").

[17] *Philadelphia National Bank*, 374 U.S. at 326-27 ("[A]mong [the roles played by banks], the creation of additional money and credit, the management of the checking-account system, and the furnishing of short-term business loans would appear to be the most important. For the proper discharge of these functions is indispensable to a healthy national economy. . . . It is therefore not surprising that commercial banking in the United States is subject to a variety of governmental controls, state and federal."); *Noble State Bank v. Haskell*, 219 U.S. 104, 112-13 (1911) (holding that the "public interest[]" in "mak[ing] the currency of checks secure" is "sufficient to warrant the state in taking the whole business of banking under its control"); S. Rep. No. 1482, 89th Cong., 2nd Sess. 5 (1966) (justifying Congress's decision to grant extensive enforcement powers to federal banking agencies by explaining that the "banking system is a fundamental part of our monetary system and the Nation's $130 billion of demand deposits represents the principal element in the Nation's money supply").

[18] *National State Bank v. Smith*, 1977 U.S. Dist. LEXIS 18184 (D.N.J., Sept. 16, 1977). As provided in 12 U.S.C. § 1815(a)(1), trust funds are not "deposits." In contrast to deposits, trust funds do not augment the nation's money supply. Trust funds must be held in segregated accounts established in accordance with customers' trust instruments and federal and state fiduciary laws. Unlike deposits, trust funds cannot be used by a bank or trust company to make loans or investments for its own account. *See* 12 U.S.C. § 92a(a)-(d); 12 C.F.R. §§ 9.8-9.13, 9.18.

to approve national bank charters for special-purpose, nondepository trust companies.[19] Based on that narrowly-tailored provision, a federal appellate court upheld the OCC's special-purpose trust company charter.[20]

Congress's 1978 amendment to Section 27(a) confirms that the NBA does not authorize the OCC to approve nondepository charters for national banks *other than* special-purpose trust companies.[21] If the OCC possessed a general power to charter nondepository national banks, the 1978 amendment to Section 27(a) would have been redundant and unnecessary surplusage. Under two well-established canons of statutory construction – the canon against surplusage and the associated canon of *expressio unius est exclusio alterius* (the naming of one thing excludes other similar things), the OCC's claim of a general authority to charter nondepository national banks is indefensible.[22]

The OCC rests its claim of authority to charter nondepository national banks on Section 36 of the NBA. However, Section 36 was not added to the NBA until 1927 – more than 60 years after the NBA's enactment. Section 36 deals only with the authority of national banks to establish *branches*. Section 36 says nothing about the chartering of *banks*, and it does not refer to "the business of banking." The OCC did not assert any chartering authority under Section 36

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[19] The 1978 amendment to Section 27(a) provides that a national bank "is not illegally constituted solely because its operations are . . . limited to those of a trust company and activities related thereto." Pub. L. 95-630, § 1504, 92 Stat. 3713 (1978) (codified as amended at 12 U.S.C. § 27(a)).

[20] *National State Bank v. Smith*, 591 F.2d 223, 231-32 (3d Cir. 1979).

[21] *See Vullo v. OCC*, 378 F.Supp.3d at 294-95.

[22] *See Independent. Ins. Agents of America v. Hawke*, 211 F.3d. 638, 641-45 (D.C. Cir. 2000) (holding that the NBA's specific authorization for national banks to sell insurance in towns with populations of 5,000 or less precluded the OCC from allowing national banks to sell crop insurance in larger communities); *American Land Title Ass'n v. Clarke*, 968 F.2d 150, 155-57 (2d Cir. 1992) (determining on similar grounds that the OCC could not permit national banks to sell title insurance in larger communities), *cert. denied*, 508 U.S. 971 (1993); *see also Vullo*, 378 F.Supp.3d at 295 (concluding, based in part on the 1978 amendment to Section 27(a), that Congress "understood the NBA's original use of the 'business of banking' phrase to require deposit-receiving, such that a non-depository institution (or class of such institutions) is not considered eligible to be granted a federal charter to commence the 'business of banking' absent a statutory amendment to the contrary").

until 2003, and the OCC did not take any definitive steps to implement that asserted authority until 2016.[23]

Section 36 defines a "branch" as a location "at which deposits are received, or checks paid, or money lent."[24] Based on the disjunctive word "or" in Section 36, the OCC argues that it can charter national banks that engage in lending or payment activities but do not accept deposits. However, a branch is a *subset* of a national bank, and Section 36 merely authorizes a branch to exercise a subset of "the business of banking." The fact that a national bank may lawfully establish a subsidiary *branch* without accepting deposits has no bearing on whether the OCC may lawfully charter a *bank* that does not accept deposits.

In contrast to Section 36, Section 24 (Seventh) of the NBA uses the conjunctive word "and" when it identifies the activities – including "receiving deposits" – that are part of "the business of banking." The activities specified in Section 24 (Seventh) include *all three* of the functions listed in Section 36. Viewed in combination with Section 22 (Second) – which requires every national bank to identify "[t]he place where its operations of discount and deposit are to be carried on" – as well as Section 27(a) – which forbids the OCC from chartering banks that are not "lawfully entitled to commence the business of banking" – Section 24 (Seventh) plainly bars the OCC from chartering nondepository national banks *other than* special-purpose trust companies.[25]

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[23] *See Vullo*, 378 F.Supp.3d at 279, 288-90, 295-96 ("The Court finds that a delay of that length" in asserting chartering authority under Section 36 "provides substantial grounds to cast doubt on OCC's interpretation" of Section 36).

[24] 12 U.S.C. § 36.

[25] *See Vullo v. OCC*, 378 F.Supp.3d at 297-98 ("receiving deposits is an indispensable part of the 'business of banking' as used by Congress in the original phrase that now appears in Section 27 and Section 24 (Seventh)"); *see also* Symons, *supra* note 7, at 721 and 721-22 note 239 (discussing "the critical importance of the deposit-taking power to the determination of an entity as a bank").

As the district court pointed out in *Vullo*, the OCC's nondepository fintech charter could have a major "impact . . . on at least 'a significant portion' of the national economy" by causing a "dramatic disruption of federal-state relationships in the banking industry." The OCC's fintech charter threatens to preempt a broad array of state financial regulations (including state licensing and supervisory standards) and other state consumer protection laws (including state usury laws), which currently apply to nonbank providers of lending and payment services.[26] In addition, the OCC could conceivably assert that fintech "banks" are exempt from state privacy and data protection laws.[27] Thus, the OCC's fintech charter threatens to abrogate the longstanding federal policy of allowing states to regulate nonbank firms that provide lending, payment, and other financial services within their borders.[28]

The OCC's fintech charter would severely undermine the states' authority to enforce laws that protect their residents against abusive, deceptive, and exploitative practices by nonbank providers of lending and payment services. As the NYDFS pointed out in its Complaint in *Vullo*, "preemption of state law governing mortgage lenders and servicers" by the OCC and the Office of Thrift Supervision during the 1990s and 2000s "was a root cause of the global financial collapse," combined with the failures by federal regulators to protect consumers against predatory lending and foreclosure practices.[29] Congress should not allow the OCC to repeat its

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[26] *Vullo*, 378 F.Supp.3d at 286-88, 296 (citing and quoting the NYDFS' Complaint, ¶¶ 3, 11-12, 35, 43-49).
[27] As discussed in Part II(B), the OCC has authority to issue regulations or orders preempting state consumer financial laws if those state laws would "prevent or significantly interfere" with the federally-authorized powers of national banks. *See* 12 U.S.C. § 25b(b)(1)(B). If the OCC issues national bank charters to nondepository fintech firms, the OCC could potentially issue preemptive rules or orders claiming that state privacy or data protection laws "prevent or significantly interfere" with the lending and payment activities of those firms.
[28] *See, e.g.*, 12 U.S.C. §§ 5551-5552; *Meade v. Avant of Colorado LLC*, 307 F.Supp.2d 1134 (D. Colo. 2018); *West Virginia v. CashCall*, 605 F.Supp.2d 781 (S.D. W. Va. 2009).
[29] NYDFS Complaint in *Vullo*, ¶ 12; *see also* S. Rep. No. 111-176, at 11-18, 175-76 (2010); Kathleen Engel & Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps* 157-226 (Oxford University Press, 2011); Lev Menand, "Too Big to Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking," 103 *Cornell Law Review* 1527, 1529-32, 1551-74 (2018); Arthur E. Wilmarth, Jr., "The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services," 36

disastrous pattern of preemptive overreach and regulatory laxity that contributed to the catastrophic events of 2007-09.

The OCC's fintech chartering initiative offers federal corporate charters to a wide range of nonbank firms that provide lending and payment services. Big Tech giants like Alphabet (Google), Amazon, Apple, Facebook, and Microsoft could potentially operate under OCC charters if they decide to establish significant lending or payment programs. Currently, Big Tech giants and other nonbank firms must operate under state corporate charters and must comply with state corporate governance laws. The OCC's attempt to expand its federal chartering authority beyond deposit-taking national banks is untenable in view of numerous court decisions that have *refused* to construe federal statutes in a manner that would override "established state policies of corporate regulation" absent clear evidence of congressional intent.[30] As shown above, Congress has never expressed an intent to allow the OCC to grant national bank charters to nondepository firms *except for* special-purpose trust companies.

B. The Federal Reserve Act Confirms That National Banks Must Operate as Depository Institutions

Congress enacted the Federal Reserve Act of 1913 (FRA) to establish the Federal Reserve System (Fed) as the nation's new monetary authority. Congress directed the Fed to establish a "sound" and "flexible" national currency in the form of Federal Reserve notes. Federal Reserve notes gradually replaced the "bond-secured note[s]" issued by national banks under the NBA.[31] Congress also instructed the Fed to clear and pay (at par) checks drawn by

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Journal of Corporation Law 893, 897-919 (2011) [hereinafter Wilmarth, "Dodd-Frank"], available at http://ssrn.com/abstract=1891970.

[30] *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 478-80 (1977); *accord, e.g., Business Roundtable v. SEC*, 905 F.2d 406, 411-17 (D.C. Cir. 1990); *Field v. Trump*, 850 F.2d 938, 947 (2d Cir. 1988), *cert. denied,* 489 U.S. 1012 (1989); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 289 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

[31] H.R. Rep. No. 63-69, at 16-19, 22-26 (1913); *see also First Agricultural Bank v. State Tax Comm'n*, 399 U.S. 339, 355-56 (1968) (Marshall, J., dissenting) (explaining that national banks "ceased" issuing bank notes by 1935).

depositors on national banks and state banks that were members of the Fed (state member banks). The Fed's duty to clear and pay checks reflected the fact that bank deposits had become a major component of the U.S. money supply by 1913.[32]

The FRA provides that Federal Reserve notes must be "receivable by all national and [state] member banks."[33] Congress included that mandate to ensure that Federal Reserve notes would be "payable . . . to any [member] bank for deposit purposes," thereby making each member bank a "quasi-redemption" facility for those notes.[34] The duty of all Fed member banks to receive Federal Reserve notes as deposits demonstrated Congress's understanding that all national banks were depository institutions.

Since 1913, the FRA has required every national bank to become a member bank of the Federal Reserve System and to purchase stock in its respective regional Federal Reserve Bank. National banks that do not fulfill those commitments must forfeit their charters.[35] The FRA's provisions requiring national banks to become member banks, to buy stock in their Federal Reserve Banks, and to accept Federal Reserve notes as deposits were crucial elements of the FRA's design for an effective monetary system and national currency.[36] Congress recognized that "the Federal Reserve System could not function without national banks, which are required to be members therein, 12 U.S.C. § 222, and in that sense they are part and parcel of the establishment and effectuation of the national fiscal and monetary policies."[37]

Congress formally abolished the power of national banks to issue bank notes in 1994. Pub. L. 103-325, §§ 602(e)-(g), 108 Stat. 2291-94 (1994).

[32] Act of Dec. 23, 1913 § 16, 38 Stat. 268 (codified as amended at 12 U.S.C. § 360); *see also* H.R. Rep. No 63-69, at 55-56.

[33] Act of Dec. 23, 1913, § 16, 38 Stat. 265 (codified as amended at 12 U.S.C. § 411).

[34] H.R. Rep. No. 63-69, at 26, 54-55 (1913).

[35] Act of Dec. 23, 1913, § 2, 38 Stat. 252-53 (codified as amended at 12 U.S.C. §§222, 282, 501a).

[36] H.R. Rep. No. 63-69, at 16-19, 31-37, 39-41 (1913); *see also Federal Reserve System: Purposes and Functions* 3-6, 9, 12-17, 35, 38-44 (10th ed. 2016) [hereinafter *Fed Purposes and Functions*].

[37] *First Agricultural National Bank*, 392 U.S. at 357 (Marshall, J., dissenting).

Deposits held by national banks and other federally-regulated depository institutions play important roles in the Fed's implementation of monetary policy. National banks and other depository institutions must maintain reserves against their deposits in accordance with the Fed's regulations.[38] Bank reserve requirements are one of the "primary means through which the [Federal Reserve] System implements monetary policy."[39] Other standard mechanisms for implementing the Fed's monetary policy (including open-market operations and discount window lending) also operate through the Fed's relationships and transactions with national banks and other depository institutions.[40]

The Fed frequently conducts monetary policy by adjusting its target for the federal funds rate – the interest rate at which depository institutions borrow from and lend to each other overnight in the federal funds market. To influence the federal funds rate, the Fed changes the rate of interest that it pays on reserve balances maintained by depository institutions in excess of their required reserves.[41] Thus, the Fed relies on national banks and other depository institutions to perform a vitally important function as a "transmission belt for monetary policy."[42]

National banks and other depository institutions enjoy a privileged relationship with the Fed, and they receive highly beneficial services from the Fed. The Fed provides loans to depository institutions through the discount window. The Fed also permits depository institutions to establish master accounts that give them direct access to the Fed's real-time payment system (Fedwire) and its securities custody and settlement services.[43]

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[38] Act of Dec. 23, 1913, § 19, 38 Stat. 270 (codified as amended at 12 U.S.C. § 461).
[39] *Committee for Monetary Reform v. Board of Governors*, 765 F.2d 538, 539 (D.C. Cir. 1985).
[40] *Fed Purposes and Functions*, *supra* note 36, at 17, 38-44.
[41] *Id.* at 23, 38-40, 50-51; Ricks, *supra* note 15, at 786-90.
[42] Corrigan *supra* note 15; *see also Fed Purposes and Functions*, *supra* note 36, at 17 (explaining that depository institutions perform "important roles in the Federal Reserve System's core functions"); Ricks, *supra* note 15, at 772-801 (describing the changing roles that banks have played in the Fed's implementation of monetary policy before and after 2008).
[43] *Fed Purposes and Functions*, *supra* note 36, at 40-46, 130-34.

As shown above, the FRA embodies Congress's clear understanding that national banks must be depository institutions to fulfill their intended functions within the Federal Reserve System. Consequently, the OCC's nondepository fintech national bank charter creates massive conflicts with the FRA's design. Financial firms that receive fintech charters could potentially argue that they have the automatic right to become Fed member banks, and that they are eligible for all the benefits and services that the Fed provides to depository member banks.[44] The Fed has not yet expressed any position on whether it would be willing to recognize the OCC's nondepository fintech "banks" as Fed member banks.[45]

If nondepository fintech "banks" obtained recognition as Fed member banks, they would immediately qualify for loans from the Fed's discount window. Such an outcome would destroy the vital distinction established by Congress between the broad support that the Fed provides to depository institutions through the discount window and the much more limited assistance that the Fed can offer to nondepository firms. Under Section 13(3) of the FRA, as amended in 2010, "nondepository institutions" may receive loans from the Fed only (1) in "unusual and exigent circumstances," (2) pursuant to a program or facility creating "broad-based eligibility" for nondepository borrowers that are "not insolvent," and (3) with the approval of a supermajority of the Federal Reserve Board and the Secretary of the Treasury.[46] Allowing nondepository fintech national banks to obtain loans through the discount window would seriously undermine Congress's intention to impose significant procedural and substantive limitations on the Fed's authority to provide loans to nondepository firms.

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[44] *See* 12 U.S.C. § 222 (requiring all national banks to become Fed member banks); *id.* § 301 (requiring the Fed to carry out its duties under the FRA "fairly and impartially and without discrimination in favor of or against any member bank or banks").
[45] *See* Guida, *supra* note 2.
[46] 12 U.S.C. § 343; *see also Fed Purposes and Functions*, *supra* note 36, at 64.

If nondepository fintech national banks achieved the status of Fed member banks, they could establish master accounts that provide access to the Fed's payment services (including Fedwire) as well as the Fed's custody and settlement services. Fedwire provides real-time payments and guaranteed finality – important privileges that are currently available only to depository institutions. Depository institutions can also obtain intraday overdraft credit from the Fed.[47] Granting nondepository fintech national banks access to the Fed's payment and settlement services and overdraft credit would violate Congress's intent that only depository institutions should receive the benefits and services authorized by the FRA.

Obtaining access to the Fed's benefits and services would give nondepository fintech "banks" major advantages over nonbank competitors that could not obtain fintech charters. Allowing nondepository fintech "banks" to obtain and exploit such competitive advantages would be contrary to the public policies embodied in the NBA and FRA. In addition, as explained below in Part I(D), the OCC's fintech charter would allow fintech "banks" to evade a number of important regulatory requirements and public interest safeguards that apply to FDIC-insured depository institutions and their parent companies.

The OCC's nondepository national bank charter would also permit Big Tech giants and other technology firms to influence our monetary and economic policies. National banks and other Fed member banks elect six of the nine directors of each Federal Reserve Bank. Half of the directors elected by member banks participate in selecting the presidents of the twelve Federal Reserve Banks. Five of those presidents serve as voting members of the Federal Open Market Committee (FOMC), which establishes the Fed's monetary policy. The other seven presidents attend the FOMC's meetings and participate in its discussions.[48] If the OCC's

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[47] *Fed Purposes and Functions*, *supra* note 36, at 131-34, 146-48.
[48] *See* 12 U.S.C. §§ 304, 341 (Fifth); *Fed Purposes and Functions*, *supra* note 36, at 12-17.

nondepository "fintech" banks were recognized as Fed member banks, they could influence the FOMC's deliberations and decisions on monetary policy through their selection of directors and presidents of Federal Reserve Banks. Allowing Big Tech giants and other technology firms to play such a role would contradict the FRA's fundamental policies.

C. The Federal Deposit Insurance Act Requires National Banks to Obtain Federal Deposit Insurance

The Banking Acts of 1933 and 1935 established a federal deposit insurance program and created the FDIC to administer that program. The 1933 and 1935 Acts mandated that all national banks must become members of the FDIC.[49] Similarly, the Federal Deposit Insurance Act of 1950 (FDI Act) required every national bank "engaged in the business of receiving deposits other than trust funds" to obtain deposit insurance.[50] National banks that fail to obtain deposit insurance must forfeit their charters.[51]

The OCC's claim of plenary authority to charter nondepository national banks is completely unfounded, given Congress's explicit mandate that national banks must obtain deposit insurance. The only national banks that currently operate without deposit insurance are nondepository, special-purpose trust companies.[52] As explained in Part I(A), those institutions are expressly permitted by Congress's 1978 amendment to Section 27(a) of the NBA.

The statutory requirement that all *other* national banks must obtain deposit insurance is consistent with Congress's understanding that deposit-taking is an essential element of the

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[49] Act of June 16, 1933, § 8, 48 Stat. 162, 168-70; Act of Aug. 23, 1935, § 101, 49 Stat. 684, 687.
[50] Act of Sept. 21, 1950, § 4, 64 Stat. 873, 875. The only national banks that were exempted from the deposit insurance mandate were "national nonmember banks" located in U.S. territories. Act of Sept. 21, 1950, §§ 3(e), 4(b), 64 Stat. 874, 875-76. When Alaska and Hawaii were admitted as states in 1958 and 1959, Congress amended 12 U.S.C. § 222 to confirm that national banks located in those former territories must become Fed member banks and obtain FDIC insurance, just like the national banks located in the other 48 states. Act of July 7, 1958, § 19, 72 Stat. 350; Act of Mar. 18, 1959, § 17, 73 Stat. 12.
[51] 12 U.S.C. §§ 222, 501a.
[52] *See* OCC Proposed Rule, "Receiverships for Uninsured National Banks," 81 Fed. Reg. 62835 (2016) ("There are only a small number of uninsured national banks in operation today. … [A]ll of these institutions are trust banks.").

"business of banking" under both the NBA and the FRA. As shown above in Parts I(A) and I(B), Congress has identified deposit-taking as the crucial and dispositive function that distinguishes banks from nonbanks. Indeed, Section 21(a)(2) of the Banking Act of 1933 imposes criminal penalties on any person who engages in "the business of receiving deposits" without being chartered and regulated as a depository institution.[53]

D. The OCC's Fintech Charter and the FDIC's Proposed ILC Rule Pose Serious Threats to the Bank Holding Company Act's Policy of Separating Banking and Commerce

1. The BHC Act's Mandate for Separating Banking and Commerce

The BHC Act regulates all "companies" that control "banks."[54] The original BHC Act of 1956 applied to companies that controlled two or more banks. In 1970, Congress expanded the BHC Act's scope to include all companies that control a single bank.[55]

Section 4 of the BHC Act prohibits banks from controlling commercial firms, and it also bars commercial firms from controlling banks. Section 4 embodies our nation's "longstanding policy of separating banking from commerce."[56] The BHC Act prohibits affiliations between banks and commercial firms because those affiliations pose significant dangers, including (1) undue concentrations of economic and financial power, (2) conflicts of interest that destroy the ability of banks to act objectively in providing loans and other services, and (3) unacceptable risks to the federal "safety net" for banks, including the FDIC's deposit insurance fund, the Fed's

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[53] 12 U.S.C. § 378(a).
[54] 12 U.S.C. § 1841(b) & (c).
[55] *See* Arthur E. Wilmarth, Jr., "Wal-Mart and the Separation of Banking and Commerce," 39 *Connecticut Law Review* 1539, 1566-69 (2007), available at http://ssrn.com/abstract=984103 [hereinafter Wilmarth, "Wal-Mart"].
[56] 12 U.S.C. § 1843; *see* S. Rep. No. 91-1084, at 2-4 (1970) (quote at 3); S. Rep. No. 100-19, at 2 (1987) ("At the foundation of American financial law is a longstanding tradition of separating banking and commerce.").

discount window, the Fed's guarantees for interbank payments made on Fedwire, and the Fed's overdraft credit facility for depository institutions.[57]

The 1970 amendments to the BHC Act changed the definition of "bank" to include financial institutions that both accepted demand (business checking) deposits and made commercial loans. In 1980, the OCC began to charter "nonbank banks" – national banks that refrained from either accepting demand deposits or making commercial loans. By omitting one of those functions, nonbank banks enabled their parent companies to evade regulation under the BHC Act. The OCC allowed many commercial firms to acquire "nonbank banks," thereby threatening the BHC Act's policy of separating banking and commerce.[58]

In 1987, Congress closed the "nonbank bank loophole" and strongly criticized the OCC's efforts to undermine the BHC Act. Congress amended the definition of "bank" under the BHC Act to include all FDIC-insured banks (as well as any other banks that accept demand deposits and make commercial loans), subject to narrowly-defined exceptions.[59] The Senate committee report on the 1987 legislation declared that "[n]onbank banks undermine the principle of separating banking and commerce, a policy that has long been the keystone of our banking system." The report also explained that Congress was closing the nonbank bank loophole to

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[57] S. Rep. No. 91-1084, at 2-4 (1970); S. Rep. No. 100-19, at 2, 8-10 (1987); Wilmarth, "Wal-Mart," *supra* note 55, at 1566-71.

[58] *Independent Bankers Ass'n of America v. Conover*, 1985 U.S. Dist. LEXIS 22529, at *2 -*6 (M.D. Fla. Feb. 15, 1985); S. Rep. No. 100-19, at 5-7 (1987).

[59] The BHC Act's definition of "bank," as amended in 1987, includes exemptions for state-chartered ILCs, special-purpose trust companies, and limited-purpose credit card banks (which cannot maintain any checking accounts or accept any time deposits smaller than $100,000 and may only provide business credit card loans to small firms), as well as thrift institutions and credit unions (which are subject to separate regulatory regimes). *See* Pub. L. No. 100-86, § 101(a), 101 Stat. 552, 555-56 (codified as amended at 12 U.S.C. § 1841(c)); S. Rep. No. 100-19, at 11, 29-31 (1987). For discussions of the exemptions in the BHC Act for special-purpose trust companies and state-chartered ILCs, *see infra* notes 61, 63-70 and accompanying text.

"minimize the concentration of financial and economic resources" and improve "the safety and soundness of our financial system."[60]

2. The OCC's Fintech Charter Would Allow Technology Firms to Evade the BHC Act's Prohibition Against Combinations of Banking and Commerce

The OCC's nondepository fintech national bank charter represents the latest attempt by the OCC to evade the BHC Act and undermine the separation of banking and commerce. Congress made clear in 1987 that the OCC had no authority to create new types of national bank charters that would allow combinations of banking and commerce. As discussed above, the 1987 amendments to the BHC Act shut down the "nonbank bank loophole." In addition, while the 1987 amendments exempted nondepository, special-purpose trust companies from the BHC Act's definition of "bank," the 1987 amendments also stipulated that special-purpose trust companies would lose that exemption if they received discount window loans or payment services from the Fed.[61]

Parent companies of the OCC's nondepository fintech national banks would escape regulation under the BHC Act. Fintech national banks would not be FDIC-insured institutions, and they would not accept demand deposits. Consequently, fintech national banks would not be treated as "banks" under the BHC Act. Big Tech giants and other commercial firms could acquire nondepository fintech national banks and avoid any regulation under the BHC Act.

As discussed above in Part I(B), fintech national banks could offer lending and payment services and could potentially claim all of the privileges provided to national banks under the FRA – including access to the Fed's discount window loans, payment and settlement services, guarantees for payments made on Fedwire, and overdraft credit. If fintech national banks

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[60] S. Rep. No. 100-19, at 2, 6-10 (1987) (quote at 8).
[61] *See* 12 U.S.C. § 1841(c)(2)(D)(iv); S. Rep. No. 100-19, at 29 (1987).

achieved status as Fed member banks, ownership of those banks by Big Tech giants and other commercial enterprises would expose major components of the federal safety net to the risks posed by their unregulated parent companies. That outcome would severely compromise the BHC Act's fundamental principle of separating banking and commerce to protect the federal safety net from risks and losses generated by commercial firms.

In addition to avoiding the BHC Act's prohibition on commercial ownership of banks, fintech national banks and their owners would evade a number of other important regulatory requirements and public interest safeguards that apply to FDIC-insured depository institutions and their parent companies. For example, FDIC-insured depository institutions and their parent companies must comply with (1) capital requirements and other safety and soundness standards for depository institutions pursuant to 12 U.S.C. §§ 1831p-1 and 3901-07; (2) prompt corrective action rules for depository institutions under 12 U.S.C. § 1831*o*; (3) "source of strength" commitments for parent companies under 12 U.S.C. § 1831*o*-1; (4) capital requirements for parent companies under 12 U.S.C. § 5371; (5) the FDIC's conservatorship and receivership powers over FDIC-insured depository institutions under 12 U.S.C. §§ 1821-23; and (6) duties of depository institutions under the Community Reinvestment Act, 12 U.S.C. §§ 3901-08.

The OCC's nondepository fintech "banks" would not be subject to any of the foregoing regulatory requirements and public interest safeguards because they would not be FDIC-insured depository institutions.[62] Thus, the OCC's fintech national bank charters would allow Big Tech firms and other commercial enterprises to engage in unconscionable regulatory arbitrage. Congress should prevent the OCC from issuing such charters.

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[62] *See* OCC, *Exploring Special Purpose National Bank Charters for Fintech Companies* (Dec. 2016), at 6-7, 12, available at https://www.occ.gov/publications-and-resources/publications/banker-education/files/exploring-special-purpose-nat-bank-charters-fintech-companies.html.

3. The FDIC's Proposed ILC Rule Poses a Grave Threat to the Separation of Banking and Commerce

The FDIC's proposed ILC rule poses an even more dangerous threat to the BHC Act's policy of separating banking and commerce. Unlike the OCC's nondepository fintech national banks, ILCs are FDIC-insured, state-chartered institutions that are authorized to accept all types of deposits except for demand (business checking) accounts. The ILC charter is the only vehicle that arguably allows commercial firms to own FDIC-insured depository institutions without violating the BHC Act.[63]

The FDIC's Proposed ILC Rule states that "the industrial bank exemption in the [BHC Act] . . . provides an avenue for commercial firms to own or control a bank."[64] However, there is no evidence indicating that Congress intended or expected that the 1987 exemption for ILCs would lead to widespread acquisitions of ILCs by large commercial firms. In 1987, ILCs were small, locally-focused institutions that offered deposit and credit services to lower- and middle-income consumers. ILCs held only $4.2 billion of assets in 1987, and the largest ILC had less than $420 million of assets. A 1993 report from the Congressional Research Service (CRS) stated that ILCs played only a "minor" role in the U.S. financial system.[65]

In July 2005, Walmart, the largest U.S. retailer, applied to acquire an FDIC-insured, Utah-chartered ILC. Walmart's application triggered vigorous public opposition as well as extensive debates about the desirability of allowing large commercial firms to own ILCs. During one of the FDIC's public hearings on Walmart's application in April 2006, Senator Jake Garn (R-UT) – the sponsor of the 1987 exemption for ILCs – stated that "it was never my intent, as the

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[63] *See* 12 U.S.C. § 1841(c)(2)(H); Wilmarth, "Wal-Mart," *supra* note 55, at 1549-53, 1572-73.
[64] 85 Fed. Reg. at 17772.
[65] In 1992, U.S. banks and trust companies held total assets of $3.5 trillion – 500 times larger than the $7 billion of assets held by ILCs. Wilmarth, "Industrial Banks," *supra* note 3, at 2 (quoting the 1993 CRS report).

author of this particular section, that any of these industrial banks be involved in retail [commercial] operations."[66]

In response to the strong public opposition against Walmart's application, the FDIC imposed a six-month moratorium on acquisitions of ILCs by commercial firms in July 2006. In its moratorium notice, the FDIC observed that the "evolution" of the "ILC industry" was occurring "in ways that may not have been anticipated at the time [Senator Garn's exemption] was enacted in 1987." In January 2007, the FDIC extended its moratorium for an additional year. In the FDIC's moratorium extension notice, the agency pointed out that "business plans" for ILCs owned by commercial firms "differ substantially from the consumer lending focus of the original industrial banks." [67]

Walmart withdrew its ILC application in March 2007, due to the FDIC's extended moratorium and continued public hostility toward Walmart's application. The magnitude of the public outcry against Walmart's proposed ILC – which included statements of opposition from many members of Congress – supported Senator Garn's view that Walmart's application went far beyond the intended scope of the exemption he sponsored in 1987.[68]

Senator Garn's exemption was included in the Competitive Equality Banking Act of 1987 (CEBA). As discussed above in Part I(D)(1), CEBA reaffirmed and strengthened Congress's policy of separating banking and commerce by closing the nonbank bank loophole. During the floor debates on CEBA, members of Congress argued that the nonbank bank loophole should be

[66] *Id.* at 2-3 (quoting Sen. Garn's statement on April 10, 2006, during one of the FDIC's three public hearings on Walmart's application).
[67] *Id.* at 3 (quoting FDIC rulemaking notices issued in Aug. 2006 and Feb. 2007).
[68] *Id.*

closed to preserve the separation of banking and commerce and ensure parity of regulatory treatment for all companies that control FDIC-insured banks.[69]

It is highly unlikely that Congress passed CEBA to *reaffirm and strengthen* the policy of separating banking and commerce by closing the nonbank bank loophole and, at the same time, intended to *undermine and weaken the same policy* by adopting Senator Garn's exemption for ILCs. The improbability of such a self-contradicting purpose is heightened by the absence of any evidence indicating a congressional belief that Senator Garn's exemption could be used to break down the barrier between banking and commerce. In 1999 – twelve years after CEBA – Congress again reinforced the policy of separating banking and commerce by passing a statute that prohibited further acquisitions of FDIC-insured savings associations by commercial firms. In view of Congress's powerful expressions of support for the policy of separating banking and commerce in 1987 and 1999, the unexplained text of Senator Garn's exemption should *not* be applied in a way that undermines that policy.[70]

Consequently, the FDIC's policy toward ILCs should adhere to Congress's strongly articulated purpose of separating banking and commerce. The appropriate policy would be for the FDIC to allow acquisitions of ILCs by companies engaged in financial activities but *not* by firms engaged in commercial activities. The FDIC followed that policy when (1) it did not approve Walmart's application, (2) it imposed a moratorium on acquisitions of ILCs by commercial firms between June 2006 and January 2008, and (3) it did not approve any

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[69] *Id.* (summarizing floor statements by 11 Senators and House members).

[70] *Id.*; *see also* Wilmarth, "Wal-Mart," *supra* note 55, at 1569-73, 1584-86 (discussing Congress's passage of CEBA and the 1999 law that prohibited further acquisitions of thrifts by commercial firms); *Kanikal v. Attorney General*, 776 F.3d 146 (3d Cir. 2015) (refusing to interpret the literal text of one federal statute to override the clearly intended purpose of another federal law because the second law's legislative history confirmed Congress's strong intent that the second law's policy should be given priority). In the course of its opinion in *Kanikal*, the Third Circuit stated, "In resolving ambiguity, we must allow ourselves some recognition of the existence of sheer inadvertence in the legislative process." 776 F.3d at 152-53 & note 5 (quoting *Cass v. United States*, 417 U.S. 72, 83 (1974)).

acquisitions of ILCs by commercial firms between the expiration of its moratorium in 2008 and March 2020. Unfortunately, on March 18, 2020 – one day after the FDIC issued its proposed ILC rule – the FDIC approved deposit insurance applications for ILCs owned by Square and Nelnet. Square and Nelnet engage in a combination of financial and nonfinancial activities and would not qualify for status as bank holding companies under the BHC Act.[71]

The FDIC's issuance of the proposed ILC rule and its approvals of Square's and Nelnet's applications represent a fundamental and unwelcome change in the FDIC's policy toward ILCs. If adopted, the proposed ILC rule would encourage many other technology and commercial firms to acquire FDIC-insured ILCs.

For example, Rakuten recently renewed its application to acquire an FDIC-insured ILC in Utah. Rakuten is a large Japanese company involved in ecommerce, technology and other commercial activities. Rakuten's global website states that it conducts "over 70 businesses across e-commerce, digital content, communications and fintech," ranging from "new open platforms for e-commerce, to experiments with drones, chatbots, deep learning and AI." Rakuten's website also declares that "we challenge the status quo" and "embrace new and disruptive ideas."[72] If Rakuten acquires an FDIC-insured ILC, other Big Tech giants will almost certainly follow its example.

The FDIC should deny – or Congress should prevent – further acquisitions of ILCs by commercial firms. Further acquisitions would (i) severely undermine our longstanding policy of separating banking and commerce, (ii) create toxic conflicts of interest and pose serious threats

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[71] Wilmarth, "Industrial Banks," *supra* note 3, at 1, 3-4 (also noting that Congress imposed a three-year moratorium on acquisitions of ILCs between July 2010 and July 2013).

[72] *Id.* at 1-2 (quoting statements on Rakuten's global website under the headings "About Us" and "Leadership"), available at https://global.rakuten.com/corp/about/); Jon Prior, "Rakuten refiles with FDIC for ILC charter," *American Banker* (May 29, 2020).

to competition and consumer welfare, (iii) threaten to inflict large losses on the federal "safety net" for financial institutions during future systemic crises, and (iv) pose grave dangers to the stability of our financial system and the health of our general economy. Further acquisitions would contravene the public interest factors that the FDIC is required to consider under the FDI Act because those acquisitions would create (a) increased risks to the federal deposit insurance fund, (b) harmful impacts on communities and their residents, (c) adverse effects on competition, and (d) greater risks to the stability of the U.S. banking and financial systems.[73]

Commercial ownership of ILCs would pose serious threats to the stability of our financial system and our economy. The federal government bailed out several large corporate owners of ILCs during the financial crisis of 2007-09, including CIT Group, GE Capital, GMAC, Goldman Sachs, Merrill Lynch, and Morgan Stanley. Those bailouts illustrate the systemic dangers that are likely to arise when large nonbank corporations acquire ILCs and combine the operations of those ILCs with their other activities.[74]

Widespread ownership of ILCs by commercial firms would greatly increase the likelihood of contagious spillovers of risks and losses between the financial system and the general economy. During future financial crises and economic downturns, federal agencies would face intense pressures to rescue large commercial owners of ILCs to ensure the stability of our financial system and the health of our economy. For example, the German technology firm Wirecard was planning to pursue an acquisition of Deutsche Bank shortly before the revelation

[73] *See* Wilmarth, "Industrial Banks," *supra* note 3, at 2-13; *see also infra* note 79 and accompanying text (discussing the public interest factors that the FDIC must consider under the FDI Act). The FDIC's issuance of its proposed ILC rule also violated the Administrative Procedure Act because the FDIC did not provide the public with adequate notice of – and an opportunity to comment on – the agency's change in policy toward acquisitions of ILCs by commercial firms and its factual, legal, and policy reasons for making that change. *Id.* at 2, 13-14.
[74] *Id.* at 6-8.

of Wirecard's massive accounting fraud led to the firm's collapse in June 2020.[75] Imagine the systemic crisis that could have occurred if Wirecard had acquired Deutsche Bank before its accounting fraud became known to regulators and the public.

FDIC-insured ILCs have full access to the federal "safety net," including deposit insurance, Fed discount window loans, and the Fed's payment and settlement services. That access would give significant competitive advantages to commercial firms that acquire ILCs. In addition to the low-cost funding provided by ILC deposits and discount window loans, commercial owners would receive implicit "catastrophe insurance" in the form of expected federal support during future systemic crises. Allowing commercial firms to own ILCs would create a highly skewed playing field favoring big enterprises that could afford to acquire ILCs and handicapping smaller firms that could not.[76]

The financial industry and many commercial sectors of our economy (including the information technology industry) already display very high levels of concentration and are dominated by a small number of giant firms. That domination enable big incumbent firms to capture unjustified super-profits by using their market power to impose unfair prices on customers and suppliers, by acquiring or crowding out smaller firms, and by deterring entry by new firms.[77] Allow Big Tech giants and other large commercial firms to acquire ILCs would give them an additional competitive edge, thereby further impairing competition and harming customers and suppliers in many lines of commerce.

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[75] *See* Olaf Storbeck, "Wirecard: the frantic final months of a fraudulent operation," *Financial Times* (Aug. 25, 2020), available at https://www.ft.com/content/6a660a5f-4e8c-41d5-b129-ad5bf9782256; Olaf Storbeck & Dan McCrum, "Wirecard's deceit went beyond its fraudulent Asian operations," *Financial Times* (Sept. 22, 2020), available at https://www.ft.com/content/04c77d71-c2ff-4340-8cf9-ee9c55b800e0; *see also* Todd H. Baker, "The Fall of Wirecard," *CLS Blue Sky Blog* (July 8, 2020), available at https://clsbluesky.law.columbia.edu/2020/07/08/the-fall-of-wirecard/.

[76] Wilmarth, "Industrial Banks," *supra* note 3, at 8-9; Wilmarth, "Wal-Mart," *supra* note 55, at 1588-93, 1621.

[77] *See* Thomas Philippon, *The Great Reversal: How America Gave Up on Free Markets* (2019); Timothy Wu, *The Curse of Bigness: Antitrust in the New Gilded Age* (2018).

4. Acquisitions of ILCs and Fintech "Banks" by Commercial Firms Would Inflict Serious Harm on Our Economy and Society

Acquisitions of ILCs and nondepository fintech national banks by Big Tech giants and other commercial firms would transform our financial system and economy in ways that are likely to impose significant harm on taxpayers, consumers, and communities. Big Tech firms already enjoy technological superiority over banks in the fields of automation, artificial intelligence, data management, and mobile payments. The rapid growth of Alibaba, Ant Financial, and Tencent in China's financial system indicate that Big Tech firms could potentially dominate major segments of our financial industry if those firms are allowed to establish "in-house banks" and exploit their technological advantages. Financial regulators around the world are just beginning to grapple with a wide array of public policy issues raised by the potential entry of Big Tech firms into the banking industry. Those issues include concerns about unfair competition, limits on sharing of customer data, protection of privacy rights in customer financial and health information, as well as operational and systemic risks created by ownership of banks by large technology firms.[78]

The FDIC and OCC should not be allowed to preempt the ongoing consideration of these vitally important issues by allowing Big Tech giants to acquire ILCs and nondepository fintech "banks." Those acquisitions would create intense pressure on Congress to remove all of the BHC Act's restrictions on joint ownership of banks and commercial firms. Big Tech giants would not be satisfied with making "toehold" acquisitions of ILCs or fintech "banks." They would want to establish a stronger competitive presence in the financial industry by acquiring large full-service banks. Conversely, big banks would push Congress to create a "level playing

[78] *See* Kathryn Petralia, Thomas Philippon, Tara Rice & Nicholas Véron, *Banking Disrupted? Financial Intermediation in an Era of Transformational Technology* 25-38, 44-82 (Geneva Reports on the World Economy 22, 2019), available at https://www.cimb.ch/uploads/1/1/5/4/115414161/banking_disrupted_geneva22-1.pdf.

field" by allowing banks to acquire technology firms. Allowing Big Tech firms to acquire ILCs and fintech national "banks" would almost certainly lead to large-scale combinations between giant technology firms and megabanks. Those combinations would magnify the excessive levels of concentration, the lack of effective competition, the "too big to fail" status, and the unhealthy political influence that our technology giants and megabanks already possess and exploit. Those outcomes would violate the public interest factors that the FDIC and other bank regulators must consider under the FDI Act.[79]

As shown above, Big Tech giants and other commercial firms that acquire ILCs or fintech "banks" would not be regulated by the Fed under the BHC Act. The FDIC and the OCC could not exercise the type of consolidated, comprehensive supervision over commercial owners of ILCs and fintech "banks" that the Fed currently exercises over bank holding companies under the BHC Act. For example, the FDIC and OCC could not conduct unlimited, full-scope examinations of commercial parent companies and their nonbank subsidiaries. In addition, the FDIC and OCC could not impose consolidated capital requirements and liquidity requirements on commercial parent companies, nor could they require those companies to undergo stress tests and resolution planning exercises that large bank holding companies must complete.[80]

The Wirecard debacle illustrates the great danger of allowing the FDIC and OCC to regulate ILCs or fintech "banks" without possessing comprehensive, consolidated supervisory authority over those institutions' parent companies and other nonbank affiliates. Felix Hufeld, president of BaFin (Germany's financial regulatory agency) told the Bundestag (Germany's

[79] Wilmarth, "Industrial Banks," *supra* note 3, at 9-13. The public interest factors that regulators must consider under the FDI Act include (a) risks to the federal deposit insurance fund, (b) the "convenience and needs" of communities and their residents, (c) adverse effects on competition, and (d) risks to the stability of the U.S. banking and financial systems. *See id.* at 12-13 (discussing 12 U.S.C. §§ 1815, 1816, 1817(j)(7), and 1828(c)(5)).
[80] *See id.* at 10-11; *see also* 12 U.S.C. §§ 5365, 5371.

federal legislature) that BaFin failed to uncover Wirecard's massive accounting fraud because BaFin lacked authority to supervise Wirecard and its complex international network of nonbank subsidiaries. Hufeld said that BaFin's "ability to act was limited because Wirecard was classified as a technology company rather than a financial services provider, and so was not fully under BaFin's purview. The agency only oversaw Wirecard Bank," a deposit-taking bank that Wirecard owned.[81]

Even if Congress decided to give the FDIC and OCC consolidated supervisory authority over commercial owners of ILCs and fintech "banks," that authority would *not* remove the grave threats posed by the resulting commercial-financial conglomerates. Any federal banking agency would face enormous logistical challenges in attempting to oversee complex and highly diversified commercial-financial conglomerates, including the need to hire personnel with expertise in many different commercial sectors of the U.S. economy. The catastrophic failures of federal financial agencies to regulate large bank holding companies as well as "shadow bank" financial conglomerates prior to the financial crisis of 2007-09 should persuade us that federal regulators would have an even *lower* probability of success in regulating highly diversified commercial-financial conglomerates.[82]

Big Tech giants and other large commercial owners of ILCs and fintech "banks" would inevitably be considered "too big to fail" by both regulators and market participants. Their "too big to fail" status, their extensive lobbying resources, and their political influence would also make them "too big to discipline adequately." Thus, any attempt to establish an effective system

[81] Guy Chazan & Olaf Storbeck, "Head of German financial watchdog defends agency's Wirecard role," *Financial Times* (July 1, 2020) (summarizing Hufeld's statement), available at https://www.ft.com/content/fd2e1442-d35e-412e-a7a5-aa4d5b52e629; *see also* Baker, *supra* note 75; Matthew Vincent, Jim Brunsden & Olaf Storbeck, "EU watchdog to probe German regulators after Wirecard collapse," *Financial Times* (July 15, 2020), available at https://www.ft.com/content/7b711f0e-0e2d-4639-94db-0c26b4073e78.

[82] Wilmarth, "Industrial Banks," *supra* note 3, at 4-7, 11-12; *see also supra* note 29, *infra* note 134 and accompanying text (discussing regulatory failures that contributed to the financial crisis of 2007-09).

of consolidated supervision for commercial-financial conglomerates would almost certainly fail. The unfeasibility of consolidated supervision for large commercial-financial conglomerates provides a further compelling reason for prohibiting their existence.[83]

II. The OCC's and FDIC's Usury Preemption Transfer and "True Lender" Rules Violate Federal Laws and Threaten to Impose Severe Injuries on Consumers and Small Businesses

A. Federal Laws Prohibit the OCC and FDIC from Extending the Scope of Federal Preemption to Benefit Nonbanks

1. The OCC's and FDIC's Usury Preemption Transfer Rules Are Unlawful

Since 1864, Section 85 of the NBA has specified the "interest" that a national bank may "take, receive, reserve, and charge" on its loans. The "interest" allowed to a national bank under Section 85 is governed by the usury laws of the state in which the bank is "located." Section 85 confers on each national bank a preemptive immunity from state usury laws except for the usury laws of the state in which that bank is "located."[84]

The OCC lacked authority to issue its usury preemption transfer rule, which purports to extend the preemption provided to national banks under Section 85 to reach third-party purchasers, assignees, and transferees of loans made by national banks.[85] Section 85's explicit terms make clear that the power to charge "interest" thereunder is granted *only* to national banks and does *not* extend to purchasers, assignees, or transferees of loans made by national banks. Less than a decade after Congress enacted the NBA, the Supreme Court held that Section 85 was intended "to allow *to National associations* the rate allowed by the State to natural persons

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[83] Wilmarth, "Industrial Banks," *supra* note 3, at 11-12; Wilmarth, "Wal-Mart," *supra* note 55, at 1617-21.
[84] Act of June 3, 1864, § 30, 13 Stat. 108 (codified as amended at 12 U.S.C. § 85); *see also Marquette National Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978).
[85] OCC Usury Preemption Transfer Rule, *supra* note 4.

generally, and a higher rate, if State banks of issue were authorized to charge a higher rate."[86] A century later, the Supreme Court's *Marquette* decision stated that Section 85 provides the terms on which "a *national bank* may charge interest."[87] The Court explained that its *Marquette* decision – which allowed a national bank to "export" to borrowers in other states the interest rate allowed by the state in which the bank was "located" – did *not* apply to the bank's nondepository subsidiary or to other parties with which the bank had contractual relationships.[88]

In 1980, Congress enacted two statutes, 12 U.S.C. §§ 1463(g)(1) and 1831d, which were designed to give federal savings associations and FDIC-insured, state-chartered depository institutions "parity, or competitive equality" with national banks in terms of the "interest" they can charge on their loans.[89] Congress also intended that Sections 1463(g) and 1831d would "provide federally-insured credit institutions with the same 'most-favored-lender' status enjoyed by national banks."[90] The preemptive immunity granted by Sections 1463(g) and 1831d applies *only* to "interest" lawfully charged by federal savings associations and FDIC-insured, state-chartered depository institutions. The preemptive scope of those statutes is the same as Section 85, which applies *only* to "interest" lawfully charged by national banks.[91]

Sections 1463(g) and 1831d were enacted as part of Section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA).[92] Like Section 85,

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[86] *Tiffany v. National Bank of Missouri*, 85 U.S. (18 Wall.) 409, 413 (1873) (emphasis added).
[87] *Marquette National Bank*, 439 U.S. at 308 (emphasis added).
[88] See *Marquette*, 439 U.S. at 307-08 ("There is no allegation in petitioners' complaints that either Omaha Service Corp. or the Minnesota merchants and banks participating in the BankAmericard program are themselves extending credit in violation of Minn. Stat. § 48.185 (1978), and we therefore have no occasion to determine the application of the National Bank Act in such a case.").
[89] *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992) (quoting 126 Cong. Rec. 6900 (1980) (remarks of Sen. Proxmire)), *cert. denied*, 506 U.S. 1052 (1993); *accord, Garvey Properties/762 v. First Financial Savings & Loan Ass'n*, 845 F.2d 519, 520-22 (5th Cir. 1988).
[90] *Garvey Properties*, 845 F.2d at 521.
[91] See *In re Community Bank of N. Va.*, 418 F.3d 277, 296 (3d Cir. 2005) (Sections 85 and 1831d "apply only to national banks and state chartered banks, not to non-bank purchasers of second mortgage loans").
[92] Pub. L. No. 96-221, § 521, 94 Stat. 132, 164.

Sections 1463(g) and 1831d do *not* include any reference to the right of a federally-chartered or federally-insured depository institution to transfer its preemptive immunity from state usury laws to purchasers, assignees, and other transferees of its loans.

In contrast, 12 U.S.C. § 1735f-7a – enacted as part of Section 501 of DIDMCA – preempts state usury laws from applying to originations and "credit sales" of first-lien residential mortgages that qualify as "federally related mortgage loans" under 12 U.S.C. § 1735f-5(b). Congress intended that the preemption provided by Section 501 would apply to *both* originations *and* sales of qualifying first-lien residential mortgages. Congress wanted to "facilitate a national housing policy and the functioning of a national secondary market in mortgage lending."[93] Congress therefore made clear that qualifying first-lien residential mortgages made by "eligible lenders" would continue to receive the benefit of Section 501's preemption of state usury laws if those mortgages were subsequently sold to investors who were not "eligible lenders."[94]

Thus, the preemption authorized by Section 501 of DIMCA applies to sales of qualifying first-lien residential mortgages and covers purchasers of those mortgages. In contrast, the preemption authorized by Section 521 of DIDMCA, which enacted Sections 1463(g) and 1831d, does *not* refer to "sales" of loans or to purchasers of loans. The Supreme Court has repeatedly held that Congress is presumed to act "intentionally and purposely" when "it includes particular language in one section of a statute but omits it in another section of the same Act."[95] That presumption is especially strong when the two statues were enacted "simultaneously" by the

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[93] *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907, 911 (3d Cir. 1990) (quoting S. Rep. No. 96-368, at 19 (1979)).

[94] *See* S. Rep. No. 96-368, at 19 (1979) ("[I]t is the committee's intent that loans originated under this usury exemption will not be subject to claims of usury even if they are later sold to an investor who is not exempt under this section.").

[95] *Barnon v. Sigmon Coal Co.*, 534 U.S. 438, 452 (2002) (quoting *Russelo v. United States*, 464 U.S. 16, 23 (1983)); *accord*, *INS v. Cardoza-Fonseca*, 480 U.S. 421, 432 (1987).

"same Congress," as Sections 501 and 521 of DIDMCA were in 1980.[96] It must therefore be presumed that Congress acted "intentionally and purposefully" when it did *not* make any reference to "sales" of loans or purchasers of loans in Section 521 of DIDMCA.

The absence of any reference to "sales" of loans in Section 521 of DIDMCA supports the conclusion that the preemption provided to national banks by 12 U.S.C. 85 – the historical model for Section 521 – also does *not* extend to purchasers of loans.[97] That conclusion is further bolstered by the Alternative Mortgage Transactions Parity Act, 12 U.S.C. §§ 3801-06 (AMTPA), which was enacted only two years after DIDMCA. Under 12 U.S.C. § 3803, "housing creditors" (including state-chartered, non-depository lenders) can "make, purchase, and enforce alternative mortgage transactions" in accordance with AMTPA, regardless of contrary state laws. Thus, the scope of AMTPA's preemption expressly extends to purchasers of qualifying alternative mortgages, in the same way that the preemptive scope of Section 501 of DIDMCA includes purchasers of qualifying first-lien residential mortgages. Section 501 of DIDMCA and AMTPA show that Congress knew how to make its intention clear when it wanted to extend preemptive immunity to purchasers of loans.

The preemption standards for national banks under 12 U.S.C.§ 25b – which Congress adopted in 2010 – reinforce the conclusion that Sections 85 does *not* provide preemptive immunity for purchasers, assignees, and other transferees of loans made by national banks. Sections 25b(b)(2), (e), and (h)(2) provide that state laws apply to subsidiaries, affiliates, and agents of national banks to the same extent as they apply to any other person subject to those

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[96] *Cardoza-Fonseca*, 480 U.S. at 432.

[97] See *Greenwood Trust,* 971 F.2d at 827 ("The historical record clearly requires a court to read the parallel provisions of [DIDMCA] and the [National] Bank Act *in pari materia*."); *accord*, *In re Community Bank of N. Va.*, 418 F.3d at 295-96 ("[T]he language of the two statutes [– Sections 1831d and 85 –] should ordinarily be interpreted in the same way.").

state laws – *unless* the subsidiary, affiliate, or agent is itself chartered as a national bank.[98] Similarly, state laws apply to subsidiaries, affiliates, and agents of federal savings associations pursuant to 12 U.S.C. § 1465(a), which establishes equivalent preemption standards for federal thrifts.

The foregoing provisions of Section 25b overruled several court decisions prior to 2010 that extended the NBA's preemptive scope to cover nonbank subsidiaries and agents of national banks.[99] In light of Section 25b's express *denial* of NBA preemption to nonbank subsidiaries, affiliates, and agents of national banks, the OCC's usury preemption transfer rule violated congressional intent by purporting to extend the preemptive scope of Sections 85 and 1463(g) to reach purchasers and assignees of loans. Purchasers and assignees of loans are counterparties to contracts with national banks and federal thrifts, just as agents are and most subsidiaries and affiliates are. Purchasers and assignees of loans cannot claim any entitlement to a preemptive immunity that Congress has expressly *denied* to other types of contract counterparties that have *closer* relationships with national banks and federal thrifts.

Section 25b(f) provides additional evidence of Congress's intent *not* to extend preemption of state usury laws beyond national banks. Section 25b(f) preserves only "the authority conferred by section 85 . . . for the charging of interest *by a national bank*" from the limitations on preemption established by Section 25b (emphasis added). Federal savings associations are subject to the same limited scope of preemption under 12 U.S.C. § 1465(a).

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[98] *See* S. Rep. No. 111-176, at 176 (2010) (Under Dodd-Frank, "State law applies to State-chartered nondepository institution subsidiaries, affiliates, and agents of national banks, other than entities that are themselves chartered as national banks."); Wilmarth, "Dodd-Frank," *supra* note 29, at 934-35.

[99] See *Mississippi Dept. of Finance v. Pikco Finance, Inc.*, 97 So.3d 1203, 1209 n.7 (Miss. 2012) (recognizing that Dodd-Frank overruled the preemptive ruling of *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2007), with respect to operating subsidiaries of national banks); *Phillips v. Bank of America, N.A.*, 186 Cal.Rptr.3d 434, 444 (Cal. App. 2015) (same); Wilmarth, *supra* note 29, at 934-35 (discussing *Watters* and other decisions whose preemptive rulings concerning subsidiaries and agents of national banks were overruled by Dodd-Frank).

Like Sections 85, 1463(g), and 1831d, Section 25b(f) does *not* refer to purchasers, assignees, or other transferees of loans made by national banks.

When the OCC proposed its usury preemption transfer rule, the OCC acknowledged that its assertion of preemptive immunity for purchasers, assignees, and other transferees of loans made by national banks and federal thrifts was *not* based on any language "expressly stated" in Sections 85 and 1463(g).[100] The OCC also recognized that its rule was contrary to the decision of the Second Circuit Court of Appeals in *Madden v. Midland Funding*. The Second Circuit held in *Madden* that any extension of Section 85's preemption to cover debt collectors who purchased loans from national banks would be an "overly broad application" of the NBA. The Second Circuit concluded that such an outcome "would create an end-run around usury laws for non-national bank entities that are not acting on behalf of a national bank."[101]

The OCC argues that its usury preemption transfer rule is supported by the "common-law [principles of] valid-when-made and the assignability of contracts," which it derives from court decisions dating back to the 19th century. According to the OCC, it is "not citing these tenets as independent authority for this rulemaking but rather as tenets of common law that inform its reasonable interpretation of section 85."[102]

The OCC cannot rely on common-law principles from federal court decisions to expand the preemptive scope of federal statutes. The Supreme Court has made clear since 1938 that "[t]here is no federal general common law."[103] The Supreme Court has repeatedly held that "cases in which judicial creation of a special federal [common law] rule would be justified . . .

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[100] OCC, Notice of proposed rulemaking, "Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred," 84 Fed. Reg. 64229, 64230 (Nov. 21, 2019).
[101] *Madden v. Midland Funding, LLC*, 786 F.3d 246, 251-52 (2d Cir. 2015), *cert. denied*, 136 S. Ct. 2505 (2016). The OCC's usury preemption transfer rule is designed to overrule *Madden*. *See* 85 Fed. Reg. at 33531-33.
[102] OCC Usury Preemption Transfer Rule, *supra* note 4, at 33532 (citing, inter alia, *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103 (1833), and *Gaither v. Farmers & Mechanics Bank of Georgetown*, 26 U.S. (1 Pet.) 37 (1828)).
[103] *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 83 (1994) (quoting *Erie R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938)).

are . . . 'few and restricted.'"[104] The Supreme Court has twice struck down attempts by the FDIC to expand the scope of preemption under the FDI Act by invoking federal common-law rules.

In its 1997 *Atherton* decision, the Supreme Court held that a "federal common law" duty of ordinary care for bank directors and officers did not expand the preemptive scope of 12 U.S.C. § 1821(k). Section 1821(k) imposes liability on directors and officers of FDIC-insured banks for gross negligence. However, the statute is silent on the question of whether the FDIC can hold bank directors and officers liable for simple negligence in cases where applicable state laws do not impose a duty of ordinary care. The FDIC claimed that it could impose liability for simple negligence based on a "federal common law" rule dating from the 19th century, even if applicable state laws denied liability for simple negligence. The Supreme Court rejected the FDIC's claim and held that "state law, not federal common law, provides the applicable rules for decision," except where Section 1821(k) preempted state law by stipulating a gross negligence standard. The Court pointed out that "federally chartered banks are subject to state law," and "a federal charter by itself shows no conflict, threat, or need for 'federal common law.'"[105]

In its 1993 *O'Melveny & Myers* decision, the Court rejected a similar preemption claim by the FDIC. The FDIC asserted that a law firm should be held liable for negligence and breach of fiduciary duty based on its alleged malpractice in representing a failed thrift institution. The FDIC argued, based on a "federal common-law rule," that the law firm could not defend itself by imputing the knowledge of corporate officers to the thrift or to the FDIC as the thrift's receiver. Again, Section 1821 was silent about any imputation of knowledge from corporate officers to their institution and the FDIC. However, applicable state laws did impute the knowledge of

[104] *Atherton v. FDIC*, 519 U.S. 213, 218 (1997) (quoting *O'Melveny & Myers*, 512 U.S. at 87) (quoting *Wheeldin v. Wheeler*, 373 U.S. 647, 651 (1963)).
[105] *Atherton*, 519 U.S. at 218-26.

those officers to both the thrift and the FDIC. After reviewing the "comprehensive and detailed" provisions of Section 1821, the Supreme Court determined that "matters left unaddressed in such a scheme are presumably left to the disposition provided by state law." The Court held that Section 1821 "places the FDIC in the shoes of the insolvent S&L, to work out its claims under state law, except where some provision in the extensive framework of [Section 1821] provides otherwise. *To create additional 'federal common-law' exceptions is not to 'supplement' this scheme, but to alter it.*"[106]

The OCC's reliance on common-law "tenets" to expand the preemptive scope of 12 U.S.C. §§ 85 and 1463(g) is invalid for the same reasons that the Supreme Court rejected the FDIC's reliance on "federal common law rules" in *Atherton* and *O'Melveny & Myers*. The OCC's usury preemption transfer rule applies to transactions between private parties (national banks and purchasers, assignees, and transferees of their loans). The OCC's rule does not implicate the rights, liabilities, or duties of the United States or its agencies, officials, or contractors, and it also does not involve U.S. foreign relations or admiralty matters. The Supreme Court has held that application of a federal common-law rule is *not* justified when "private parties," including national banks, are involved in a dispute relating to a "private transaction" that "does not touch the rights and duties of the United States."[107]

Consequently, the OCC cannot rely on common-law "tenets" to expand the preemptive scope of 12 U.S.C. 85 and 1463(g). In determining whether federal statutes preempt state authority in a traditional field of state regulation, such as consumer protection, federal courts "start with the assumption that the historic police powers of the States were not to be superseded

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[106] *O'Melveny & Myers*, 512 U.S. at 85-88 (emphasis added).
[107] *Bank of America National Trust & Savings Ass'n v. Parnell*, 352 U.S. 29, 33-34 (1956); *see also Atherton*, 519 U.S. at 226.

by the Federal Act unless that was the clear and manifest purpose of Congress."[108] Courts have held that "compelling evidence of [Congress's] intention to preempt" is required" before they will conclude that a federal statute preempts state consumer protection laws.[109]

There is no "compelling evidence" of any "clear and manifest purpose of Congress" to extend the scope of usury preemption under Sections 85 and 1463(g) to reach purchasers, assignees, and other transferees of loans made by national banks and federal thrifts. On the contrary, as shown above, the express terms of Sections 85 and 1463(g) apply only to "interest" that is lawfully "charge[d]" by national banks and federal thrifts. When Congress wanted to extend usury preemption to reach purchasers of mortgage loans under DIDMCA and AMTPA, Congress made its intention crystal clear.

When the FDIC proposed its own usury preemption transfer rule, it acknowledged that 12 U.S.C. § 1831d "is patterned after section 85 and receives the same interpretation as section 85."[110] Accordingly, the FDIC's authority to preempt state usury laws under Section 1831d is no broader than the OCC's authority under Section 85 and does *not* extend to third parties that acquire bank loans. The OCC's and FDIC's usury preemption transfer rules plainly exceed their statutory authority, and both rules are invalid.[111]

2. The OCC's Proposed "True Lender" Rule Is Unlawful and Would Enable National Banks to Form "Rent-a-Charter" Schemes with Predatory Nonbank Lenders

Under the OCC's proposed "true lender" rule, a national bank or thrift would be deemed to "make" a loan if the institution, "as of the date of origination," is either "named as the lender

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[108] *Wyeth v. Levine*, 555 U.S. 555, 565 (2009) (quoting *Medtronic v. Lohr*, 518 U.S. 470, 485 (1996)).
[109] *Lusnak v. Bank of America, N.A.*, 883 F.3d 1185, 1188, 1191-94 (9th Cir.), *cert. denied*, 139 S. Ct. 567 (2018) (quoting *Aguayo v. U.S. Bank*, 653 F.3d 912, 917 (9th Cir. 2011) (quoting *General Motors Corp. v. Abrams*, 897 F.2d 34, 41-42 (2d Cir. 1990)).
[110] FDIC, Notice of proposed rulemaking, "Federal Interest Rate Authority," 84 Fed. Reg. 66845, 66849 (Dec. 6, 2019).
[111] *See* Wilmarth Usury Preemption Transfer Comment Letter, *supra* note 4, at 7-13.

in the loan agreement" or "[f]unds the loan."[112] The proposed rule is designed to "operate together" with the OCC's usury preemption transfer rule.[113] Working in tandem, the rules would permit national banks or federal thrifts to form "partnerships" with nonbank lenders. A nonbank lender that generates loans through such a "partnership" could claim preemptive immunity from state usury laws under 12 U.S.C. 85 or 1463(g), even if its bank "partner" does not retain any meaningful credit risk or other economic risk related to those loans. The bank "partner" could act as a mere conduit by quickly transferring loans to the nonbank lender, and the nonbank lender could assume all of the economic risks, dictate the terms, and control the enforcement of those loans. Such "partnerships" would represent "rent-a-charter" schemes, which the OCC barred national banks from establishing during the early 2000s.[114]

The OCC's proposed "true lender" rule evidently seeks to preempt not only state usury laws but also a wide range of other state laws – including state licensing, examination, and consumer protection laws – that would otherwise apply to nonbank lenders that establish "partnerships" with national banks. For example, a loan that is deemed to be "made" by a national bank under either of the proposed rule's two tests would apparently be covered by the OCC's sweeping claims of preemption of state law under 12 C.F.R. § 7.4008 (for loans "made" by national banks that are not secured by real estate) or 12 C.F.R. § 34.4 (for real estate loans "made" by national banks) – even if the bank subsequently transfers the loan to a nonbank "partner." The proposed rule's potential scope of preemption therefore embraces a very broad array of state laws.[115]

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[112] OCC Proposed "True Lender" Rule, *supra* note 5, at 44228.
[113] *Id.* at 44227.
[114] *See* Wilmarth "True Lender" Comment Letter, *supra* note 5, at 1-2.
[115] *See id.* at 2 (citing 85 Fed. Reg. at 44225).

In its notice of proposed rulemaking, the OCC acknowledged that federal statutes – including 12 U.S.C. §§ 85 and 1463(g) – "do not specifically address which entity makes a loan (or, in the vernacular commonly used in case law, which entity is the 'true lender')" and therefore do not identify "what legal framework applies, when the loan is originated as part of a lending relationship between a bank and a third party." In addition, the OCC admitted that *none* of the federal statutes authorizing national banks and federal savings associations to make contracts and loans "describes how to determine when a bank has, in fact, exercised this authority, and when, by contrast, the bank's relationship partner has made the loan."[116] Thus, the OCC conceded that its proposed "true lender" tests are *not* supported by any explicit statutory authority.

The proposed rule also ignores the fact that contracts made by national banks are governed by applicable state laws *unless* a particular state law creates an irreconcilable conflict with a federal statute. The Supreme Court has repeatedly held that national banks "

> are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. *All their contracts are governed and construed by State laws.* Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law."[117]

Similarly, the Supreme Court affirmed in 2009 that "States . . . have always enforced their general laws against national banks – and have enforced their banking-related laws against national banks for at least 85 years."[118]

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[116] OCC Proposed "True Lender" Rule, *supra* note 5, at 44224, 44225.
[117] *Atherton v. FDIC*, 519 U.S. 213, 222-23 (1997) (emphasis added) (quoting *National Bank v. Commonwealth*, 76 U.S. (9 Wall.) 353, 362 (1870)).
[118] *Cuomo v. Clearing House Ass'n*, 557 U.S. 519, 534 (2009); *see also* Wilmarth, "Dodd-Frank," *supra* note 29, at 944-48 (discussing additional Supreme Court decisions upholding the application of state laws to contracts and other transactions made by national banks).

Contracts for loans are subject to state usury laws as well as general state contract laws. State usury laws are valid exercises of the states' historic police power to protect their residents from abusive and exploitative lending practices.[119] Because usury is a traditional field of state regulation, federal courts have declined to infer from statutory silence that Congress intended to preempt state usury laws.[120] As indicated above, Congress has *not* expressed any intention to preempt "true lender" doctrines that are a key element of many state usury laws.[121]

Federal courts have repeatedly held that Section 85 incorporates the entire usury jurisprudence of the relevant state, including that state's usury statutes and interpretations of those statutes by the state's courts.[122] Federal and state courts have also held that usury claims should be determined based on the "substance" of the relevant transactions and not their legal

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[119] *See Griffith v. Connecticut*, 218 U.S. 563, 569 (1910) (It is "elementary" that usury laws fall "within the police power" of the states.); *Goleta National Bank v. Lingerfelt*, 211 F.Supp.2d 711, 716 (E.D.N.C. 2002) ("[T]he State does have a vital interest in protecting its citizens from predatory lending, usury, and other forms of deceptive trade practices."); *Pa. Dept. of Banking v. NCAS of Delaware, LLC*, 948 A.2d 752, 759 (Pa. 2008) ("[R]egulation of the rate of interest is a subject within the police power of the State, and this is especially true in the case of loans of comparatively small amounts, since the business of making such loans profoundly affects the social life of the community.") (quoting *Equitable Credit & Discount Co. v. Geier*, 21 A.2d 53, 58 (Pa. 1941)); James M. Ackerman, "Interest Rates and the Law: A History of Usury," 1981 *Arizona State Law Journal* 61, 85-110 (explaining that state usury laws "are viewed as a protective measure imposed to safeguard consumers from abuse and exploitation by sellers of credit," *id.* at 110).

[120] *See Doyle v. Southern Guaranty Corp.*, 795 F.2d 907, 914 (11th Cir. 1986) (noting Congress's "traditional deference to the state's right to determine its usury statute"); *Goleta National Bank v. Lingerfelt*, 211 F. Supp. 2d at 716-18 (rejecting the assertion that the NBA completely preempted the application of state usury laws to a nonbank lender that made loans as an alleged partner of a national bank, because that preemption claim was "far from being facially conclusive or readily apparent"); *see also In re Seolas*, 140 B.R. 266, 272 (E.D. Cal. 1992) ("ERISA does not preempt generally applicable usury laws [in the] absence of any evidence that Congress intended preemption," because "usury laws are a traditional subject of state regulation.").

[121] *See* the third paragraph of this Part 2(b).

[122] *Union National Bank v. Louisville, N., A. & C. Ry. Co.*, 163 U.S. 325, 330-31 (1896) (holding that 12 U.S.C. § 85 incorporated the usury statutes of Illinois as interpreted by Illinois state courts); *accord, Citizens National Bank v. Donnell*, 195 U.S. 369, 374 (1904) ("[W]e follow the state court" in determining whether a national bank violated Missouri's usury laws); *Daggs v. Phoenix National Bank*, 177 U.S. 549, 555 (1900) ("The intention of the [NBA] is to adopt the state law, and permit to national banks what the state law allows to its citizens and to the banks organized by it."). *See also Bartholomew v. Northampton National Bank*, 584 F.2d 1288, 1295 (3d Cir. 1978) (The NBA "incorporates by reference the usury law of the state where the national bank is located."); *First National Bank of Mena v. Nowlin*, 509 F.2d 872, 876 (8th Cir. 1975) (Section 85 "adopts the entire case law of the state interpreting the state's limitations on usury; it does not merely incorporate the numerical rate adopted by the state."); *Roper v. Consurve, Inc.*, 777 F. Supp. 508, 513 (S.D. Miss. 1990) (Section 85 "adopts not only the numerical interest rates set by state statute, but also the entire case law of the state interpreting the state's limitations on usury."), *aff'd*, 932 F.2d 965 (5th Cir.) (table), *cert. denied*, 502 U.S. 861 (1991).

"form." In an 1835 decision, the Supreme Court declared (in an opinion by Chief Justice John Marshall) that an alleged violation of usury laws should be evaluated based on "*the substance of the transaction* and the true intent and meaning of the parties, for they alone are to govern, *and not the words used*."[123] Other courts have similarly evaluated usury claims against national banks by "look[ing] behind the form of a transaction to its substance" in accordance with state usury laws.[124]

Several courts have applied a substance-over-form analysis in determining whether nonbank lenders were actually the "true lenders" even though they claimed to be "partners" of banks." Those courts rejected claims by nonbank lenders for preemptive immunity under 12 U.S.C. § 85 or 12 U.S.C. § 1831d, based on their status as "partners" or "agents" of national banks or FDIC-insured state banks. The courts held that nonbank lenders should be treated as the "true lenders" if they held the "predominant economic interest" in the loans. In determining which party possessed the "predominant economic interest," the courts considered several factors, including which party bore the greatest amount of credit risk under the loans, which party dictated the terms and controlled the enforcement of the loans, and whether the nonbank lender agreed to indemnify its "partner" bank.[125]

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[123] *Scott v. Lloyd*, 34 U.S. 418, 453 (1835) (quoting Lord Mansfield; emphasis added); *see also id.* at 456 ("[T]he only question in all cases like the present, is, *what is the real substance of the transaction*, not what is the colour and form" (quoting Lord Mansfield; emphasis added).

[124] *Anderson v. Hershey*, 127 F.2d 884, 886 (6th Cir. 1942) (applying Kentucky law); *accord*, *First National Bank in Mena v. Nowlin*, 509 F.2d at 877 (applying Arkansas law); *Ubaldi v. SLM Corp.*, 852 F. Supp. 2d 1190, 1194-98 (N.D. Cal. 2012) (applying California law); *First National Bank v. Phares*, 174 P. 519, 521 (Okla. 1918) (applying Oklahoma law).

[125] *In re Community Bank of N. Va.*, 418 F.3d at 283-85, 294-97 (applying Pennsylvania law); *Ubaldi*, 852 F. Supp. 2d at 1194-1200 (applying California law); *Eul v. Transworld Systems*, 2017 WL 1178537 at *5 –*10 (N.D. Ill. Mar. 30, 2017) (applying Illinois law); *Goleta National Bank v. O'Donnell*, 239 F. Supp. 2d 745, 753-58 (S.D. Ohio 2002) (applying Ohio law); *Goleta National Bank v. Lingerfelt*, 211 F. Supp. 2d at 717-19 (applying North Carolina law); *CashCall, Inc. v. Morrissey*, 2014 WL 2404300, at *14 –*15 & n.19, *18 (W.Va. May 30, 2014) (applying West Virginia law); *see also CFPB v. CashCall, Inc.*, 2016 WL 4820635 at *5 (C.D. Cal. Aug. 31, 2016) (applying the laws of 16 states, and concluding that the court "should look to the substance, not the form, of the transaction to identify the true lender" in a joint venture between a nonbank lender and a "tribal lending entity," and determining that the nonbank lender was the "true lender").

The OCC's proposed rule disregards the foregoing court decisions and seeks to preempt state "true lender" laws. The proposed rule attempts to create a conclusive, inflexible, and formalistic standard for determining the "true lender" for loans produced by "partnerships" between national banks and nonbank lenders. The proposed rule would consider only two narrow factors – whether the national bank was named as the lender in the loan agreements or funded the loans *for at least one day*. The proposed rule would grant preemptive immunity to nonbank lenders from a wide range of state laws even if those lenders held the "predominant economic interest" in loans generated by "partnerships" with national banks.

The OCC's proposed rule would enable national banks and federal thrifts to form "rent-a-charter" schemes with nonbank lenders. "Rent-a-charter" schemes are designed to prevent states from enforcing their usury laws and other consumer protection laws against high-cost nonbank lenders, including payday lenders and auto title lenders. Those lenders impose very high interest charges on consumers and small businesses with annual percentage rates ("APRs") that often exceed 100%. Loans made by high-cost nonbank lenders produce staggering rates of delinquency and default among borrowers. For example, Elevate, a high-cost lender that is a "partner" of several banks, reported charge-off rates on its loans that exceeded 52% of its revenues in 2016 and 2017. Similarly, more than one-fifth of borrowers who enter into auto title loans eventually lose their cars through repossession. High-cost nonbank lenders usually focus their marketing efforts on vulnerable minority and lower-income households.[126]

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[126] Testimony of Graciela Aponte-Diaz, Center for Responsible Lending, before the House Financial Services Committee (Feb. 5, 2020), at 3-8, available at https://financialservices.house.gov/uploadedfiles/graciela_testimony_crl_rent_a_bank_final_rev.pdf; Testimony of Lauren Saunders, National Consumer Law Center, before the House Financial Services Committee (Feb. 5, 2020), at 7-13, available at https://financialservices.house.gov/uploadedfiles/lauren_saunders_testimony_on_rent_a_bank_hearing_revised_2-5-20.pdf; *see also CashCall, Inc. v. Morrissey*, 2014 WL 2404300, at *1 –*8 (stating that more than two-thirds of West Virginia borrowers who received high-cost loans from CashCall defaulted on those loans, and describing the

In the early 2000s, the OCC recognized the dangers to consumers from payday loans that were marketed by "rent-a-charter" schemes between national banks and nonbank lenders.[127] The OCC took decisive action to shut down those schemes. The OCC issued enforcement orders that required four national banks (Eagle National Bank, First National Bank of Brookings, Goleta National Bank, and Peoples National Bank of Paris, Texas) to stop making payday loans and to terminate their "rent-a-charter" arrangements with nonbank lenders.

In January 2002, the OCC issued an enforcement order against Eagle National Bank after determining that Eagle's payday lending partnership with Dollar Financial Group "risked its financial viability" and violated "a multitude of standards of safe and sound banking, compliance requirements, and OCC guidance." The OCC stated that the Eagle's partnership with Dollar "demonstrates the dangers inherent in arrangements under which national banks rent out their charters to nonbank providers of financial services . . . . [Eagle] effectively collaborated in Dollar's scheme to evade state law requirements that would otherwise be applicable to it."[128]

In announcing a similar enforcement order against Peoples National Bank in January 2003, Comptroller of the Currency John D. Hawke, Jr. stated:

> We have been greatly concerned with arrangements in which national banks essentially rent out their charters to third parties who want to evade state and local consumer protection laws . . . . The preemption privileges of national banks derive from the Constitution and are not a commodity that can be transferred for a fee to nonbank lenders.[129]

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predatory lending and abusive debt collection practices that CashCall perpetrated against those borrowers in violation of West Virginia laws).

[127] OCC Consent Order 2003-2, at 1-2 (Jan. 30, 2003) (Peoples National Bank), available at https://www.occ.gov/static/enforcement-actions/ea2003-2.pdf.

[128] OCC News Release 2002-1 (Jan. 3, 2002) (Eagle National Bank), available at https://www.occ.gov/news-issuances/news-releases/2002/nr-occ-2002-1.html.

[129] OCC News Release 2003-6 (Jan. 31, 2003) (Peoples National Bank), available at https://www.occ.gov/news-issuances/news-releases/2003/nr-occ-2003-6.html. *See also* OCC News Release 2003-3 (Jan. 31, 2003) (First National Bank of Brookings), available at https://www.occ.gov/news-issuances/news-releases/2003/nr-occ-2003-3.html; OCC Consent Order 2002-93 (Oct. 28, 2002) (Goleta National Bank), available at https://www.occ.gov/static/enforcement-actions/ea2002-93.pdf.

In a speech delivered in February 2002, Comptroller Hawke declared that "rent-a-charter" schemes posed serious threats to the "safety and soundness" of national banks and represented "an abuse of the national charter." He condemned such schemes as illegitimate because

> [t]he benefit that national banks enjoy by reason of this important constitutional doctrine [of preemption] cannot be treated as a piece of disposable property that a bank may rent out to a third party that is not a national bank. Preemption is not like excess space in a bank-owned office building. *It is an inalienable right of the bank itself.*[130]

Thus, the OCC established a strong policy in the early 2000s against allowing national banks to organize "rent-a-charter" schemes with nonbank payday lenders. As shown by the OCC's current website, that policy has remained in effect – at least formally – *until now*.[131] The OCC's enforcement orders from the early 2000s provide compelling evidence of the significant harms that the OCC would inflict on states, consumers, and small businesses if it adopts its proposed "true lender" rule and implements its usury preemption transfer rule. Those harms would include: undermining the states' longstanding authority to protect their residents from predatory nonbank lenders, threatening the financial and reputational soundness of national banks, encouraging reckless lending practices, and facilitating efforts by predatory nonbank lenders to exploit consumers and small businesses with exorbitant interest charges and fees, deceptive marketing practices, privacy violations, abusive debt collection practices, and other unconscionable conduct.[132]

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[130] Remarks by Comptroller of the Currency John D. Hawke, Jr. before the Women in Housing and Finance (Feb. 12, 2002), at 10 (emphasis added), available at https://www.occ.gov/news-issuances/speeches/2002/pub-speech-2002-10.pdf.

[131] OCC webpage, "Consumers and Communities: Consumer Protection – Payday Lending," available at https://www.occ.gov/topics/consumers-and-communities/consumer-protection/payday-lending/index-payday-lending.html (visited on Sept. 27, 2020). .

[132] *See* Comments filed by the Center for Responsible Lending et al. opposing the OCC's proposed "true lender" rule (Sept. 3, 2020), available at https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/OCC-True-

By enabling predatory lending and impairing the states' authority to protect their residents, the OCC's proposed "true lender" rule and its usury preemption transfer rule undermine fundamental purposes of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[133] When Congress passed the Dodd-Frank Act in 2010, it strongly criticized federal financial regulators for failing to take effective measures to stop predatory nonprime mortgage lending during the 1990s and 2000s. Congress also condemned the OCC and the Office of Thrift Supervision ("OTS") for aggressively preempting efforts by many states to stop predatory lending during the 1990s and 2000s.[134]

The OTS's and OCC's regulatory failures and their unjustified preemption of state laws were major factors behind Congress's decisions to abolish the OTS and to adopt 12 U.S.C. § 25b, which imposes significant constraints on the OCC's authority to preempt state consumer financial laws.[135] As shown in the next section, the OCC has not complied with Section 25b and therefore has no legal authority for its new preemption efforts, which would severely undermine the states' ability to protect their residents from predatory nonbank lenders.

B. The OCC's Fintech Charter Initiative and Preemption Rules Do Not Comply with Section 25b

Section 25b of the NBA, enacted as part of the Dodd-Frank Act, establishes a new framework for determining whether state consumer financial laws apply to national banks and federal savings associations. Under Section 25b(b)(1) , a state consumer financial law is preempted "only if" (A) the state law has "a discriminatory effect on national banks," or (B) the

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Lender-Comments.pdf; Christopher K. Odinet, "Predatory Fintech and the Politics of Banking," *Iowa Law Review* (forthcoming) (Aug. 26, 2020 draft available at http://ssrn.com/abstract=3677283).

[133] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[134] S. Rep. No. 111-176, at 15-18 (2010). For analysis of the pervasive failures by federal financial regulators to stop predatory nonprime lending and the devastating injuries caused to states, consumers, and the U.S. economy by the OCC's and OTS's preemption of state consumer protection laws and state enforcement efforts, see Kathleen Engel & Patricia A. McCoy, *supra* note 29, at 157-226; Wilmarth, "Dodd-Frank," *supra* note 29, at 897-919.

[135] S. Rep. No. 111-176, at 16-17, 25-26, 175-77 (2010).

state law "prevents or significantly interferes with the exercise by the national bank of its powers," or (C) the state law is preempted by a federal statute other than the NBA. Section 25b(b)(1)(B) expressly incorporates the "prevent or significantly interfere" standard for preemption established by the Supreme Court's 1996 decision in *Barnett Bank of Marion County, N.A. v. Nelson*.[136] The preemption framework for national banks under Section 25b also governs federal thrifts.[137]

When the OCC issues a preemptive ruling, Section 25b(c) requires the OCC to demonstrate that "substantial evidence, made on the record of the proceeding," supports the OCC's "specific finding" of preemption in accordance with *Barnett Bank*. The OCC must also act on a "case-by-case basis" when it issues a preemptive ruling. To satisfy the "case-by-case" requirement, the OCC must consider "the impact of a particular State consumer financial law on any national bank that is subject to that law, or the law of any other State with substantially equivalent terms." In addition, the OCC must "first consult with the Bureau of Consumer Financial Protection and take the views of the Bureau into account" when the OCC makes its "case-by-case" determination.[138]

The OCC fintech charter initiative, usury preemption transfer rule, and proposed "true lender" rule did not comply with Section 25b. The OCC did not apply the "prevents or significantly interferes" preemption standard, or satisfy the "substantial evidence" requirement,

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[136] 517 U.S. 25, 33 (1996); *see* 12 U.S.C. § 25b(b)(1)(B); *Lusnak*, 883 F.3d at 1188, 1191-94; *Hymes v. Bank of America, N.A.*, 408 F. Supp. 3d 171, 184 (E.D.N.Y. 2019); S. Rep. No. 111-176, at 175-76 (2010).

[137] 12 U.S.C. § 1465. Sections 25b(b)(4) and Section 1465(b) declare that the statutes governing national banks and federal thrifts do *not* create a regime of field preemption. Accordingly, state laws apply to national banks and federal thrifts *unless* they create an irreconcilable conflict with federal law, based on the "prevent or significantly interfere" preemption standard set forth in *Barnett Bank*, 517 U.S. at 31, 33. *See* Jared Elosta, "Dynamic Federalism and Consumer Financial Protection: How the Dodd-Frank Act Changes the Preemption Debate," 89 *North Carolina Law Review* 1273, 1276-77, 1298 (2011); Wilmarth, "Dodd-Frank," *supra* note 29, at 925-30 (2011).

[138] 12 U.S.C. § 25b(b)(3)(A), (B); *see Lusnak*, 883 F3d at 1192, 1194; Elosta, *supra* note 137, at 1300-01; Wilmarth, "Dodd-Frank," *supra* note 29, at 931-32.

or follow the "case-by-case" procedure when it issued those measures. Indeed, the OCC did not even attempt to fulfill Section 25b's requirements when it adopted those measures.[139]

The OCC claimed that its usury preemption transfer rule fell "outside of the scope of section 25b because of section 25b(f)."[140] However, that assertion is clearly erroneous. As shown above, Section 25b(f) provides that Section 25b does not affect "the authority conferred by [Section 85] for the charging of interest *by a national bank*" (emphasis added). Section 25b(f) did *not* exempt the OCC from complying with Section 25b when it sought to extend the preemptive scope of Section 85 to reach purchasers, assignees, and transferees of bank loans. The OCC's rule went far beyond the subject of the "charging of interest *by a national bank*."

The OCC's recent actions are the latest examples of its repeated failures to comply with Section 25b. When Congress passed the Dodd-Frank Act in 2010, it rejected the sweeping preemption rules issued by the OCC in 2004. The Senate committee report stated that, under Section 25b, "[t]he standard for preempting State consumer financial law would return to what it had been for decades, those recognized by the Supreme Court in *Barnett Bank v. Nelson*, 517 U.S. 25 (1996) (*Barnett*), undoing broader standards adopted by rules, orders, and interpretations issued by the OCC in 2004."[141]

In 2011, the OCC revised its preemption rules, purportedly to bring them into conformity with Section 25b.[142] However, the OCC's revised rules do not include the "prevent or significantly interfere" preemption standard established by *Barnett Bank*, despite Congress's express incorporation of that standard in 12 U.S.C. 25b(b)(1)(B). Notwithstanding that explicit

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[139] *See* Wilmarth Usury Preemption Transfer Comment Letter, *supra* note 4, at 2-4; Wilmarth "True Lender" Comment Letter, *supra* note 5, at 3-5.
[140] *See* OCC Usury Preemption Transfer Rule, *supra* note 4, at 33533.
[141] S. Rep. No. 111-176, at 175-76 (2010); *see also* Elosta, *supra* note 138, at 1298-1300; Wilmarth, "Dodd-Frank," *supra* note 29, at 936-37.
[142] OCC, "Office of Thrift Supervision Integration; Dodd-Frank Act Implementation," 76 Fed. Reg. 43549 (July 21, 2011).

mandate, the OCC asserted that "the Dodd-Frank Act does not create a new stand-alone 'prevents or significantly interferes' preemption standard."[143]

Three of the preemption rules that the OCC reissued in 2011 – 12 C.F.R. §§ 7.4007, 7.4008, and 34.4 – continue to assert that broad categories of state laws are preempted across the nation. When the OCC issued those sweeping and categorical preemption rules in 2011, the OCC did not comply with Section 25b's "substantial evidence" and "case-by-case" requirements. The OCC claimed that it did not need to comply with those requirements because its blanket preemption rules were based on the rules it adopted in 2004. The OCC claimed that its "regulations in effect prior to the effective date [of Dodd-Frank] are not subject to the case-by-case requirement."[144]

The OCC's contention that its 2004 rules remained valid – even though they did *not* comply with Section 25b's requirements – was plainly wrong. Under Section 25b(b)(1), state consumer financial laws are preempted "only if" a federal agency or court makes a preemption determination in full compliance with *all* of the requirements of Section 25b. Section 1043 of the Dodd-Frank Act (codified at 12 U.S.C. §5553) provides a very limited exception to that mandate. Section 1043 preserves the applicability of previous OCC regulations and orders to "any contract entered into [by a national bank or its subsidiary] before July 21, 2010" (the date of Dodd-Frank's enactment).[145] Congress intended that Section 1043 would "provide stability to existing contracts" – those entered into *before* Dodd-Frank's enactment – by allowing those contracts to be governed by the OCC's pre-Dodd-Frank rules and orders.[146]

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[143] *Id.* at 43555; *see Lusnak*, 883 F.3d at 1193-94 ("[T]he OCC has largely reaffirmed its previous preemption conclusions without further analysis under the *Barnett Bank* standard," and therefore the OCC's 2011 preemption rules "are entitled to little, if any, deference.").
[144] 76 Fed. Reg. at 43553, 43556-57, 43558.
[145] 12 U.S.C. § 5553.
[146] S. Rep. No. 111-176, at 175 (2010).

Section 1043's carefully limited exception demonstrates Congress's intent that the OCC's previous preemptive rules and orders would *not* apply to national bank transactions occurring *after* July 21, 2010 *unless* they were brought into full compliance with the new preemption framework established by Section 25b. The OCC's argument that its 2004 preemption rules – as reissued in 2011 – remain valid for *new* transactions *after* 2010 would render Section 1043 "meaningless, in violation of the 'endlessly repeated principle of statutory construction . . . that all words in a statute are to be assigned meaning, and that nothing therein is to be construed as surplusage.'"[147] Accordingly, the OCC violated Section 25b by issuing three blanket preemption rules in 2011 that did not comply with Section 25b's "prevents or significantly interferes" preemption standard or with Section 25b's "case-by-case" and "substantial evidence" requirements.[148]

The OCC has also failed to comply with Section 25b(d), which requires the OCC to "periodically conduct a review, though notice and public comment, of each determination that a provision of Federal law preempts a State consumer financial law," within five years after issuing that determination. The OCC must issue a public notice for each preemption review, including an invitation for public comments. After completing each preemption review, the OCC must issue a public notice describing the results of its review and submit a report to the House Financial Services Committee and the Senate Committee on Banking, Housing, and Urban Affairs. The OCC's public notice and report to those Committees must state whether the OCC intends to continue, rescind, or amend the preemption determination it reviewed. The OCC

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[147] *Independent Ins. Agents of America, Inc. v. Hawke*, 211 F.3d 638, 643-44 (2000) (quoting *Qi-Zhou v. Meissner*, 70 F.3d 136, 139 (D.C. Cir. 1995)); *see also* Wilmarth, "Dodd-Frank," *supra* note 29, at 939-40.
[148] 12 C.F.R. §§ 7.4007, 7.4008 & 34.4. *See* Arthur E. Wilmarth, Jr., "OCC Gets It Wrong on Preemption, Again," *American Banker* (July 29, 2011), at 8, available on Westlaw at 2011 WLNR 14961080; *see also* Arthur E. Wilmarth, Jr., "The Financial Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau," 31 *Review of Banking & Financial Law* 881, 914-16 (2012), available at http://ssrn.com/abstract=1982149.

has not conducted any public reviews pursuant to Section 25b(d), even though the OCC issued its most important preemption rules nine years ago, in July 2011. The OCC has issued several other preemption rules that are at least 15-20 years old, and it has not conducted any public reviews of those rules under Section 25b(d).[149]

The Supreme Court has admonished the OCC that it cannot "pick and choose what portion of the law binds [it]."[150] The OCC should abandon its nondepository fintech charter initiative, rescind its usury preemption transfer rule, and withdraw its proposed "true lender" rule due to their lack of compliance with 12 U.S.C. § 25b. The OCC should also conduct public reviews of all of its existing preemption rules and orders that are more than five years old, as required by Section 25b(d). I urge Congress to exercise its oversight powers to compel the OCC to bring all of its preemptive regulations, orders, and policies into full compliance with Section 25b.

A.E.W., Jr. (9/29/20)

[149] 12 U.S.C. § 25(d); *see, e.g.*, 12 C.F.R. §§ 7.4002, 7.4003, 7.4004, 7.4005, 34.5, and 37.1.
[150] *First National Bank of Logan v. Walker Bank & Trust Co.*, 385 U.S. 252, 261 (1966).

Septmeber 29, 2020

Statement for the Record

On behalf of the

American Bankers Association

before the

Task Force on Financial Technology

Of the

House Financial Services Committee

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Chairman Lynch, Ranking Member Emmer, and Members of the Task Force on Financial Technology, the American Bankers Association[1] (ABA) appreciates the Task Force's interest in the role technology has on the financial services industry and respectfully submit this statement for the record for the hearing titled "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age."

Today's topic is an important and timely one. Fintech was born in America's banks. Innovation can promote financial inclusion, make it possible to extend credit to many more borrowers, and give customers improved transparency into the financial products they use every day. When banks and technology companies partner, they can deliver customers the best of both worlds: innovative services that customers demand from a partner that they can trust with their financial future.

In recent years we have seen innovation emerging from both the traditional banking sector, from non-bank technology firms, and from partnerships between financial institutions and fintechs. These innovations have the potential to make financial services more convenient, efficient, and accessible but the legacy regulatory framework has created arbitrage opportunities for technology companies to reap the benefits of being "bank-like" without the obligations of being an actual bank. What's more, some have suggested the way to level the playing field and narrow the arbitrage opportunity is to simply give technology companies bank charters even if they do not make loans or take deposits. ABA fundamentally disagrees with this approach. Redefining what constitutes a bank could put consumers and our financial system at risk.

ABA and organizations representing every insured depository institution in the country have raised serious concerns about the Acting Comptroller of the Currency's stated intention to issue non-depository bank charters often referred to as "payments charters." While the intent is to recognize American consumers' increasing interest in a diverse array of financial services, this proposal would have serious unintended

[1] The American Bankers Association is the voice of the nation's $21.1 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $17 trillion in deposits and extend nearly $11 trillion in loans.

consequences, creating regulatory gaps that leave consumers exposed and vulnerabilities in the larger banking system.

To be clear, ABA believes in the continued evolution of banking, allowing banks to offer innovative products and leverage third-party innovations that help customers access diverse banking products and services. We support competition in banking and are strong proponents of diversity in financial services as evidenced by the breadth of charters represented in ABA's membership. But we must also ensure that customers receive the protection they deserve wherever they get their banking services through consistent regulation and oversight.

Congress Should Ensure that Regulators Undertake an Open and Transparent Process When Considering New Charters or Applications that Present Novel Risks.

In recent years, regulators have put a focus on promoting innovation in banking. ABA supports these intiatives and believe this is an important step in ensuring that banks are able to meet customer needs and remain competitive. As regulators look to promote innovation within banking, they will inevitably come across business models that challenge our current understanding of what constitutes a bank. In situations where these novel risks are present, Congress should encourage regulators to undertake an open and transparent process, deferring to Congress where appropriate.

Unfortunately, not all banking agencies appear to be taking this consultative, deliberative approach. We have serious concerns around the recent discussion of a payments-focused charter being issued by the OCC. While no formal proposal exists, Acting Comptroller Brian Brooks has stated publicly that he would welcome bank applications from non-depository payments companies.[2]

Despite public calls for an open and transparent process by ABA and six other financial services trades[3] to establish the legal authority and regulatory framework for a payments-only "banks", the OCC has indicated that they do not believe any formal proposal is needed to issue such a charter.[4] The OCC has argued that these companies qualify as banks like any other and plans to consider applications without any proposal subject to public notice and comment.

The banking trades are not alone in the view that the proposed charter represents a serious change in public policy. The Conference of State Banking Supervisors has questioned the OCC's authority to issue such a charter.[5] In a recent op-ed, Karen Shaw Petrou criticized the proposal, noting that "evolution by edict is incompatible with both the rule of law and the proven risks of financial-system 'innovation' outside the reach of prudential and consumer regulation. The OCC can and should lead the way with great ideas, but

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[2] https://www.politico.com/news/2020/08/31/currency-comptroller-reshape-banking-406393

[3] https://www.aba.com/-/media/documents/comment-letter/joint-trades-letter-on-proposed-payments-charter.pdf?rev=6c673df60b6e4ea08ba040ec21a3eef3

[4] https://www.wsj.com/articles/fintech-can-come-out-of-the-shadows-11599693184

[5] https://www.americanbanker.com/opinion/congress-not-the-occ-decides-what-is-and-isnt-a-bank

Congress has established an entity-based construct for national banks and the agency cannot and should not alter it by fiat."[6]

Whether you agree or disagree with the thinking behind these charters, the issues being considered have broad and lasting implications for the banking system. Major policy determinations should be made with robust public input and should not be implemented via the approval of an individual charter.

The Market Impact of a Payments Charter Should be Subjected to a Rigorous Cost-Benefit Analysis

Despite the fast pace with which OCC has proceeded since initially broaching the idea of a payments charter, the fundamental question of whether existing charters are insufficient to meet the needs of the marketplace has not been analyzed through any formal methodology. The federal government's increased involvement in the payments marketplace without evidence of a solvable market failure could have unintended consequences.

There have been recent examinations of the structure of the payments ecosystem by leading payments organizations and although they have identified needed improvements, chartering new kinds of institutions has not been among the recommendations of these diverse working groups. For instance, the Faster Payments Task Force coordinated by the Federal Reserve produced a comprehensive report that was ratified nearly-unanimously by financial institutions, retailers, service providers, and consumer groups – but chartering was not identified as an obstacle to faster payments deployment in the United States. The Federal Reserve itself periodically releases payments improvement roadmaps and work plans, and chartering has not been among the issues they have identified as inhibiting payment system efficiency, resiliency, or access.

Against this backdrop of market-driven recommendations for action, the OCC has tendered the payments charter concept as its key payments priority without connecting that new course to data or other evidence. We are skeptical that spontaneous agency actions untethered to the known conclusions of existing, robust, public consultation processes will have broad benefit to the nation.

A rigorous analysis of market need, economic costs associated with this change in policy, and unintended consequences of any regulatory interventions is a precondition of rational government action in this arena. As a foundational element of a transparent policymaking process, OCC or the Government Accountability Office (GAO) should produce an independent, data-driven analysis of relevant issues to ensure that the public interest and private sector efficiency are not adversely impacted by an expansion of the federal government's role in this innovative market segment. Of primary importance in such an analysis is whether the introduction of new uninsured payments counterparties could impose costs on existing market participants or reduce access to customers through necessary additional risk and/or liquidity management practices.

The U.S. Payment System is Working and More Improvements are Coming

The American economy is the world's most productive developer of payments technology. It is not necessary to recite here the many innovations that have come to market at a rapid clip in recent years, nor is it our view that the task of creating a world-class payment system is ever complete.

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[6] https://www.americanbanker.com/opinion/occ-chief-goes-too-far-reimagining-national-bank-charter

However, we urge Congress to take account of the ways that America's economic incentive systemhas produced innovations that become the standards around the globe. In virtually every foreign country, American technology is at the core of payments transactions and often a firm based here is facilitating the payment. This is not an example of a lagging part of our economy. Nevertheless, American leadership is not assured: in a highly-competitive world, any action that could undermine our presumed advantages (such as trust, reliability, and counterparty safety) should be approached with due caution.

From the introduction of new real-time payments networks to the speeding up of existing options, consumers and merchants have more options than ever to help ends meet and reduce the incidence of fees such as overdraft. New structural evolutions such as the Federal Reserve's FedNow system were conceived under an expectation that regulators broadly supported a stable framework where a flurry of uninsured, nondepository users would not proliferate. Introducing regulatory disruption into the marketplace now could delay or impair the payment system upgrades that are being rolled out at this time.

While various forms of payments licenses are offered by other jurisdictions that heavily plan their payments system (such as the European Union), it should not be presumed that this path produces the most "competition" or is appropriate for this country. Before taking any action that would upend regulatory certainty in the U.S. payments ecosystem, OCC should enter into dialogue with all interested U.S. stakeholders including (and beyond) financial institutions that currently participate in providing payments to end-users.

Congress Should Ensure that New Charters Are Subject to Consistent Supervision and Oversight
Innovations in banking are only beneficial to the extent that they are delivered responsibly and provide consumers the protections they have come to expect when dealing with banks. As new business models are considered, Congress should ensure that regulations are being applied consistently with those of any other charter.

When the OCC proposed its lending-focused Special Purpose National Bank "fintech" charter in 2016 – and gave two separate opportunities for pubic comment – ABA noted[7] the importance of existing rules and oversight being applied consistent with those for any national bank. We noted that a bank charter is a clear signal to customers that the consumer is dealing with a trusted partner. Any fintech company that is granted a bank charter will receive the instant market and public credibility that comes with being a chartered financial institution. Likewise, any missteps by a fintech operating through a national bank charter will inevitably reflect poorly on all banks.

Through our comments, we have raised questions around how regulations would be tailored to new business models and whether oversight would be consistent to that of other banks. We have not yet seen a clear indication of how these principles would be applied to a narrow-purpose bank, such as a payments charter. Congress should ensure that the OCC clarifies its expectations before proposing any narrow-purpose charters. This is critical to ensuring that regulations and consumer protection are applied evenly; that protections remain in place to preserve the existing separation of banking and commerce; and to ensure even-handed application of OCC policy objectives, including those related to financial inclusion and CRA responsibilities.

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[7] https://www.aba.com/advocacy/policy-analysis/occ-charter

Before considering any novel banking charters, regulators should clearly outline how they plan to oversee and address the novel risks posed by such a charter.

Non-depository Business Models Introduce Regulatory Gaps

Many novel charters have centered around non-depository or uninsured[8] business models. A number of banking regulations are triggered by holding deposits and this is one area where we see instances of unintended consequences resulting from new business models.

The applicability of the Bank Holding Company Act (BHCA) is an acute example of a regulatory gap introduced by a non-depository model. Depending on the activities a narrowly focused bank conducts, its holding company may not be considered a bank holding company, subject to the Federal Reserve Board's oversight. The BHCA is triggered if the special purpose national bank is considered a bank under the BHCA definition which is one that either (i) has FDIC insurance or (ii) both accepts demand deposits and makes commercial loans. The OCC payments charter proposal explores the possibility of a narrow purpose bank charter applicant that would not take deposits and, therefore, would not have FDIC insurance, or meet the definition of a bank. While limited purpose charters in the past have a specific exemption from "bank" status under the BHCA, no such specific exemption exists for the charter under consideration by the OCC, and the Federal Reserve Board has not yet publicized its views on the potential application of the BHCA to such a charter.

Through its authority under the BHCA, the Federal Reserve Board serves an important role in supervising banking organizations on a consolidated basis (i.e., banks together with their owners and affiliates). If this kind of oversight matters for full service national banks, that same oversight would be important for a special purpose national bank.

Importantly, the BHCA reflects Congress' policy determinations regarding oversight and supervision of holding companies that engage in activities beyond the bank subsidiary. Any change to this balance would represent a significant policy change. We believe that such a significant policy change should be subject to scrutiny in the public notice and comment process, and not simply by approving a new charter.

Conclusion

The rapid convergence of banking and technology has the potential to improve banking, making it more efficient, convenient and accessible. This potential is only realized to the extent that these innovations are brought to market in a measured and responsible manner. Congress should support policies that bring innovative activities into banking and allow banks to bring their customers the latest technologies. However, as new business models are considered Congress should ensure that regulatory gaps do not emerge that could leave consumers exposed.

ABA believes that a full and open public process is critical to ensuring that any unintended consequences are fully understood in cases where new business models present risks that are not considered by today's regulatory framework. Important policy determinations should not be made through executive fiat or the approval of individual applications. Given the concerns outlined above, ABA opposes efforts by the OCC to

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[8] See Kraken's recent approval for Wyoming's Special Purpose Depository Institution https://blog.kraken.com/post/6241/kraken-wyoming-first-digital-asset-bank/

approve a non-depository payments charter and we encourage Congress to actively discharge their oversight prerogatives regarding the legality and administrative processes connected to any such charters.







September 29, 2020

The Honorable Stephen Lynch
Chairman, U.S. House Task Force on Financial Technology
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Tom Emmer
Ranking Member, U.S. House Task Force on Financial Technology
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Lynch and Ranking Member Emmer:

We write to share our concerns with the Office of the Comptroller of the Currency's (OCC) newly proposed special purpose payments charter for non-banks, as described recently by Acting Comptroller Brian Brooks.

We oppose the OCC's effort to grant commercial companies like Amazon or Facebook a national payments charter to access to the Federal Reserve payments system and safety net.

As detailed below, we oppose any effort by the OCC to offer a payments charter, particularly one that would ultimately grant these companies access to the Federal Reserve payments system—the most critical part of our country's financial infrastructure—and its corresponding federal safety net without protecting the financial system and consumers from the concomitant increase in systemic risk.

Banks are innovating to serve their customers.

We believe that innovations in financial services offer customers significant benefits, as they have throughout the history of banking. Banks have long pioneered innovations in financial services to better connect with and benefit customers by making credit more inclusive, providing more transparency around products and enhancing user experience. Today, both traditional banks and non-bank technology firms are embracing innovation, which has allowed banks and technology companies to partner in order to deliver the innovative services that customers seek while also providing for regulatory protections under the banking system.

Innovation should not undermine systemic stability of the financial system.

However, innovation cannot come at the cost of ensuring a safe and sound banking and payments system. A payments charter for non-banks firms raises a number of regulatory concerns—such as the continuation of the long-standing principles of the separation of banking and commerce, application of

traditional banking statutes and regulations governing safety and soundness and consumer protection, and, most significantly, the potential introduction of systemic risk into the payments system.

Commercial companies accessing a payments charter would avoid oversight and regulations that protect the financial system and consumers.

Specifically, a payments charter for non-bank firms raises a number of questions, including whether parent companies of the new special purpose bank would be subject to the Bank Holding Company Act (BHCA) and other relevant statutes. In particular, the failure to apply the BHCA to these companies would raise significant safety and soundness concerns by not requiring prudential regulation consisting of capital and liquidity requirements of the parent company or its subsidiaries and affiliates, no requirement for the parent to act as a source of strength to chartered entities, and no requirement to plan for recovery or resolution in severe financial situations.

Additionally, there would be potential harm to consumers should these narrowly chartered institutions not be subject to federal laws like the Federal Deposit Insurance Act, which imposes liability on directors, officers and institution-affiliated parties and has annual audit and reporting requirements, and the Federal Reserve Act which puts limits on transactions between a bank and its affiliates and limits on bank loans to insiders and related parties. Similarly, whether these chartered entities would be subject to the Community Reinvestment Act, which is designed to help ensure banks lend money and provide banking services to underserved and minority consumers, is an important issue to resolve. The potential for asymmetries in regulation across companies with different banking charters could produce regulatory arbitrage and undermine safety and soundness and consumer protection.

A lack of safety and soundness rules will expose to financial system to significant vulnerabilities.

Another significant question is how these narrowly chartered firms would be able to access the Federal Reserve's payment system, which is a critical component of our nation's financial infrastructure. Given that these firms would not be subject to the safety and soundness requirements that typically are required to have access to the payments system, it is imperative to consider what the ramifications are of potentially expanding access to the Fed's payment system for these companies. There is no existing framework for how best to mitigate any potential systemic risk that could be introduced by these companies, and these questions must be answered prior to any payments company being chartered by the OCC.

A new bank charter should be subject to an open, transparent notice and comment process.

In order to help fully understand all the potential consequences, any efforts to grant a new type of bank charter need to be conducted through an open and deliberative notice and comment process. The need for a transparent process is further heightened, given a recent court decision and continuing litigation has raised additional uncertainty around the OCC's authority to issue such charters. We also believe that Congress should have a role in these deliberations, including whether a federal money transmitter license that would preempt a patchwork of state licensing laws is practical.

The benefits of financial innovation are only realized when they are delivered responsibly, in a way that does right by customers. This means getting regulation right is critical. Regulation must be flexible enough to allow innovations to be driven from within traditional banks. We must also ensure that customers receive the protection they deserve wherever they get their financial services through consistent regulation and oversight.

We look forward to a continued discussion around these important issues and stand ready as policymakers look to help promote responsible innovation in banking.

Sincerely,

American Bankers Association
Bank Policy Institute
Independent Community Bankers of America

Center for Responsible Lending
Statement for the Record

Hearing on
"License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age"
Before the Task Force on Financial Technology,
Committee on Financial Services,
U.S. House of Representatives

September 29, 2020

The Center for Responsible Lending appreciates this opportunity to submit a statement for the record for today's hearing.

CRL shares concerns about the OCC's and FDIC's recent so-called valid-when-made rules and the OCC's proposal to gut the true lender doctrine, raised by witnesses Raul Carrillo of Americans for Financial Reform and Professor Arthur Wilmarth. The agencies lack the authority to issue those rules, which will cause profound harm to consumers, and particularly to communities of color, by undermining state laws.[1] We share similar concerns about OCC fintech or payments charters.

In addition, **we call the Committee's attention to our comments to the FDIC addressing Industrial Loan Company (ILC) charters**, submitted jointly with the following consumer and civil rights organizations: National Consumer Law Center (on behalf of its low income clients), Americans for Financial Reform Education Fund, Consumer Action, Consumer Federation of America, the Leadership Conference on Civil and Human Rights, NAACP, National Association of Consumer Advocates, National Association for Latino Community Asset Builders, UnidosUS, U.S. PIRG.

Professor Wilmarth's testimony discusses thoroughly systemic and other risks ILC charters pose. **Our comments, attached for reference, focus in particular on risk ILC expansion poses by making it easier for predominantly online non-bank lenders to obtain bank charters. Should the FDIC finalize its proposed ILC rule and continue to approve new ILCs, it would pave the way for non-banks to obtain the benefit of federal preemption far more easily than they otherwise could.** A law firm representing payday lenders recently wrote of the ILC proposal: "The proposed rule, together with the FDIC's recent approvals of deposit insurance applications for NelNet Bank and Square Financial Services, Inc., suggest the ILC charter as a viable alternative to the OCC's fintech charter, which has been stalled by litigation."[2] To be clear: Financial companies seeking interest rate preemption will seek ILC charters over traditional bank charters because they want the benefits of a bank charter without with the responsibilities stemming from consolidated Fed supervision.

As our comments discuss, ILCs may use this preemption to make high-cost loans directly, in avoidance of state rate caps, or by renting their charter to high-cost lenders to use the ILC to do the same. **First**

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[1] The comments of CRL, the National Consumer Law Center (on behalf of its low income clients), and a number of civil rights and consumer groups are here, here, and here.
[2] Ballard Spahr, March 25, 2020, https://www.jdsupra.com/legalnews/fdic-issues-proposed-rule-for-approval-86042/.

Electronic Bank,[3] a Utah-chartered ILC, is currently being used by **Personify Financial** to offer high-cost installment loans of $1,000 to $10,000 at APRs as high as 179.99% in 22 states that do not allow that rate for some or all loans in that size range.[4] Personify touts itself as "Serving the Underestimated Underbanked" with a target market of those with incomes between $20,000 and $75,000, many with less-than-prime credit.[5] It claims to "fill[] the void left by traditional financial institutions" while it "makes payday lenders and other sources of short-term financing obsolete."[6]

The Appendix to the attached comments includes a number of narratives from Personify Financial customers from the CFPB complaints database. They document borrowers' distress that their payments are not reducing principal due to the loan's high interest rates; consumers' inability to sustain those payments; and queries about how such loans can possibly be legal. One narrative conveys a borrower's struggle to repay a Personify Financial loan on top of multiple payday loans, which in total took 90% of the borrower's take-home income for well over three months.[7] This narrative supports the reality that neither Personify Financial, nor any other triple digit loan, is "making payday lenders . . . obsolete," as it claims. Rather, it is piling yet more unaffordable debt on those also struggling with payday loans. The involvement of an FDIC-supervised bank with this lending program also highlights how FDIC supervision cannot compensate for lack of an interest rate cap.

Celtic Bank, also a Utah-chartered ILC, is used by **OnDeck Capital** and **Kabbage** to originate large small business loans up to 99% APR. OnDeck makes small business term loans up to $500,000, up to 36 months long, at rates up to 99% APR, and lines of credit up to $100,000 at rates up to 61.9% APR.[8] Its charge-off rate as a percentage of principal balance outstanding was 13.6% in 2019.[9] Kabbage makes small business loans up to $250,000 up to 99% APR for terms up to 18 months.[10]

In some states, these loans won't violate usury limits because those limits don't apply to commercial/non-consumer loans. Even still, a rate of 99% APR, particularly on relatively larger and longer-term loans like the OnDeck and Kabbage products, is extremely high—and for many small businesses, unsustainable, placing the business at risk.

Thank you for consideration of our input.

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[3] https://www.firstelectronic.com/. First Electronic Bank is wholly owned by Fry's Electronics, which is based in Silicon Valley. https://www.firstelectronic.com/about-us/

[4] https://www.personifyfinancial.com/, last visited June 30, 2020. Those states are Alaska, Arizona, Delaware, Florida, Hawaii, Indiana, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Montana, Nebraska, North Carolina, Ohio, Oklahoma, Tennessee, Texas, and Washington. In early 2020, this list included California and Rhode Island, but those states no longer appear on Personify's website.

[5] https://www.applieddatafinance.com/ (last visited June 30, 2020).

[6] *Id.*

[7] Appendix, Personify Financial examples, last bullet point.

[8] https://www.ondeck.com/business-loans; OnDeck, Form 10K, 2019, at 8, http://d18rn0p25nwr6d.cloudfront.net/CIK-0001420811/b106838d-1f1f-4c80-bb2a-21757fead116.pdf.

[9] OnDeck, 10K, 2019, at 47, http://d18rn0p25nwr6d.cloudfront.net/CIK-0001420811/b106838d-1f1f-4c80-bb2a-21757fead116.pdf.

[10] https://www.kabbage.com/what-it-costs/loan-rates-and-terms/. For a recent summary of Kabbage and OnDeck's loan offerings and required qualifications, see https://www.nerdwallet.com/blog/small-business/kabbage-ondeck-lender-small-business/.

Center for Responsible Lending
National Consumer Law Center (on behalf of its low income clients)
Americans for Financial Reform Education Fund
Consumer Action
Consumer Federation of America
The Leadership Conference on Civil and Human Rights
NAACP
National Association of Consumer Advocates
National Association for Latino Community Asset Builders
UnidosUS
U.S. PIRG

Comments to the Federal Deposit Insurance Corporation
Notice of Proposed Rulemaking
Parent Companies of Industrial Banks and Industrial Loan Companies
12 CFR Part 354
RIN 3064-AF31

July 1, 2020

Submitted via email to comments@fdic.gov

The **Center for Responsible Lending (CRL)** is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, one of the nation's largest nonprofit community development financial institutions. Over 37 years, Self-Help has provided over $7 billion in financing through 146,000 loans to homebuyers, small businesses, and nonprofits. It serves more than 145,000 mostly low-income members through 45 retail credit union locations in North Carolina, California, Florida, Greater Chicago, and Milwaukee.

Since 1969, the nonprofit **National Consumer Law Center® (NCLC®)** has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness.

Americans for Financial Reform Education Fund (AFREF) works in concert with a coalition of more than 200 consumer, investor, labor, civil rights, business, faith-based, and community groups to lay the foundation for a strong, stable, and ethical financial system. Through policy analysis, public education, and outreach, AFREF works for stronger consumer financial protections and against predatory practices.

Consumer Action has been a champion of underrepresented consumers since 1971. A national, nonprofit 501(c)3 organization, Consumer Action focuses on financial education that empowers low to moderate income and limited-English-speaking consumers to financially prosper. It also advocates for consumers in the media and before lawmakers and regulators to advance consumer rights and promote industry-wide change particularly in the fields of consumer protection, credit, banking, housing, privacy, insurance and utilities.

The **Consumer Federation of America** is a nonprofit association of more than 250 national, state and local consumer groups that was founded in 1968 to advance the consumer interest through research, advocacy, and education. For over 50 years CFA has been at the forefront of consumer protection with a broad portfolio of issues including product safety, banking, telecommunications, investor protection, energy, housing, insurance, privacy and saving. CFA's non-profit members range from large organizations such as Consumer Reports and AARP, to small state and local advocacy groups and include unions, co-ops, and public power companies.

The Leadership Conference on Civil and Human Rights is a coalition charged by its diverse membership of more than 200 national organizations to promote and protect the civil and human rights of all persons in the United States. Through advocacy and outreach to targeted constituencies, The Leadership Conference works toward the goal of a more open and just society - an America as good as its ideals. The Leadership Conference is a 501(c)(4) organization that engages in legislative advocacy. It was founded in 1950 and has coordinated national lobbying efforts on behalf of every major civil rights law since 1957.

Founded in 1909, the **National Association for the Advancement of Colored People (hereinafter NAACP**) is our nation's oldest, largest and most widely known grassroots civil rights organization. The principal objectives of NAACP are to ensure the political, educational, social and economic equality of all citizens; to achieve equality of rights and eliminate racial prejudice among the citizens of the United States; to remove all barriers of racial discrimination through democratic processes; to seek enactment and enforcement of federal, state and local laws securing civil rights; to inform the public of the adverse effects of racial discrimination and to seek its elimination; to educate persons as to their constitutional rights and to take all lawful action to secure the exercise thereof.

The **National Association of Consumer Advocates (NACA)** is a national nonprofit association of private and public sector attorneys, legal service attorneys, law professors and law students committed to representing consumers' interests. NACA's mission is to promote justice for all consumers by maintaining a forum for information-sharing among advocates across the country and to serve as a voice for its members in its work to curb unfair and abusive business practices, including predatory lending and other conduct that adversely affect consumers.

National Association for Latino Community Asset Builders (NALCAB) represents and serves a geographically and ethnically diverse group of more than 120 non-profit community development and asset-building organizations that are anchor institutions in our nation's Latino communities. Members of the NALCAB Network are real estate developers, business lenders, economic development corporations, credit unions, and consumer counseling agencies, operating in 40 states and DC.

UnidosUS, previously known as NCLR (National Council of La Raza), is the nation's largest Hispanic civil rights and advocacy organization. Through its unique combination of expert research, advocacy, programs, and an Affiliate Network of nearly 300 community-based organizations across the United States and Puerto Rico, UnidosUS simultaneously challenges the social, economic, and political barriers at the national and local levels. For 50 years, UnidosUS has united communities and different groups seeking common ground through collaboration, and that share a desire to make our country stronger.

U.S. PIRG, the federation of state Public Interest Research Groups, is a consumer group that stands up to powerful interests whenever they threaten our health and safety, our financial security, or our right to fully participate in our democratic society. It is part of The Public Interest Network, which operates and supports organizations committed to a shared vision of a better world and a strategic approach to getting things done.

TABLE OF CONTENTS

I. Introduction and Overview 5

I. Now is among the most inappropriate times imaginable to disrupt longstanding safeguards that protect both the systemic health of the economy and consumers. 8

II. The FDIC's proposal poses severe risks to the federal safety net. 10

III. The past financial crisis demonstrates that the FDIC's supervision of ILCs was not adequate, including with respect to predatory lending. 13

IV. The proposal, along with new ILC charters, would severely undermine the States' historical and constitutional role in our federalist system. 18

V. Expansion of ILCs will erode consumer protections and expose consumers to severe harm, which the proposal fails to consider. 19

A. High-cost lending is fundamentally different than responsible lending and inflicts severe harm on financially vulnerable consumers. 19

B. Predatory lending causes particular harm to communities of color. 23

C. Existing ILCs are already involved in rent-a-bank partnerships, including very high-cost schemes. 25

D. The proposal fails to consider that proliferation of new ILCs will enable high-cost lending, evidenced by existing rent-a-bank schemes that the FDIC is not restraining. 28

E. Features of online loans pose heightened risk of unaffordability and other risks. 31

1. The originate-to-distribute model, which additional ILCs would proliferate, encourages riskier loan terms and warrants greater oversight. 31

2. High-cost lenders use electronic repayment as an abusive collection mechanism for unaffordable loans. 32

F. The proposal fails to consider the safety and soundness risks of predatory lending, which the FDIC has long acknowledged. 33

VI. The proposal gives inadequate consideration to Community Reinvestment Act concerns. 35

VII. Any final rule should not permit the FDIC staff to waive conditions imposed upon ILCs without Board approval. 36

VIII. Conclusion 36

IX. Appendix 38

July 1, 2020

The Honorable Jelena McWilliams
Chairman
Federal Deposit Insurance Corporation
1776 F Street, NW
Washington, DC 20006
Delivered electronically

I. Introduction and Overview

We, the consumer and civil rights groups named above, write to strongly oppose the Federal Deposit Insurance Corporation (FDIC)'s proposed rule on Parent Companies of Industrial Banks and Industrial Loan Companies (proposal or proposed rule)[1] as well as the agency's approval of new ILC charters. While these actions raise a number of concerns, our comments focus on the dramatic and inappropriate expansion of federal interest rate preemption the rule and additional ILC charters would precipitate.

We are in the midst of an unprecedented health crisis and a severe economic crisis, with both crises impacting communities of color more heavily than white communities. The future, on both the health and economic fronts, is profoundly uncertain.

We are, at the same time, at a pivotal moment in our nation's reckoning with its history of structural racism. Systemic racial barriers persist in virtually every sphere, and the banking and credit arenas are no exception. In fact, racist financial practices are among the most well-known and documented in the history of racial exclusion. As we reevaluate structural racism across our society, we should be critically scrutinizing the effects of financial practices, particularly as they impact Black households' efforts to achieve financial stability and advancement.

Thus, it is difficult to imagine a more uncertain or otherwise inappropriate time to disrupt longstanding safeguards that have played a fundamental role in protecting both our economy from systemic risk and consumers from predatory financial practices. Yet that is just what the proposal at issue would do. By permitting unprecedented blending of commercial and financial activities, and by making it easier than ever to make high-cost loans above states' interest rate limits, this proposal is a recipe for disaster. And no one will feel the misery worse than the millions of households, disproportionately households of color, who are targeted by the abusive lending the proposal will proliferate.

We deeply object to the attempts that banking regulators, online lenders, and others make to justify bank/non-bank partnerships, or preemption of state interest limits more broadly, with claims that these are a path to a more inclusive market, particularly for communities of color. We heard the same claims about predatory subprime mortgage lending until the foreclosure crisis ravaged neighborhoods of color and only widened the racial wealth gap. High-cost, usurious loans represent the worst of financial services. They have no place in America. The suggestion that high-cost lending offers a path toward upward mobility insults those of us who understand that our communities deserve better. High-interest

[1] 84 Fed. Reg. 66845 (Dec. 6, 2019).

loans will never "make poor people rich."[2] Nor do they help with the lack of income and assets caused by centuries of discrimination and growing inequality. Rather, predatory lending only makes poor people poorer. For years now, we have been registering our objection to the notion that credit at rates that exceed reasonable state interest rate limits is the answer. Adding the new label "fintech" to high-cost lending may attract investors and make it easier for banking regulators to justify their support, but it doesn't soften the blow high-cost loans land on struggling families.

This proposal comes amidst a number of attacks on state usury limits by federal banking regulators in recent years, as State-regulated lenders increasingly look to federal regulators to help them avoid state laws against high-cost loans and predatory lending.[3] These attacks include the proposed OCC "special purpose charter," which New York successfully challenged in Federal District Court and which the OCC is appealing to the Second Circuit; the so-called "valid-when-made" interest rate preemption rules issued by the FDIC and OCC (a theory recently rejected by a Colorado court); and a potential proposed "true lender" safe harbor, intended to protect sham bank partnerships from litigation and from states' efforts to stop schemes that flout their laws.[4] Importantly, these attacks are not on state usury limits as they apply to *banks*—the entities under the federal banking regulators' supervision. Rather, these efforts attempt to effectively exempt *non-banks* from state usury limits. But exemption from state law is a case those non-bank lenders should have to make to state legislatures across the land, rather than have the federal banking regulators exceed their authority to achieve for them.

The ILC charter is no different. By making it easier for predominantly online non-bank lenders to obtain bank charters, while avoiding the consolidated supervision of the Federal Reserve, the FDIC would pave the way for non-banks to benefit from federal preemption far more easily than they otherwise could. Indeed, a law firm representing payday lenders recently wrote of the ILC proposal: "The proposed rule, together with the FDIC's recent approvals of deposit insurance applications for NelNet Bank and Square Financial Services, Inc., suggest the ILC charter as a viable alternative to the OCC's fintech charter, which

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[2] *See, e.g.*, Remarks of Acting Comptroller of the Currency Brian Brooks to the Online Lending Policy Institute, June 11, 2020, https://www.youtube.com/watch?v=Ae_SoZeRbxM, at 33:00 (stating "I want to make poor people rich" while addressing financial inclusion, in a conversation where he also states that his personal belief is that "price controls generally create shortages" and that "if we believe in market pricing for hamburgers, for jeans, for automobiles, I'm not sure why we don't believe in market rates for money; it's another commodity, and we want it to flow freely").

[3] *See, e.g.*, Jeremy T. Rosenblum, *FDIC seeks comment on small-dollar lending*, Ballard Spahr's Consumer Finance Monitor, Nov. 15, 2018, https://www.consumerfinancemonitor.com/2018/11/15/fdic-seeks-comments-on-small-dollar-lending/ (noting that the "most significant[]" outcome of the FDIC's 2018 Request for Information on Small Dollar Lending would be its explicit approval of non-bank/bank arrangements "despite 'true lender' and *Madden* arguments to the contrary"); Comments to FDIC on its Request for Information on Small Dollar Lending from the Online Lenders Alliance (Jan. 2019) ("The FDIC Should Address existing Legal Impediments to the Bank-Fintech Partnership Model in Order to Facilitate Small Dollar Lending").

[4] Remarks of Acting Comptroller of the Currency Brian Brooks to the Online Lending Policy Institute, June 11, 2020, https://www.youtube.com/watch?v=Ae_SoZeRbxM, at 19:30 (noting that the OCC will shortly be releasing a proposed rulemaking on true lender; that the rule needs to be a bright-line rule because otherwise, "there will just be litigation over this like you see in Colorado, and this cannot be open to interpretation"; and that he expects to partner with the FDIC on the rulemaking).

has been stalled by litigation."[5] That is, the ILC charter is another way for the federal bank regulators to give non-bank companies bank privileges to which they are not entitled, without the full oversight required for traditional banks.

So we should be clear: Financial companies seeking interest rate preemption will seek ILC charters over traditional bank charters because they want the benefits of a bank charter without with the responsibilities stemming from consolidated Fed supervision. This should be the case in point showing that the FDIC lacks the authority and tools to supervise those companies as effectively as the Fed can. In this way, expansion of ILC charters exacerbates the risks of an uneven playing field that have been acknowledged by the FDIC, and cited by a range of parties, over the years.[6]

Yet federal interest rate preemption was never intended to extend to non-banks. States have had powers since the time of the American Revolution to protect their residents from high-cost lending. The ability to "export" a non-existent home state interest rate into other states came only in recent decades and only for banks.

A number of traditional FDIC-supervised banks are already facilitating evasion of state usury limits by non-banks through rent-a-bank schemes that the FDIC has not addressed. The loans these schemes peddle are among the most exorbitantly priced and irresponsible loans on the market. These include high-cost installment loans and lines of credit, typically directly accessing the borrower's checking account, and car title installment loans. Recent regulatory guidance in the small dollar loan space and the FDIC's rescission of previous guidances have increased the risk that balloon-payment payday and car title loans, which have not used rent-a-bank schemes since the mid-2000s, may return as well. (The FDIC has also indicated that it plans changes to its 2005 guidance addressing payday lending, which could exacerbate the risk that bank payday loans will return.)

Existing ILCs are also engaged in rent-a-bank arrangements. One ILC facilitates predatory consumer loans at rates up to 179.99% APR; another is facilitating small business loans at up to 99% APR; and another has been helping an online lender violate Colorado's state usury limit.

The proposal dramatically understates the impact it would have, suggesting that it "generally would codify the FDIC's current supervisory processes and policies with respect to industrial banks" and "include[] additional safeguards."[7] But, in reality, the proposal, along with the first two charter approvals in over a decade, marks a clear change in course by the agency. The agency does not explain or justify this change. And at the same time, the proposal wholly fails to consider the strong likelihood that it will cause a significant increase in predatory lending, either directly by companies that acquire ILCs or obtain

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[5] Ballard Spahr, March 25, 2020, https://www.jdsupra.com/legalnews/fdic-issues-proposed-rule-for-approval-86042/.

[6] *See, e.g.*, Press Release, FDIC, *Moratorium on Certain Industrial Loan Company Applications and Notices*, 2006, https://www.fdic.gov/news/news/press/2006/pr06073a.html ("The FDIC has noted a recent increase in deposit insurance applications for, and change in control notices with respect to, ILCs that will be affiliated with commercial concerns or other companies that will not have a Federal consolidated supervisor. Some members of Congress, the Government Accountability Office, the FDIC's Office of Inspector General, and members of the public have expressed concerns regarding the lack of Federal consolidated supervision, the potential risks from mixing banking and commerce and the potential for an unlevel playing field.")

[7] 85 Fed. Reg. at 17776.

ILC charters, or indirectly through increased rent-a-bank schemes with ILC banks. That risk is greater given the agency's recently finalized "federal interest rate authority rule," which will encourage predatory lenders to enter into rent-a-bank schemes with FDIC-supervised banks, including ILCs.

Our comment makes the following points in turn:

- Now is among the most inappropriate times imaginable to disrupt longstanding safeguards that protect both the systemic health of the economy and consumers.
- The FDIC's proposal poses severe risks to the federal safety net.
- The past financial crisis demonstrates that the FDIC's supervision of ILCs was not adequate, including with respect to predatory lending.
- The proposal, along with new ILC charters, would severely undermine the States' historical and constitutional role in our federalist system.
- Expansion of ILCs will erode consumer protections and expose consumers to severe harm, which the proposal fails to consider.
    - High-cost lending is fundamentally different than responsible lending and inflicts severe harm on financially vulnerable consumers.
    - Predatory lending causes particular harm to communities of color.
    - Existing ILCs are already involved in rent-a-bank partnerships, including very high-cost schemes.
    - The FDIC fails to consider that proliferation of ILCs will enable high-cost lending, evidenced by existing rent-a-bank schemes that the FDIC is not restraining.
    - Features of online loans, including the originate-to-distribute model and heavy reliance on preauthorized electronic repayment, pose heightened risk of unaffordability and other risks.
    - The proposal fails to consider the safety and soundness risks of predatory lending, which the FDIC has long acknowledged.
- The proposal gives inadequate consideration to Community Reinvestment Act concerns.
- Any final rule should not permit the FDIC staff to waive conditions imposed upon ILCs without Board approval.

I. Now is among the most inappropriate times imaginable to disrupt longstanding safeguards that protect both the systemic health of the economy and consumers.

We are in the midst of an unprecedented health crisis and a severe economic crisis. In May 2020, unemployment hit 17.6% for Hispanic or Latino workers, 16.8% for Black workers, 15.0% for Asian

workers and 12.4% for white workers,[8] representing a much steeper climb, and reaching a higher peak, than in the Great Recession.[9] Economic forecasts, domestic and global, are bleak.[10] With the trajectory of the pandemic unclear, there remains great uncertainty around how severe the economic fallout will be, and how long it will last.

The severe economic crisis has several implications for the risks posed by ILCs. In section III below, we discuss that, during the 2008 financial crisis, ILCs experienced great distress and caused severe drains on the federal safety net. The current crisis further demonstrates that commercial owners of ILCs can indeed be liabilities to ILCs, rather than strengths, in a crisis. Corporate bankruptcies rose 48% over the prior year this May, with experts predicting that they will continue to rise as federal relief tapers.[11] Large corporations are receiving equity aid from Treasury of over $450 billion, which the Fed has leveraged into more than $4 trillion.[12] The FDIC's proposal would usher in unprecedented blending of commercial and financial activities that poses severe systemic risks to the financial system.

The pandemic also has strained the FDIC's supervision of regular banks, which should be the agency's current focus. April's FDIC Office of the Inspector General (OIG) report underscores that this is the wrong time for the FDIC to loosen safeguards or take on a surge of supervisory authority. The report was based on evaluation in 2018 and early 2019, unrelated to the COVID pandemic. The report found, among other things, that the FDIC's Pandemic Influenza Plan "did not adequately address how the FDIC might need to adjust supervision, resolution, or closing activities in the event of a pandemic impacting [insured depository institutions]" and that the FDIC had not updated it in five years.[13] The need to adjust

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[8] *See* Testimony of Ashley C. Harrington, Federal Advocacy Director and Senior Counsel, Center for Responsible Lending, Before the U.S. House Committee on Small Business, "Paycheck Protection Program: Loan Forgiveness and Other Challenges," June 17, 2020, at 3-4, https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-testimony-harrington-house-smallbusiness-17jun2020.pdf (citing Bureau of Labor Statistics Current Population Survey, Table A-2 and A-3 and elaborating on the racially disproportionate economic impact of the COVID-19 crisis).

[9] *Id.*

[10] *See* Press Release, *Federal Reserve issues FOMC statement*, June 10, 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200610a.htm (announcing that it is holding interest rates at near zero in light of the "considerable risks to the economic outlook over the medium term" posed by the public health crisis); World Economic Outlook Reports, International Monetary Fund, *World Economic Outlook Update, June 2020,* https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020 (noting drop in global growth forecast versus April; that there is a "higher-than-usual degree of uncertainty around this forecast"; and that the "adverse impact on low-income households is particularly acute").

[11] Katy Stech Ferek, *U.S. Business Bankruptcies Rose 48% in May: Year-to-year jump in chapter 11 filings shows toll of coronavirus pandemic*, Wall Street Journal, June 4, 2020, https://www.wsj.com/articles/u-s-business-bankruptcies-rose-48-in-may-11591308842.

[12] Howard Schneider, *Fed's dilemma: Picking winners for $4 trillion in credit*, Reuters, Apr. 3, 2020, https://www.reuters.com/article/us-health-coronavirus-fed-credit/feds-dilemma-picking-winners-for-4-trillion-in-credit-idUSKBN21L0HR.

[13] FDIC Office of Inspector General, *The FDIC's Readiness for Crises*, Evaluation Report, at 24 (April 2020), https://www.fdicoig.gov FDIC /sites/default/files/publications/EVAL-20-004.pdf.

supervision of traditional banks highlights the challenge to bringing on a new ILCs in the midst of this pandemic.

While we face a pandemic and an economic crisis, we are also grappling more deeply with structural racism, reevaluating the systems and power dynamics that fuel, perpetuate, and exacerbate racial disparities. As we discuss in section V.B below, high-cost lenders have long targeted Black and Latino communities. As we discuss in sections V.C and V.D, the FDIC is currently failing to address existing predatory rent-a-bank schemes from the traditional banks, as well as the ILCs, it supervises. The FDIC should be devoting attention to rooting out those schemes to protect consumers from predatory loans, rather than laying groundwork that will proliferate high-cost lending that, history tells us, disproportionately impacts Black and Latino households.

II. The FDIC's proposal poses severe risks to the federal safety net.

For years, federal regulators, lawmakers, banks, and others have raised concerns about the risks posed by lack of consolidated federal supervision for ILCs. While particular attention, at times, has been given to commercial ownership, versus financial ownership, of ILCs, concern about consolidated federal supervision has consistently been a substantial concern, independent of the degree to which owners engage in commercial activity. A 2005 GAO report,[14] a 2004 FDIC OIG report,[15] a 2016 joint regulator report to Congress and the Financial Stability Oversight Council,[16] and the FDIC's own notices in 2007[17] all make this concern clear.

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[14] As the proposal notes, a 2005 GAO report raised concerns about the FDIC's ability to protect industrial banks from risks as effectively as consolidated Fed supervision. 85 Fed. Reg. 17774 (citing U.S. Gov't Accountability Office, GAO-05-621, *Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority* (Sept. 2005)).

[15] The 2007 FDIC proposed ILC rule acknowledged that the 2004 OIG report had raised concerns about lack of consolidated supervision and the possible limitations of the FDIC's authority. 72 Fed. Reg. 5291 (citing FDIC OIG Report No. 2004–048, *The Division of Supervision and Consumer Protection's Approach for Supervising Limited Charter Depository Institutions* (2004), https://www.fdicoig.gov/publications/reports04/04-048-Report.shtml. That 2004 report noted: "We concluded that ILCs may pose additional risks to the deposit insurance fund by virtue of the fact that these depository institutions' parent holding companies are not always subject to the scope of consolidated supervision, consolidated capital requirements, or enforcement actions imposed on parent organizations subject to the BHCA. Further, the banking organizations that are being created as a result of ILC charter powers allow some mixing of banking and commerce, which is otherwise prohibited for most depository institutions owned by commercial firms." It went on to note that the agency "has established controls to *help mitigate* these added risks" (emphasis added)). *See* section III for discussion of how these risks were not sufficiently mitigated.

[16] *See* Board of Governors of the Fed. Res. Sys., Fed Deposit Ins. Corp., and Office of the Comptroller of the Currency, *Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act* (Sept. 2016), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908a1.pdf, at 33-34 (Fed citing risks from lack of consolidated supervision of ILCs), 52 (FDIC acknowledging that "[c]onsolidated federal supervision of companies that own FDIC-insured institutions is an important part of the prudential regulatory framework for banking organizations" from which "a small number of companies" are exempt) [hereinafter "2016 Joint Report to Congress and FSOC"].

[17] The 2007 proposal acknowledges the risk of lack of consolidated supervision as a stand-alone risk while also noting that the agency believes it can "deal with" the difficulty in identifying problems in the controlling company that may affect the bank, at least for financially-owned ILCs, through the conditions laid out in that proposal. FDIC,

The FDIC's proposal suggests that the conditions it would require sufficiently compensate for its lack of consolidated supervision. But they do not. The proposal states that the proposed conditions largely formalize existing practices, including historic FDIC requirements that ILC holding companies have capital and liquidity maintenance agreements and "prudential conditions."[18] Yet whatever agreements and conditions the FDIC has imposed in the past have been clearly inadequate, as discussed in the next section. In one particularly striking example discussed below, in 2013, the FDIC sued the management of an ILC—predatory credit card issuer Advanta—that had failed during the 2008 crisis, alleging that Advanta had implemented "massive" interest rate increases on consumers (which led customers to flee and Advanta to fail) to prop up the parent company's crumbling stock price during the financial crisis.[19]

As law professor Arthur Wilmarth explains in his comments to this docket, even if the FDIC could require all the conditions it proposes for ILC owners, the supervision those conditions establish falls well short of the Fed's consolidated supervision. Professor Wilmarth notes that under the proposed conditions, "the FDIC could not conduct unlimited, full-scope examinations" of ILC owners and their nonbank subsidiaries; "impose consolidated capital or consolidated liquidity requirements on ILC owners"; nor "require large owners to conduct stress tests or prepare resolution plans pursuant to [the enhanced supervision and prudential standards under the Dodd-Frank Act for non-bank financial companies supervised by the Fed]."[20] The Fed describes lack of consolidated supervision as "problematic" because "risks that cross legal entities and that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one, or even several, of the legal entity subdivisions" and notes that "financial distress in one part of a business organization can spread, sometimes rapidly, to other parts of the organization."[21]

As Professor Wilmarth discusses at length in his comments, the FDIC's proposal, by not distinguishing between commercial and financial ownership of ILCs, represents a change in course that the FDIC has not explained or justified.[22] As his comments demonstrate, and as discussed more briefly in the following section, commercial nonbank parents of ILCs inherently pose excessive risk that cannot be supervised away. Permitting further acquisition of ILCs by commercial firms runs counter to Congressional intent to separate banking and commerce and poses grave systemic risks to our nation's economy.

Even with respect to financially-owned ILCs, however, the proposal plows ahead without adequately grappling with the demonstrated risks posed by lack of consolidated supervision. Critically, even the

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Proposed Rule, Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5222 (Feb. 5, 2007). *See also* FDIC, Moratorium on Certain Industrial Bank Applications and Notices, Limited Extension of Moratorium, 72 Fed. Reg. 5290, 5291 (Feb. 5, 2007).

[18] 85 Fed. Reg. at 17781.

[19] Kevin Koeninger, *FDIC Sues Advanta Bank Execs for $219 Million*, Courthouse News Service, June 19, 2013, https://www.courthousenews.com/fdic-sues-advanta-bank-execs-for-219-million/.

[20] Comments of Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, to this docket, at 18, https://www.fdic.gov/regulations/laws/federal/2020/2020-parent-companies-of-industrial-banks-3064-af31-c-002.pdf [hereinafter "Wilmarth comments"].

[21] *Id.* at 18 (citing 2016 Joint Report to Congress and FSOC at 33-34).

[22] *See id.* at 3-6.

financial activities of Fed-supervised bank holding companies (BHCs) are permitted *only* if the BHC is well capitalized and well managed and all of its subsidiaries are well capitalized and well managed.[23]

In 2007, the FDIC acknowledged that financial companies without consolidated supervision "present some of the same issues that industrial banks owned by commercial companies do."[24] The FDIC stated, however, that it believed that "those issues can be controlled or minimized in such cases."[25] The agency offered little rationale for this conclusion, however. It noted that "some such companies are subject to well-established regulatory authorities, e.g., by state insurance commissions or the [SEC]" and that those companies engage only in financial activities, not commercial activities.[26] The agency explained, with seemingly less than total confidence, that its 2007 proposed rule "*could be* helpful to identify and avoid or control, on a consolidated basis, the safety and soundness risks and the risks to the DIF" stemming from financial company ownership of ILCs.[27]

Of course, many prospective ILC owners will not be supervised by the SEC or a state insurance commission. And importantly, the vast majority of technology companies expressing interest in federal charters today differ sharply from the "small, community-focused institutions" that the FDIC noted were already a shrinking share of applications back in 2007, when it justified an extended moratorium for commercially-owned ILCs.[28] At that time, the FDIC noted that the "business plans" for ILCs owned by commercial firms "differ substantially from the consumer lending focus of the original industrial banks."[29] The vast majority of companies seeking ILC charters today are not "small, community-focused institutions" and, as the current proposal notes, some "operate unique business models, some of which are focused on innovative technologies and strategies."[30] This will often be the case, regardless of whether those companies are commercial or financial in nature. Thus, the reasons cited in 2007 for the moratorium on commercially owned ILCs support not only the discontinuation of new commercially owned ILCs, but financially owned ILCs as well.

Indeed, the market fully expects that financial companies seeking interest rate preemption will seek ILC charters over traditional bank charters for the primary purpose of avoiding consolidated Fed supervision. This should be the case in point that the FDIC lacks the authority and tools to supervise those companies with the rigor the Fed can apply.

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[23] 2016 Joint Report to Congress and FSOC at 33-34.

[24] 72 Fed. Reg. 5292.

[25] *Id.*

[26] 72 Fed Reg 5292-93.

[27] 72 Fed. Reg. 5293 (emphasis added).

[28] 72 Fed. Reg. 5291 (noting that a growing number of applications were from companies that "would be affiliated with commercial companies *or other entities* that would not be subject to Federal Consolidated Bank Supervision" (emphasis added)).

[29] 72 Fed. Reg. 5291.

[30] 85 Fed. Reg. 17776.

III. The past financial crisis demonstrates that the FDIC's supervision of ILCs was not adequate, including with respect to predatory lending.

In its 2007 proposed rule—a rule similar to this one, but applicable only to financially-owned ILCs, and never finalized—the FDIC noted the following:

> "[T]he financial viability of industrial banks that are owned by companies not subject to consolidated oversight is largely untested in times of economic stress or a downturn in the economy. There is almost no track record that indicates how such ownership structures might perform under stress and, specifically, whether such ownership would tend to cause or exacerbate any risks to the subsidiary industrial banks or the Deposit Insurance Fund."[31]

But the couple of years following the 2007 proposed rule would provide a clear track record, and it is not a good one. Yet the current proposal does not grapple with the financial distress ILC owners and some ILCs experienced during the financial crisis, or their drain on the safety net. Instead, it states that the 2008 financial crisis "demonstrated that the FDIC's supervisory approach with respect to industrial banks was effective."[32] The FDIC states that only two small industrial banks failed and others converted to commercial banks or BHCs for "financial and strategic reasons."[33]

But Professor Wilmarth's comments document thoroughly the financial distress ILC owners experienced during the financial crisis—a fact unacknowledged by the FDIC's proposal. At least six very large corporate owners of ILCs either "received huge bailouts" to prevent failure (General Motors Acceptance Corp. (GMAC), Merrill Lynch, Goldman Sachs, and Morgan Stanley); had "very serious liquidity problems" and "received extensive financial assistance from federal agencies" (GE Capital); or failed, wiping out $2.3 billion of TARP funding (CIT group).[34] The hundreds of billions of dollars in assistance that the federal government extended to these ILC owners is discussed in detail in Professor Wilmarth's comment.[35]

Another ILC owner, Fremont General, discussed in detail below, collapsed in 2008.[36] In a 2016 joint report to Congress and the FSOC, the Fed noted, and the FDIC acknowledged, the poor performance of a number of ILC owners during the crisis.[37]

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[31] 72 Fed. Reg. 5222.

[32] 85 Fed. Reg. 17776.

[33] *Id.*

[34] Wilmarth comments at 7.

[35] *Id.* at 7-10.

[36] *Id.*

[37] *Id.* at 7 (citing 2016 Joint Report to Congress and FSOC at 34 (note 116) (Fed's statement that "companies that failed or required assistance at the outset of the 2008 financial crisis included a number of companies that owned and controlled ILCs") and 52 (FDIC's acknowledgment that some "parent companies or affiliates [of ILCs] failed or experienced severe stress" during the financial crisis)).

Importantly, ILC owners and ILCs have a history of engaging in predatory lending, which led to systemic economic consequences, drains on the safety net, and severe harm to consumers—which their supervisory framework did not prevent. All the entities below were engaged in predatory subprime lending; these bullets are drawn from Professor Wilmarth's comments:[38]

- Long before the crisis, two ILCs engaged in subprime lending, Pacific Thrift and Loan and Southern Pacific Bank, failed in 1998 and 2003, respectively, resulting in significant drains on the Deposit Insurance Fund.

- General Motors Acceptance Corp. (GMAC), which owned a large Utah ILC with $33 billion in assets and $17 billion in deposits, suffered steep losses in 2007-2008 resulting from its subprime mortgage lending business, as well as its auto lending business. It was converted into a bank holding company to avoid failure and received over $40 billion through various forms of financial assistance.

- GE Capital, the large owner of an ILC, held $700 billion in assets in 2008. To address its severe liquidity problems, the Fed purchased $16 billion of its commercial paper and the FDIC guaranteed over $70 billion of a debt issuance. In 2019, GE Capital paid the Department of Justice a fine of $1.5 billion related to its subprime lending leading up to the crisis;[39] its WMC mortgage unit was ranked fourth on the U.S. Treasury Department's list of worst subprime originators.[40]

- CIT Group, also holder of a Utah ILC, was engaged in subprime mortgage lending. It also underwent an emergency conversion to a BHC, received TARP funding of $2.3 billion, and then failed nonetheless in 2009.

Fremont Investment and Loan

Perhaps the ILC most well-known for its involvement in predatory lending was Fremont Investment and Loan. Fremont was one of the nation's largest and most notorious predatory subprime mortgage lenders, "known at the time within the financial industry for issuing poor quality loans and RMBS securities."[41] In November 2008, after the OCC analyzed the ten metropolitan areas with the highest foreclosure rates and identified the ten lenders in those areas with the most foreclosed loans, Fremont

[38] *See* Wilmarth comments at 7-9.

[39] Press Release, U.S. Dept. of Treasury, *General Electric Agrees to Pay $1.5 Billion Penalty for Alleged Misrepresentations Concerning Subprime Loans Included in Residential Mortgage-Backed Securities*, Apr. 12, 2019, https://www.justice.gov/opa/pr/general-electric-agrees-pay-15-billion-penalty-alleged-misrepresentations-concerning-subprime.

[40] OCC, *Worst Ten in the Worst Ten*, https://www.occ.gov/news-issuances/news-releases/2009/nr-occ-2009-112b.pdf.

[41] *Wall Street and the Financial Crisis: Anatomy of Financial Collapse, Majority and Minority Staff Report, U.S. Senate Permanent Subcommittee on Investigations* at 331 (Apr. 13, 2011), available at https://fraser.stlouisfed.org/title/wall-street-financial-crisis-anatomy-a-financial-collapse-5094 [hereinafter Senate Committee Report]; *see also id.* at 338, 361.

was among the "Worst Ten in the Worst Ten," with the fifth-highest number of foreclosures in the Worst 10 Metro Areas.[42]

From 2005-2007, Fremont made $61.7 billion in high interest loans, the seventh largest subprime lender in the country during that period.[43] In November 2006, Fremont made history: its rise in early payment defaults prompted Moody's to downgrade, or put on watch for future downgrades, securities that Moody's had rated that very same year—something Moody's had never done before.[44]

By late 2006, Fremont was experiencing steep losses, registering a $202 million net operating loss in the fourth quarter.[45] In March 2007, the FDIC issued a cease and desist order against Fremont that required it to cease making subprime loans. The order raised a number of issues, including unsafe and unsound banking practices, "a large volume of poor quality loans," excessive risk, and inadequate capital.[46] It also noted that Fremont was making exploding adjustable rate mortgages with teaser rates; approving borrowers without consideration of income; and approving loans with loan-to-value ratios exceeding 100%.[47]

But the FDIC's action came after Fremont had pumped thousands of toxic mortgages into the market, despite numerous warnings from lawmakers, policy groups, and other regulators, that a subprime foreclosure crisis was afoot.[48] In July 2007, when Moody's downgraded 399 subprime mortgage-backed securities that had been issued in 2006, and put 32 additional securities on watch, all totaling $5.2 billion,[49] Fremont had the worst ratio of securities downgraded compared to securities issued in 2006.[50]

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[42] Senate Committee Report at 331 (Apr. 13, 2011), https://www.occ.gov/news-issuances/news-releases/2009/nr-occ-2009-112b.pdf (citing OCC, *Worst Ten in the Worst Ten*, https://www.occ.gov/news-issuances/news-releases/2009/nr-occ-2009-112b.pdf).

[43] The Center for Public Integrity, *Who's Behind the Financial Meltdown? The Top 25 Subprime Lenders and Their Wall Street Backers* at 14 (2009), https://cloudfront-files-1.publicintegrity.org/documents/pdfs/The%20Financial%20Meltdown.pdf.

[44] The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* at 221 (Jan. 2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [hereinafter *Financial Crisis Inquiry Report*].

[45] Housing Justice, *Foreclosures Involving Fremont Investment Loans*, March 2, 2018, https://thjf.org/2018/03/02/foreclosures-involving-fremont-investment-loans/.

[46] Senate Committee Report at 238 (referencing and quoting Press Release, *FDIC Issues Cease and Desist Order Against Fremont Investment & Loan, Brea, California, and its Parents*, March 7, 2007, https://www.fdic.gov/news/news/press/2007/pr07022.html).

[47] *Id.*

[48] See The Center for Public Integrity, *Who's Behind the Financial Meltdown? The Top 25 Subprime Lenders and Their Wall Street Backers* at 32-37 (2009), https://cloudfront-files-1.publicintegrity.org/documents/pdfs/The%20Financial%20Meltdown.pdf.

[49] Senate Committee Report at 264 (citing Moody's Investors Service, "Moody's Downgrades Subprime First-lien RMBS-Global Credit Research Announcement," July 10, 2007).

[50] *Id.* at 124, *see also id.* at 237-239 for further discussion of Fremont.

Fremont makes a number of unflattering appearances in the Financial Crisis Inquiry Commission (FCIC) Report. One former risk manager for Fremont told the FCIC that Fremont had a "three strikes, you're out rule," describing the practice whereby, if a loan securitizer rejected a loan for, among other reasons, not meeting underwriting guidelines, Fremont would try a different pool until the loan was kicked out three times.[51] When an appraiser began studying the mortgage market after foreclosures began rising in his home of Bakersfield, California, he called Fremont to report findings of what he believed were fraudulent mortgages. He was told by a quality assurance officer: "Don't put your nose where it doesn't belong."[52]

Fremont was subject to other litigation as well. In October 2007, the State of Massachusetts filed suit against Fremont for engaging in "unfair and deceptive conduct on a broad scale" in connection with predatory mortgage lending,[53] including selling "exceedingly risky loan products that Fremont knew or should have known were designed to fail."[54] The suit also addressed Fremont's selling practices, which employed yield-spread premiums that incentivized high-cost loans, and led to "rampant abuse of stated-income loans and misleading borrowers about the loans offered and their ability to refinance to lower cost products."[55] The suit resulted in a $10 million settlement and injunctive relief aimed at stemming the tide of foreclosures Fremont's loans were causing in Massachusetts.[56]

In March 2008, Fremont reported that it had received default notices on $3.15 billion in mortgages it had sold to investors.[57] Later that month, the FDIC again filed an enforcement action against Fremont addressing inadequate capitalization, ordering the company to adequately capitalize the bank within 60 days or sell it.[58] The parent sold the bank's branches, deposits, and other assets, to CapitalSource, Inc., another California ILC, and filed for bankruptcy.

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[51] Financial Crisis Inquiry Report at 168.

[52] *Id.* at 15.

[53] Martha Neil, *MA Sues Lender, Seeks Foreclosure Role*, ABA Journal, Oct. 5, 2007, https://www.abajournal.com/news/article/ma_sues_lender_seeks_foreclosure_role.

[54] Scott Van Voorhis, *AG Coakley sues big subprime lender Fremont*, Boston Herald, Oct. 5, 2007, updated Nov. 7, 2018, https://www.bostonherald.com/2007/10/05/ag-coakley-sues-big-subprime-lender-fremont/ (quoting complaint or Mass. AG press release).

[55] *Id.*

[56] *Commonwealth of Massachusetts v. Fremont Investment & Loan*, Civil Action No. 07-4373-BLS1, Final Judgment by Consent, Apr. 17, 2009, https://www.mass.gov/files/documents/2016/08/up/2009-06-09-fremont-consent-judgment.pdf?_ga=2.82870418.560611157.1592319793-586388755.1592319793.

[57] Senate Committee Report at 238, *see also* n. 941.

[58] *Id.* at 238 (citing *In re Fremont Investment & Loan, Supervisory Prompt Corrective Action Directive*, Docket No. FDIC-08-069 PCAS (March 26, 2008)).

Advanta

Another ILC engaged in predatory lending, credit card issuer Advanta, filed for bankruptcy in March 2010 with $1.5 billion in deposits.[59] The FDIC estimated that this failure would inflict more than $600 million in losses on the Deposit Insurance Fund because there were no buyers.[60]

Advanta was effectively a monoline small business credit card issuer that securitized its receivables.[61] In 2009, the FDIC settled with Advanta related to alleged unfair and deceptive practices, including a "cash bank reward" program that falsely advertised the rates of cash back cardholders could receive, as well as unfair implementation of interest rate increases that caused substantial injury to borrowers.[62]

Following Advanta's failure, the FDIC Inspector General noted that Advanta had "failed to develop adequate contingency plans for responding to an early amortization of the bank's securitization."[63] It concluded:

> "In hindsight, earlier and greater supervisory emphasis or concern could have been expressed regarding the failure of the bank's capital allocation model and contingency funding plans to incorporate more extreme stress scenarios. Such action would have helped ensure adequate capitalization and liquidity to support an unwinding of the securitizations through early amortization, a significant risk associated with Advanta's monoline business strategy."[64]

In 2013, the FDIC sued Advanta's management for $219 million in an effort to claw back losses to the Deposit Insurance Fund. The suit alleged that the ILC had raised interest rates to prop up the parent company, Advanta Corp's, crumbling stock price during the financial crisis—a clear example of the risks of a lack of consolidated supervision.[65] These rate increases—from 7.99% or 14.99% to up to 37%—, the FDIC alleged, drove off 400,000 customers and led to the ILC's failure.[66] Moreover, over 40% of the ILC's

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[59] Press Release, *FDIC Approves the Payout of the Insured Deposits of Advanta Bank Corp., Draper, Utah*, March 19, 2010, https://www.fdic.gov/news/news/press/2010/pr10058.html.

[60] *Id.*; FDIC, *Failed Bank Information for Advanta Bank Corp., Draper, UT,* https://www.fdic.gov/bank/individual/failed/advanta-ut.html (noting no acquiring institution could be located).

[61] FDIC Office of Inspector General, *Semiannual Report to the Congress, October 1, 2010 - March 31, 2011,* https://www.fdicoig.gov/publications/fdic-office-inspector-generals-semiannual-report-congress-10.

[62] Press Release, *FDIC Announces Settlement With Advanta Bank Corporation for Deceptive and Unfair Practices*, July 1, 2009, https://www.fdic.gov/news/news/press/2009/pr09109.html.

[63] FDIC Office of Inspector General, *Semiannual Report to the Congress, October 1, 2010 - March 31, 2011,* https://www.fdicoig.gov/publications/fdic-office-inspector-generals-semiannual-report-congress-10.

[64] *Id.*

[65] Kevin Koeninger, *FDIC Sues Advanta Bank Execs for $219 Million*, Courthouse News Service, June 19, 2013, https://www.courthousenews.com/fdic-sues-advanta-bank-execs-for-219-million/.

[66] Stewart Bishop, *FDIC Nears Accord in $219M Suit Against Ex-Advanta Execs*, Mullin Hoard Brown LLP, Aug. 11, 2014, https://mullinhoard.com/fdic-nears-accord-219m-suit-ex-advanta-execs/.

remaining customers defaulted on their accounts. Management, the FDIC alleged, disregarded more than 35,000 complaints from disgruntled customers.[67]

In other litigation involving Advanta, bank leadership and their auditor, KPMG, paid $3.55 million to settle a putative securities class action alleging that they concealed unfavorable financials from investors.[68]

Thus, ILCs have demonstrated disproportionate involvement in predatory lending, which has inflicted a drain on the safety net and harmed consumers, and which the FDIC's supervision did not prevent.

In section V.C. below, we discuss ILCs currently engaged in high-cost lending.

IV. The proposal, along with new ILC charters, would severely undermine the States' historical and constitutional role in our federalist system.

By making it easier for an entity to gain banking privileges, including preemption, without the consolidated supervision required of other bank owners, the proposed rule threatens to deprive states of their historic power to protect their residents.

States have a long-standing, well-recognized interest in determining the policies best suited to prevailing conditions and priorities within state borders. As compared with the federal government, states are more familiar, accessible, and accountable to their constituencies and can more nimbly develop policies to address the problems they face.[69] With good reason, the Constitution preserves the rights and role of States within our federalist republic.

Interest rate limits are the simplest and most effective protection against predatory lending.[70] Since the time of the American Revolution, states have set interest rate caps to protect their residents from predatory lending.[71] In more recent years, a handful of states eliminated their rate caps, others carved out limited exceptions for short-term payday loans (some since reversed), and a combination of federal and state laws exempt most banks from interest rate limits.[72] But the vast majority of states retain interest rate caps for non-bank installment loans and lines of credit.[73]

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[67] *Id.*

[68] *Id.*

[69] *See Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991) (stating that federalism "assures a decentralized government that will be more sensitive to the diverse needs of a heterogenous society" and "allows for more innovation and experimentation in government").

[70] *See* NCLC, *Misaligned Incentives: Why High-Rate Installment Lenders Want Borrowers Who Will Default* (July 2016), https://www.nclc.org/issues/misaligned-incentives.html.

[71] James M. Ackerman, *Interest Rates and the Law: A History of Usury*, 1981 Ariz. St. L.J. 61 (1981).

[72] *See generally* NCLC, Consumer Credit Regulation (2d ed. 2015), updated at www.nclc.org/library.

[73] *Id.*

At least 45 states and the District of Columbia (DC) impose interest rate caps on some consumer loans. Among those that cap rates, the median annual rate including all fees is 38.5% for a $500, six-month loan; 31% for a $2000, two-year loan; and 25% for a $10,000, five-year loan.[74] While payday and other high-cost lenders are pushing hard at the state level to make high-cost longer-term loans legal in more states, the large majority of state legislatures have rejected these efforts. In addition, sixteen states plus DC have interest rate caps that prevent short-term payday loans, a number that has grown by several over the last decade. The proliferation of ILCs would severely weaken the protection that consumers receive from state interest rate caps.

Broad preemption of state consumer protection laws via the ILC charter is also inconsistent with the original intent of ILCs and the type of activity in which they were engaged when they were exempted from consolidated supervision. As the proposal notes, ILCs began in the early 1900s to make small loans to industrial workers.[75] They did not have access to deposit insurance until 1982.[76] At the time of their exemption from the definition of "bank" in the Bank Holding Company Act in 1987, they were still small, locally-focused institutions.[77] The notion that a behemoth like Rakuten would have federal preemption privileges without the responsibility borne of consolidated supervision was very likely never foreseen when ILCs were carved out from more rigorous supervision. Indeed, when the FDIC imposed its moratorium in 2006, it noted that the ILC industry was evolving "in ways that may not have been anticipated at the time [the exemption] was enacted in 1987."[78]

Since 2006, Congress has only narrowed preemption, including federal interest rate preemption. After federal preemption played a major role in creating the financial crisis of 2008, Congress amended the National Bank Act to limit the OCC's ability to preempt state consumer protection laws and to make clear that the preemption national banks enjoy does not extend to bank affiliates, subsidiaries, or agents. Expansion of federal preemption through ILCs is clearly inconsistent with Congress's aim to construe preemption very narrowly by prohibiting it even for subsidiaries and affiliates of national banks.

V. Expansion of ILCs will erode consumer protections and expose consumers to severe harm, which the proposal fails to consider.

A. High-cost lending is fundamentally different than responsible lending and inflicts severe harm on financially vulnerable consumers.

In recent years, the harms of high-cost lending have been more comprehensively and thoroughly documented than ever before.[79] High-cost lending is a debt trap by design, exploiting the financially

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[74] *See* NCLC, State Rate Caps for $500 and $2,000 Loans (Feb. 2020), http://bit.ly/state-loan-caps; NCLC, *A Larger and Longer Debt Trap? Analysis Of States' APR Caps For A $10,000 5-year Installment Loan* (Oct. 2018), overview http://bit.ly/2QOp6AG and full report, http://bit.ly/instloan18.

[75] 85 Fed. Reg. at 17772.

[76] Wilmarth comments at 3-4.

[77] *Id.*

[78] *Id.* (citing 71 Fed. Reg. at 43482).

[79] *See* CFPB, Rule Addressing Payday, Vehicle Title, and Certain High-Cost Installment Loans, Final Rule, 82 Fed. Reg. 54472 (Nov. 17, 2017) (CFPB Payday Rule) and Docket No. CFPB-2016-0025 associated with that rule; *see* CRL and

distressed and leaving them worse off, leading to a host of financial consequences that include greater delinquency on other bills,[80] high checking account fees and closed accounts,[81] and bankruptcy.[82] These toxic products inflict financial, emotional, and physical turmoil that can pervade every aspect of a person's life. Growing research documents the links between high-cost loans and negative health impacts.[83]

Today's high-cost loans include so-called "fintech" loans that portray themselves as better alternatives to payday loans, but which, in most significant respects, are not distinguishable from loans by traditional, "non-fintech" payday lenders. These longer-term loans typically still carry extremely high interest rates, are often still tied to repayment on payday, and are still made with little regard for the

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NCLC's comments to that docket, filed with additional consumer and civil rights groups, https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl_payday_comment_oct2016.pdf (CRL, NCLC, et al., Comments on CFPB Payday Rule); *see id.* at §2, pp. 17-40 (discussing harm to consumers).

[80] *See, e.g.*, B. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, (2011), Oxford University Press, *available at* http://bit.ly/10M01tZ; Agarwal, S., Skiba, P. M., & Tobacman, J., *Payday loans and credit cards: New liquidity and credit scoring puzzles?* NBER Working Paper (2009), *available at* http://bit.ly/RtDsXx.

[81] CFPB Payday Rule, 82 Fed. Reg. 54564, 73; *see also* Dennis Campbell, Asis Martinez Jerez, & Peter Tufano, *Bouncing out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures,* Harvard Business School, 12/3/08, *available at* www.bostonfed.org/economic/cprc/conferences/2008/payment-choice/papers/campbell_jerez_tufano.pdf.

[82] Paige Marta Skiba and Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?,* Vanderbilt University and the University of Pennsylvania, 10/10/08, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266215.

[83] One finds that access to payday loans substantially increased suicide risk—including by over 16% for those ages 25-44. Jaeyoon Lee, *Credit Access and Household Welfare: Evidence From Payday Lending* (SSRN Working Paper, 2017. Another finds that short-term loans, including payday loans, are associated with a range of negative health outcomes, even when controlling for potential confounders. Elizabeth Sweet et al., *Short-term lending: Payday loans as risk factors for anxiety, inflammation and poor health,* 5 SSM—Population Health, 114–121 (2018), *https://doi.org/10.1016/j.ssmph.2018.05.009.* These outcomes include symptoms of physical health, sexual health, and anxiety, as well as higher levels of C-reactive protein, which is an indicator of many long-term diseases, including cardiovascular disease, and an indicator of psychological stress. *Id.* Another study finds that restrictions on payday lending reduced liquor sales. Harold E. Cuffe & Christopher G. Gibbs, *The Effect of Payday Lending Restrictions on Liquor Sales,* 85(1) J. Banking & Fin. 132–45 (2017). In one study of qualitative data, respondents revealed symptoms of "allostatic load," a health psychology term that describes how compounding stress can lead to wear and tear on the body. Elizabeth Sweet et al., *Embodied Neoliberalism: Epidemiology and the Lived Experience of Consumer Debt*, 48(3) International Journal of Health Services (2018). The authors describe the respondents as having "embodied" their debt through idioms like "drowning in debt" and "keeping [their] head above water," which illustrated that the participants "experienced debt as a bodily sensation, not only a socioeconomic position or emotional stressor." *Id.* One payday borrower has reported that after being a "a pretty healthy young person," she "became physically sick, broke out in hives . . . [and] had to go to urgent care" as a result of her high-cost loan. Health Impact Partners and Missouri Faith Voices, *When Poverty Makes You Sick: The intersection of health and predatory lending in Missouri* (Feb. 2019), https://humanimpact.org/wp-content/uploads/2019/02/HIP-MFV_PayDayLending_2019.02fin1.pdf. Another expressed feeling, "[i]f I died, my debt would die with me. At least I could give my family that." *Id.*

borrower's ability to repay the loan while meeting other expenses.[84] These loans often inflict as much or more harm—creating a deeper, longer debt trap—for borrowers than two-week payday loans.[85]

Harm caused by high-rate loans extends far beyond the higher cost itself. Yes, a 150% APR costs dramatically more than a 15% APR loan. And the payments alone often strip financially distressed borrowers of what little they may have, leaving them without funds for needed expenses. But the harm is far more than the total cost of the loan. High-cost credit is not like a gallon of milk at the grocery store—a one-and-done purchase for which free market economies, as a general matter, reject price fixing. As a nation we generally *have* regulated the price of credit. And this is because predatory lending is fundamentally, structurally different than responsible lending.

High-cost lending turns incentives on their head, so that lenders succeed when borrowers fail.[86] As shown in the following chart,[87] high rates slow down repayment of principal so much that for months, or even years, progress toward principal is close to negligible, even after hundreds or thousands of dollars has been repaid. Litigation against CashCall exposed that the lender, even without breaking 100% APR, recovered far more than its original principal and started making a profit at month 19 on its 42-month loan, even while very little of those payments were applied to principal. That discrepancy only grew, with the profit point at 14 months on a 47-month loan, once CashCall increased the interest rate and lengthened the term. The chart also demonstrates how little progress the borrower has made toward principal at that point, and how long they have to go.

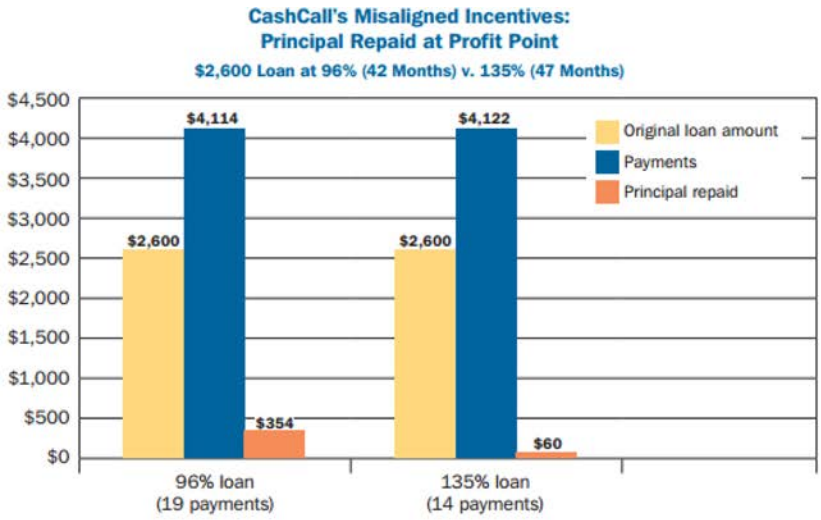
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[84] CRL, NCLC, et al., Comments on CFPB Payday Rule at § 2.5 (pp. 31-34) and § 10.1-10.3 (pp. 165-172). *See also* CFPB Proposed Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans, discussion of longer-term high-cost loans, 81 Fed. Reg. 47864, 47885-92 (July 11, 2016).

[85] *Id.*

[86] *See, generally*, NCLC, *Misaligned Incentives: Why High-Rate Installment Lenders Want Borrowers Who Will Default* (July 2016), https://www.nclc.org/issues/misaligned-incentives.html.

[87] This chart is drawn from NCLC, *Misaligned Incentives*, *supra*, at 15.



Once even small portions of principal are paid down, lenders aggressively push refinances to borrowers to keep them on a high-cost debt treadmill.[88] Even with these high refinance rates, defaults on high-cost loans are extraordinarily high. Elevate, one high-cost lender using FDIC-supervised banks to make loans averaging 122% APR,[89] has net charge-offs as a percentage of revenues of 50%.[90] The CFPB found that Elevate's charge-off rate as a percentage of outstanding loan volume in 2014 was over 50%.[91] Elevate has stated that it does not intend to drive down its charge-off rates.[92] Essentially, Elevate's is a high-rate, high-default model that profits while making unaffordable loans.

[88] The CFPB found that for online payday installment loans (the channel for most new "fintech" loans) refinance rates were very high. CFPB Supplemental Findings on payday, payday installment, and vehicle title loans (June 2, 2016) at 15 (35% for storefront, 22% for online). *See also* Elevate Credit, Inc., Form 10K, 2019, https://www.sec.gov/Archives/edgar/data/1651094/000165109420000010/elevate10-kx2019.htm, at 15 (noting "[a]pproximately 55% of Rise installment customers in good standing had refinanced or taken out a subsequent loan as of December 31, 2019, with 40% of the outstanding Rise installment loan balances on that date consisting of new customer loans and 60% related to returning customer loan."). While mainstream lenders also often have substantial rates of refinancings, those lenders also charge rates that permit reasonable amortization of loan balances.

[89] Elevate Form 10K, 2019, at 75.

[90] *Id;* the CFPB found that 55% of online loan sequences ended in default. CFPB Supplemental Findings on payday, payday installment, and vehicle title loans (June 2, 2016) at 15.

[91] As calculated by the CFPB, CFPB Proposed Payday Rule, 81 Fed Reg. 47886, n.246.

[92] Elevate Form 10K, 2019, at 81.

Car title lenders, which are also expanding into rent-a-bank operations that the FDIC has failed to curtail (see section V.D for further), inflict a special kind of pain. Lenders take title to unencumbered cars borrowers previously owned outright. An astounding one in five borrowers have their car repossessed.[93] The consequences of losing one's vehicle are dire—both the loss of a valuable asset and the serious disruption of a borrower's ability to get to work, earn income, and manage their lives.[94] More than a third of auto title borrowers have reported pledging the only working car in their household as security for their auto title loan.[95]

Thus, high-cost lending is not just credit at a higher price. It is a wrecking ball of a business model, designed by lenders to extract as much as possible, for as long as possible, from often already desperate borrowers, leaving them worse off than when they started. In this way, high-cost lending is also a mechanism that siphons resources from the poorest communities—often communities of color—to some of the wealthiest companies and individuals in the world.[96]

Consumer narratives of dozens of borrowers of loans made by lenders using rent-a-bank schemes, included in the Appendix to these comments, help to convey the harm these unaffordable loans inflict.

B. Predatory lending causes particular harm to communities of color.

The undersigned groups deeply object to the attempts that banking regulators, fintech lenders, or others, make to justify bank/non-bank partnerships, or preemption of state interest limits more broadly, with claims that these are a path to a more inclusive market.[97] Rather than help communities of color, which several of the undersigned groups represent, high-cost lending disproportionately harms communities of color, exploiting and fueling the racial wealth gap.

A legacy of racial discrimination in housing, lending, banking, policing, employment, and otherwise, has produced dramatically inequitable outcomes that persist today. Communities of color, often largely

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[93] CFPB Single-Payment Vehicle Title Lending at 4 (2016). CRL estimates that approximately 340,000 auto title borrowers annually have their car repossessed, well exceeding the population of St. Louis. For calculation, *see* CRL, Public Citizen, NCLC et. al comments on CFPB's proposed repeal of the ability-to-repay provisions of the payday rule at 26, n.90 (May 15, 2019), https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/comment-cfpb-proposed-repeal-payday-rule-may2019.pdf.

[94] *See* CFPB Payday Rule, 82 Fed. Reg. at 54573, 93.

[95] *Id.*, n. 592 (internal citations omitted).

[96] *See* Nicholas Confessore, *Mick Mulvaney's Master Class in Destroying a Bureaucracy From Within*, N.Y. Times Magazine, Apr. 16, 2019 (discussing the involvement of venture capitalists and private equity firms in high-cost lending and quoting Diane Standaert, former director of state policy at CRL: "These are entities that suck up billions of dollars a year from people making $25,000 a year. And it's going into the pockets of the wealthiest peoples in the world.").

[97] *See, e.g.*, Remarks of Acting Comptroller of the Currency Brian Brooks to the Online Lending Policy Institute, June 11, 2020, https://www.youtube.com/watch?v=Ae_SoZeRbxM, at 33:00 (stating "I want to make poor people rich" while addressing financial inclusion, in a conversation where he also states that his personal belief is that "price controls generally create shortages" and that "if we believe in market pricing for hamburgers, for jeans, for automobiles, I'm not sure why we don't believe in market rates for money, it's another commodity, and we want it to flow freely").

segregated due to the history of redlining and other racially exclusionary housing policies, experience higher rates of poverty, lower wages, and higher cost burdens to pay for basic living expenses. These disparities have been laid bare of late, as communities of color, and especially Black communities, are experiencing far greater human and economic loss during the COVID-19 pandemic.

High-cost lenders peddling unaffordable loans cause particular harm to these communities,[98] often in the same geographic areas that experienced redlining. Storefront high-cost lenders have long targeted borrowers of color, more likely to locate stores even in more affluent communities of color than in less affluent white communities.[99] Online high-cost lenders may focus more on subprime credit score than geography, although we understand that some lenders use zip codes to target online marketing. But historical discrimination against communities of color is also reflected in credit scores.[100] Lenders that focus on subprime borrowers inevitably will disproportionately target borrowers of color. The algorithms and big data that "fintech" lenders use may also result in disparate impacts on these communities.[101]

Moreover, online lenders often promote their models as expanding economic inclusion, which will often put borrowers of color among their target borrowers. Communities of color have historically been disproportionately left out of the traditional banking system, a disparity that persists today. About 17 percent of African American and 14 percent of Latino households are unbanked, compared to three percent of white households.[102] Some defend the high-cost "fintech" loans as bringing communities of

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[98] *See* CFPB Payday Rule, 82 Fed. Reg. at 54556-57 (African Americans are payday borrowers at three times the rate, and Hispanics at twice the rate, of non-Hispanic whites (citing 2015 FDIC National Survey of Unbanked and Underbanked Households (calculations using custom data tool). Vehicle title borrowers are also disproportionately African American and Hispanic. *Id.*)

[99] Li, *et al.*, *Predatory Profiling: The Role of Race and Ethnicity in the Location of Payday Lenders in California*, Center for Responsible Lending (2009), http://www.responsiblelending.org/payday-lending/research-analysis/predatory-profiling.pdf; Brandon Coleman and Delvin Davis, *Perfect Storm: Payday Lenders Harm Florida Consumers Despite State Law*, Center for Responsible Lending at 7, Chart 2 (March 2016); Delvin Davis and Lisa Stifler, *Power Steering: Payday Lenders Targeting Vulnerable Michigan Communities*, Center for Responsible Lending (Aug. 2018), https://www.responsiblelending.org/research-publication/power-steering-payday-lenders-targeting-vulnerable-michigan-communities; Delvin Davis, *Mile High Money: Payday Stores Target Colorado Communities of Color*, Center for Responsible Lending (Aug. 2017; amended Feb. 2018), https://www.responsiblelending.org/research-publication/mile-high-money-payday-stores-target-colorado-communities-color.

[100] *See* Chi Chi Wu, *Past Imperfect: How Credit Scores and Other Analytics "Bake In" and Perpetuate Past Discrimination*, National Consumer Law Center (May 2016), https://www.nclc.org/images/pdf/credit_discrimination/Past_Imperfect050616.pdf.

[101] *See* Testimony of Chi Chi Wu, National Consumer Law Center, Before the U.S. House Committee on Financial Services Task Force on Financial Technology Regarding "Examining the Use of Alternative Data in Underwriting and Credit Scoring to Expand Access to Credit" (July 25, 2019); Carol A. Evans, *Keeping Fintech Fair: Thinking about Fair Lending and UDAP* Risks, Consumer Compliance Outlook (2017), https://consumercomplianceoutlook.org/2017/second-issue/keeping-fintech-fair-thinking-about-fair-lending-and-udap-risks/.

[102] 2017 FDIC National Survey of Unbanked and Underbanked Households, at 3, https://www.economicinclusion.gov/downloads/2017_FDIC_Unbanked_HH_Survey_Report.pdf.

color into the economic mainstream.[103] But high-cost loans, particularly with their high association with lost bank accounts,[104] drive borrowers out of the banking system and exacerbate this disparity. By sustaining and exacerbating an existing precarious financial situation, high-cost lending reinforces and magnifies existing income and wealth gaps—legacies of continuing discrimination—and perpetuates discrimination today.[105]

C. Existing ILCs are already involved in rent-a-bank partnerships, including very high-cost schemes.

ILCs are already involved in rent-a-bank schemes, including those facilitating very high cost loans. The programs these banks facilitate vary, ranging from loans that start in the single digits and top out at below 36% APR to those routinely well into the triple digits.

First Electronic Bank,[106] a Utah-chartered ILC, is being used by Personify Financial to offer high-cost installment loans of $1,000 to $10,000 at APRs as high as 179.99% in 22 states that do not allow that rate for some or all loans in that size range.[107] At the same time, Personify Financial is offering these loans directly in three states whose laws do permit those rates—one of many characteristics that evidence that Personify is the true lender.[108] In May of this year, Personify became subject to a class action lawsuit alleging violation of Florida's state usury limits on consumer installment loans, as well as a

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[103] *See* Remarks of Acting Comptroller of the Currency Brian Brooks to the Online Lending Policy Institute, June 11, 2020, supra.

[104] CFPB found that about half of borrowers with online payday or other high-cost online loans paid a nonsufficient funds (NSF) or overdraft fee. These borrowers paid an average of $185 in such fees, while 10% paid at least $432. It further found that 36% of borrowers with a bounced payday payment later had their checking accounts closed involuntarily by the bank. CFPB Online Payday Loan Payments at 3-4, 22 (April 2016).

[105] For further on the undersigned groups' concerns about the harm predatory consumer loans cause communities of color, and the efforts we have long made to stop that harm, see the sampling of references cited here: http://stopthedebttrap.org/wp-content/uploads/2014/11/PayDay-loans.7-2016.pdf; http://stopthedebttrap.org/wp-content/uploads/2015/08/lcchr_resolution_payday_deposit_advance_lending_12dec2015.pdf; http://stopthedebttrap.org/wp-content/uploads/2015/08/naacp_letter_obama_payday_15december2014.pdf; https://www.unidosus.org/about-us/media/press/releases/NCLR-CFPB-Payday-Lending-Rule-Release; http://ourfinancialsecurity.org/2011/04/hilary-shelton-cfpb-testimony/; http://www.responsiblelending.org/payday-lending/policy-legislation/states/Letter-JBond_Rendell-012306.pdf; https://nalcab.org/nalcab-new-pay-day-rule-step-forward-latino-consumers-businesses/; http://stopthedebttrap.org/blog/cfpb-payday-lending-rule-will-disrupt-abusive-lending-protect-families-financial-predators/.

[106] https://www.firstelectronic.com/. First Electronic Bank is wholly owned by Fry's Electronics, which is based in Silicon Valley. https://www.firstelectronic.com/about-us/

[107] https://www.personifyfinancial.com/, last visited June 30, 2020. Those states are Alaska, Arizona, Delaware, Florida, Hawaii, Indiana, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Montana, Nebraska, North Carolina, Ohio, Oklahoma, Tennessee, Texas, and Washington. In early 2020, this list included California and Rhode Island, but those states no longer appear on Personify's website.

[108] Personify was lending directly in eight other states as of early 2020; as of June 30, 2020, they are only lending directly in three states (Alabama, Georgia, and Illinois).

willful attempt to evade Florida law through a rent-a-bank scheme.[109] The complaint underscores the myriad indications that Personify is the true lender, including that it defines itself as the "Lender" on the "loan agreement" Florida consumers see when they apply for a loan,[110] even while it claims that Florida loans are originated by First Electronic Bank.

Personify touts itself as "Serving the Underestimated Underbanked" with a target market of those with incomes between $20,000 and $75,000, many with less-than-prime credit.[111] It claims to "fill[] the void left by traditional financial institutions" while it "makes payday lenders and other sources of short-term financing obsolete."[112]

The Appendix to these comments includes a number of narratives from Personify Financial customers from the CFPB complaints database. They document borrowers' distress that their payments are not reducing principal due to the loan's high interest rates; consumers' inability to sustain those payments; and queries about how such loans can possibly be legal. One narrative conveys a borrower's struggle to repay a Personify Financial loan on top of multiple payday loans, which in total took 90% of the borrower's take-home income for well over three months.[113] This narrative supports the reality that neither Personify Financial, nor any other triple digit loan, is "making payday lenders . . . obsolete," as it claims. Rather, it is piling yet more unaffordable debt on those also struggling with payday loans. The involvement of an FDIC-supervised bank with this lending program also highlights how FDIC supervision cannot compensate for lack of an interest rate cap.

WebBank, a Utah-chartered ILC, is used by marketplace lenders that charge 36% or less, though for large loans in the $10,000-$40,000 range, that is still a very high that exceeds the rate permitted by many states.[114] WebBank—sold to Steel Partners LP, a large, public, diversified global holding company the year after its 1997 founding—has experienced regulatory troubles over the years.[115] In 2005, the

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[109] Complaint, *Ryan Derosier v. Applied Data Financial LLC, d/b/a Personify Financial*, 17th Cir. Ct., Broward County, Florida (filed May 22, 2020).

[110] *Id.* at 17.

[111] https://www.applieddatafinance.com/ (last visited June 30, 2020).

[112] *Id.*

[113] Appendix, Personify Financial examples, last bullet point.

[114] These include Lending Club, Prosper Marketplace, and Avant. S&P Global, 2018 US Digital Lending Market Report at 2 (May 22, 2020), http://marketplacelendingassociation.org/wp-content/uploads/2018/11/SP-2018-US-Digital-Lending-Mkt-Report.pdf. WebBank's partnership with Avant has been the subject of litigation brought by the Colorado Attorney General for violating Colorado's usury limit. In June 2020, in similar litigation involving a different bank and lender, the Colorado trial court rejected the lender's and bank's argument that a non-bank assignee could charge rates free of state usury laws on a loan originated by a bank. (The court has not yet addressed the issue of which entity is the true lender.) *Martha Fulford, Administrator, Uniform Consumer Credit Code v. Marlette Funding, LLC et al.*, Case No. 17CV30376, Order Regarding Plaintiff's Motion for Determination of Law (June 9, 2020) (District Ct., Denver Cty., Colo.), https://www.consumerfinancemonitor.com/wp-content/uploads/sites/14/2020/06/2020.06.09-CO-v.-Marlette.pdf.

[115] *See* Joseph Caputo and Lee Reiners, *The Rise of Rent-a-Charter: Examining New Risks Behind Bank-Fintech Partnerships*, The FinReg Blog, Global Financial Markets Center, Duke University School of Law, Jan. 23, 2020, https://sites.law.duke.edu/thefinregblog/2020/01/23/the-rise-of-rent-a-charter-examining-new-risks-behind-bank-fintech-partnerships/. The background on WebBank provided in this paragraph was drawn primarily from this

FDIC issued a cease and desist order against WebBank, finding that it had engaged in "unsafe and unsound banking practices and violations of the law" and ordering WebBank to, among other things, stop operating with management that has failed to adequately supervise the bank, harming the bank and putting deposits at risk.[116] Again in 2010, the bank was cited by the FDIC, related to a partnership with Genesis credit cards for allegedly engaging in unsafe and unsound practices, unfair and deceptive acts and practices, and violations of the Fair Debt Collection Practices Act.[117] The order instructed WebBank to establish effective oversight of third-party agreements and services.[118]

Yet these FDIC actions against WebBank have not stopped problems at lending programs facilitated by the bank. WebBank lender partners have been the subject of two FTC enforcement actions in the last two years. In 2018, the FTC sued Lending Club for allegedly deducting hidden fees of hundreds or even thousands of dollars; telling consumers they are approved for loans when they are not; taking money from consumers' bank accounts without authorization; and failing to provide privacy notices.[119] In 2019, the FTC entered into a $3.85 million settlement with Avant involving allegations that Avant engaged in unfair and deceptive practices; illegally required consumers to repay via automatic repayment from their checking accounts; charged consumers late fees and interest they didn't owe; and reported to credit bureaus that loans were delinquent even after consumers paid the quoted payoff amount. In one instance, a customer's monthly payment was debited from their account eleven times in one day. The lawsuit alleges problems continued even after hundreds of consumer complaints about unauthorized charged and internal documents acknowledging there was a problem.[120]

Celtic Bank, also a Utah-chartered ILC, is used by OnDeck Capital and Kabbage to originate large small business loans up to 99% APR. OnDeck makes small business term loans up to $500,000, up to 36 months long, at rates up to 99% APR, and lines of credit up to $100,000 at rates up to 61.9% APR.[121] Its

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piece. In 2004, WebBank was warned by the FDIC in 2004 because one of largest shareholders of Steel Partners had failed to notify the FDIC that he had acquired a controlling interest in WebBank. (citing 2004 letter from FDIC to Steel Partners leadership). *Id.*

[116] *Id.* (citing FDIC order).

[117] *Id.* The consent order prohibited WebBank from offering credit cards intended for the transfer and payment of charged-off consumer debt without prominently disclosing that the debt could not be collected under applicable statutes of limitations, as well as from misleading consumers about the utility of such cards if consumers have no available credit on the card when it is issued. FDIC, *In the Matter of WebBank*, Consent Order, Order for Restitution, and Order to Pay Civil Money Penalty, Dec. 29, 2010, https://www.fdic.gov/bank/individual/enforcement/2010-12-19.pdf.

[118] *Id.*

[119] Press Release, *FTC Amends Complaint against Lending Club*, Nov. 29, 2018, https://www.ftc.gov/news-events/press-releases/2018/11/ftc-amends-complaint-against-lending-club.

[120] Press Release, FTC, *Online Lending Company Agrees to Settle FTC Charges It Engaged in Deceptive and Unfair Loan Servicing Practices*, Apr., 15, 2019, https://www.ftc.gov/news-events/press-releases/2019/04/online-lending-company-agrees-settle-ftc-charges-it-engaged.

[121] https://www.ondeck.com/business-loans; OnDeck, Form 10K, 2019, at 8, http://d18rn0p25nwr6d.cloudfront.net/CIK-0001420811/b106838d-1f1f-4c80-bb2a-21757fead116.pdf.

charge-off rate as a percentage of principal balance outstanding was 13.6% in 2019.[122] Kabbage makes small business loans up to $250,000 up to 99% APR for terms up to 18 months.[123]

In some states, these loans won't violate usury limits because those limits don't apply to commercial/non-consumer loans. Even still, a rate of 99% APR, particularly on relatively larger and longer-term loans like the OnDeck and Kabbage products, is extremely high—and for many small businesses, unsustainable, placing the business at risk.

D. The proposal fails to consider that proliferation of new ILCs will enable high-cost lending, evidenced by existing rent-a-bank schemes that the FDIC is not restraining.

As described below, FDIC-supervised, non-ILC banks are currently engaged in rent-a-bank schemes facilitating high-cost longer-term installment payday loans, lines of credit, and vehicle title installment loans. The FDIC's failure to crack down on these schemes is strong indication that non-bank lenders will find new paths to exploit state interest rates caps, either by entering into a rent-a-bank scheme with an ILC or pursuing their own ILC charter. The FDIC continues to let these schemes persist even as they generate State Attorney General action. In June 2020, the District of Columbia sued Elevate, with which Republic Bank & Trust and FinWise Bank scheme, for violating its interest rate cap.[124]

In this section, we focus on the most egregious examples of lenders making loans far in excess of 36%. But as noted above, even 36% is a very high rate, and most states limit large loans well below that level.

With respect to consumer loans, we are aware of four FDIC-supervised banks engaging in rent-a-bank schemes that include high-cost payday installment loans, lines of credit, auto title loans, or auto repair loans.

Republic Bank & Trust (Kentucky-chartered) and **FinWise Bank** (Utah-chartered) are helping three high-cost lenders, **OppLoans**, **Elevate**, and **Enova**, make installment loans or lines of credit in excess of 100% APR in a total of at least 30 states that do not allow such high rates.[125]

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[122] OnDeck, 10K, 2019, at 47, http://d18rn0p25nwr6d.cloudfront.net/CIK-0001420811/b106838d-1f1f-4c80-bb2a-21757fead116.pdf.

[123] https://www.kabbage.com/what-it-costs/loan-rates-and-terms/. For a recent summary of Kabbage and OnDeck's loan offerings and required qualifications, see https://www.nerdwallet.com/blog/small-business/kabbage-ondeck-lender-small-business/.

[124] Press Release, Office of the Attorney General for the District of Columbia, *AG Racine Sues Predatory Online Lender for Illegal High-Interest Loans To District Consumers*, June 5, 2020, https://oag.dc.gov/release/ag-racine-sues-predatory-online-lender-illegal.

[125] For details on rent-a-bank lending, see NCLC, *High-Cost Rent-a-Bank Loan Watch List* (tracking which lenders are scheming with which banks in which states), https://www.nclc.org/issues/high-cost-small-loans/rent-a-bank-loan-watch-list.html; NCLC, *Fact Sheet: Stop Payday Lenders' Rent-a Bank Schemes!* (Dec. 2019), http://bit.ly/StopRent-a-BankSchemes; NCLC, *Issue Brief: FDIC/OCC Proposal Would Encourage Rent-a-Bank Predatory Lending* (Dec. 2019), http://bit.ly/FDICrent-a-bankproposal (providing links to lenders' websites).

OppLoans offers $500 to $4,000 installment loans through FinWise Bank at 160% APR in 24 states that do not allow that rate.[126] FinWise sells the receivables back to OppLoans or a related entity. OppLoans makes loans directly through a state license in states that allow high rates.

Elevate Credit uses FinWise Bank to originate **Rise** installment loans at 99% to 149% APR in 18 states that do not allow those rates and in other states through a state license.[127] FinWise sells a 96% interest in the loans to an entity controlled by Elevate for which Elevate is the primary beneficiary.[128]

Elevate also offers a line of credit called **Elastic** that carries an effective APR of up to 109% in 14 states that do not allow that rate on a line of credit.[129] Elevate uses Republic Bank & Trust of Kentucky to originate the Elastic product. Republic sells a 90% interest in the loans to an entity controlled by Elevate for which Elevate is the primary beneficiary.[130]

Republic is also helping **Enova's NetCredit** brand to make $1,000 to $10,000 installment loans with APRs up to 99.9% in 23 states that do not allow that rate.[131] Enova or a related entity likely purchases the loans or receivables shortly after origination.

Capital Community Bank (of Utah) is helping car title lender **LoanMart** evade state law in a number of states.[132] LoanMart's loans range from 60-222% interest; a typical loan is $2,500, 18-month loan at 90%, totaling $2,136 in interest.[133]

In addition, **Transportation Alliance Bank**, **dba TAB Bank** (Utah)[134] is helping **EasyPay Finance** make predatory loans for furniture, appliances, pets, auto repairs and other products. For example, TAB helped EasyPay make a $1,500 loan for a car repair at a rate of 188.99%, with bi-weekly payments of $129 for 26 months. The marketing the mechanic provided the borrower was for EasyPay Finance. The

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[126] *See* https://www.opploans.com/rates-and-terms/. Earlier this year, OppLoans was also making loans through FinWise in the District of Columbia; DC is no longer listed on OppLoans's website as of June 30, 2020.

[127] *See* https://www.risecredit.com/ (bottom of page) (last visited July 1, 2020).

[128] Elevate Form 10K, 2019, at 87.

[129] *Id.* at 16, 79; NCLC, High-Cost Rent-a-Bank Loan Watch List, supra.

[130] Elevate Form 10K, 2019, at 77.

[131] *See* https://www.netcredit.com/ (bottom of page); https://www.netcredit.com/rates-and-terms (last visited June 30, 2020).

[132] *See* https://www.800loanmart.com/ (last visited July 1, 2020) ("Loans for certain California residents, and residents of Delaware, District of Columbia, Florida, Illinois, Indiana, Kansas, Kentucky, Michigan, Mississippi, Oklahoma, Ohio, Oregon, South Dakota, Tennessee, Texas, and Washington residents are made by Capital Community Bank . . ..").

[133] *See* https://www.800loanmart.com/ (accessed January 2020).

[134] *See* https://www.easypayfinance.com/privacy-policy/ (last visited July 1, 2020) ("Not available to customers in NY. Financing offered to residents in AL, AR, CO, CT, FL, GA, HI, IA, IN, LA, MA, MD, ME, MI, MN, MS, MT, NC, NE, NJ, OH, OK, RI, SC, SD, TN, TX, VT, WV, WY and District of Columbia is made by Transportation Alliance Bank, Inc., dba TAB Bank, which determines qualifications for and terms of credit. Financing in all other states is administered by EasyPay Finance.").

loan documents indicate that EasyPay Finance is the "servicer" and refer to it as the "agent" of TAB Bank.

In the small business area, FDIC-supervised **Bank of Lake Mills** (Wisconsin-chartered) formerly helped **World Business Lenders (WBL)** originate loans. For example, WBL used Bank of Lake Mills to originate a 120% APR $550,000 loan[135] and a 74% APR mortgage.[136] The loans appear to be resold to a WBL-related entity. Indeed, the FDIC filed an amicus brief in a district court bankruptcy case, *Rent-Rite Super Kegs v. World Business Lenders*,[137] defending WBL's ability to charge 120% APR without one word expressing any concern about the grossly predatory interest rate. The agency also supported this loan despite knowledge that Bank of Lake Mills has engaged in unfair and deceptive practices in recent years, the subject of an FDIC enforcement action involving harmed military servicemembers.[138]

In summary, FDIC-supervised, non-ILC, banks are facilitating the following loans:

- 160% APR, $400 to $5,000 loans (OppLoans's product)
- 99% to 149% APR, $500 to $5,000 loans (Elevate's Rise product)
- Up to 109% effective APR, $500 to $4,500 lines of credit (Elevate's Elastic product)
- Up to 99.9% APR, $1,000 to $10,000 loans (Enova's NetCredit product)
- Up to 222% APR, $2,500 loans (LoanMart's auto title loan)
- Up to 188.9% APR, $1,500 loans (EasyPay Finance's auto repair loan)

A review of the CFPB Consumer Complaints data on those predatory lenders currently using rent-a-bank scams find several recurring themes:

- consumers puzzled and distraught that their large bi-weekly or monthly payments are not reducing principal due to the loan's high interest rates;
- frequent inability to sustain the high payments;
- queries about how such loans can possibly be legal;
- distress caused by wage garnishment; and

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[135] *See Rent-Rite Super Kegs West, Ltd., v. World Business Lenders*, LLC, 603 B.R. 41 (Bk. Ct. D. Colo. 2019).

[136] *See* Complaint, *Deramo et al. v. World Business Lenders, LLC, et al.*, No. 8:17-cv-01435-RAL-MAP (Cir. Ct. of 12th Jud'l Cir., Sarasota Co., Fla. June 16, 2017), *available at* https://www.nclc.org/images/Deramov.WBL_.pdf.

[137] *See Amicus Brief of the [FDIC] and the [OCC] in Support of Affirmance and Appellee, In Re: Rent-Rite Super Kegs West Ltd.*, https://www.consumerfinancemonitor.com/wp-content/uploads/sites/14/2019/09/Amicus_Brief.pdf (Sept. 10, 2019); *see also* Letter to the OCC and FDIC from NCLC, CRL, and additional groups opposing the agencies' support of a predatory small business lender using a rent-a-bank scheme (Oct. 24, 2019), https://www.nclc.org/issues/ltr-opp-rent-a-bank.html; Complaint, *Rent-Rite Super Kegs West Ltd. v. World Business Lenders* (Bankr. D. Colo) (filed March 14, 2018) *available at* https://www.nclc.org/images/Rent-Ritev.WBL_.pdf.

[138] *See* FDIC Press Release, *FDIC Announces Settlement with Bank of Lake Mills, Freedom Stores, Inc., and Military Credit Services, LLC, for Unfair and Deceptive Practices* (May 11, 2017) (The FDIC determined that Bank of Lake Mills and affiliates had violated federal law prohibiting unfair and deceptive practices by, among other things, charging interest on loans promoted as interest free).

- stress caused by relentless collection calls to a borrower's home or workplace.[139]

Having reviewed complaints about payday and other payday installment loans, these comment authors can attest that complaints about these loans are of the very same nature, replete with financial and emotional anguish at the hands of unaffordable high-cost loans. Dozens of examples of complaints about loans made by these lenders are included in the Appendix.

E. Features of online loans pose heightened risk of unaffordability and other risks.

In critical ways, high-cost online loans are just like high-cost loans from storefronts, most notably in that they are designed by lenders to be unaffordable for huge swaths of borrowers. But online loans carry additional risks as well.[140] This is overwhelmingly clear of the highest-cost rent-a-bank schemes discussed above; it also true of online lenders that make large loans at rates of up to 36%. These higher-risk features argue for the importance that these loans comply with state interest rate limits. High rates only further reduce the incentives for lenders to make affordable loans, since, as discussed in section V.A above, high-rate loans are more likely to be profitable to the lender even when unaffordable to the borrower.

1. The originate-to-distribute model, which additional ILCs would proliferate, encourages riskier loan terms and warrants greater oversight.

A number of FDIC-supervised banks partner with online lenders, facilitating those lenders' avoidance of state laws. Online loans are often securitized and sold to investors. The lending platform often earns the bulk of its revenues through an initial origination fee, with a smaller percentage coming from servicing fees and actual repayment of the loan. Just as in the mortgage market, securitization can lead originators to pay insufficient attention to the borrower's ability to repay.[141] This operate-to-distribute model limits the "skin in the game," or a significant stake in how the securitizations of their loans perform, needed to incentivize lenders to make affordable loans.

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[139] Complaints related to Elevate, OppLoans, Enova (NetCredit), Curo (SpeedyCash), and LoanMart, 2015 to present; downloaded from CFPB's complaint database and on file with CRL.

[140] *See, generally*, Lauren Saunders, *Fintech and Consumer Protection: A Snapshot*, NCLC (March 2019), https://www.nclc.org/images/pdf/cons-protection/rpt-fintech-and-consumer-protection-a-snapshot-march2019.pdf; Comments of National Consumer Law Center to U.S. Department of the Treasury on Marketplace Lending RFI, TREA-DO-2015-0007-0001 (Sept. 30, 2015), https://www.nclc.org/images/pdf/rulemaking/treasurymarketplace-loan-comments.pdf.

[141] *See* Moody's Investor Services, Press Release, *Moody's: Unique risks in marketplace versus traditional lending* (May 5, 2015), https://www.moodys.com/research/Moodys-Unique-risks-in-marketplaceversus-traditional-lending--PR_324544; *see also* Michael Corkery, *Pitfalls for the Unwary Borrower Out on the Frontiers of Banking*, New York Times (Sept. 13, 2015), https://www.nytimes.com/2015/09/14/business/dealbook/pitfalls-for-the-unwary-borrower-out-on-the-frontiers-of-banking.html?mcubz=0, ["Pitfalls, NY Times"]. Moody's credit-rating firm likens this industry to mortgage lending in the years leading up to the 2008 financial crisis in that "the companies that market the loans and approve them quickly sell them off to investors," relieving themselves of the risk of the loan later going bad.

Even in a strong economy before the COVID-19 crisis, various online lenders have experienced periods of high delinquencies and charge-offs;[142] have had to repay investors for their losses in securitizations sold to Wall Street;[143] and have failed to verify borrowers' income for large portions of their loans.[144] The current economic crisis has placed the sector under significant stress, as sources of funding have dried up. Lending Club reduced originations by 90%; OnDeck and Kabbage stopped their normal lending operations altogether; 45% of OnDeck's total loans outstanding were delinquent by the end of April.[145]

As Board Member Gruenberg noted in his statement opposing approval of an ILC charter for Square, the originate-to-distribute model is "highly vulnerable to an economic downturn," since if demand diminishes, the bank's "liquidity and capital positions would be quickly and seriously impacted."[146]

2. High-cost lenders use electronic repayment as an abusive collection mechanism for unaffordable loans.

Federal law prohibits lenders from requiring electronic repayment for installment loans. But high-cost online lenders routinely coerce repayment via electronic means. This is evidenced both by tactics lenders use, like delaying access to loan proceeds or use of remotely created checks in the absence of electronic repayment by ACH, and by the take-up rates of borrowers using electronic payment, which is far higher than for other forms of credit like credit cards. Automatic repayment prevents the borrower from prioritizing which bills to pay when funds are short. If the account lacks sufficient funds, lenders repeatedly ping the account—turning electronic access to the account a collection device rather than a payment device. These repeated hits to the account severely harm borrowers, including by causing non-sufficient funds and overdraft fees that ultimately drive borrowers out of their checking accounts altogether.[147] The CFPB payday loan rule established modest protections of high-cost loan borrowers'

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[142] Matt Scully, *Consumer Loans Souring Fast in Bonds Tied to Online Lenders*, Bloomberg (Nov. 15, 2016), https://www.bloomberg.com/news/articles/2016-11-15/consumer-loans-souring-fast-in-some-bonds-tied-to-online-lenders; Kevin Wack, *Spike in delinquency rate mars outlook for personal loans*, American Banker (Jan. 18, 2018), https://www.americanbanker.com/news/spike-in-delinquency-rate-mars-outlook-for-personal-loans.

[143] Steve Daniels, *Online lender Avant's reboot still hasn't yielded profit*, Crain's Chicago Business (May 27, 2017) (Avant had so many of its loans fail that it had to repay investors for their losses in consecutive securitizations of the loans it bundled up and sold to Wall Street), *available at* http://www.chicagobusiness.com/article/20170527/ISSUE01/170529902/online-lender-avants-reboot-still-hasnt-yielded-profit.

[144] One online lender reportedly failed to verify a borrower's income for a full two-thirds of its loans in 2016.

Matt Scully, *Biggest Online Lenders Don't Always Check Key Borrower Data*, Bloomberg (June 14, 2017), https://www.bloomberg.com/news/articles/2017-06-14/biggest-online-lenders-don-t-always-check-key-borrower-details.

[145] Kevin Wack, *Battered by coronavirus crisis, online lenders face reckoning*, American Banker, May 14, 2020, https://www.americanbanker.com/news/battered-by-coronavirus-crisis-online-lenders-face-reckoning.

[146] *See* Statement by Martin J. Gruenberg, Member, FDIC Board of Directors, Application for Federal Deposit Insurance: Square Financial Services, Inc., Salt Lake City, Utah, March 17, 2020, https://www.fdic.gov/news/news/speeches/spmar1820b.html.

[147] CFPB found that about half of borrowers with online payday or other high-cost online loans paid a nonsufficient funds (NSF) or overdraft fee. These borrowers paid an average of $185 in such fees, while 10% paid at least $432. It

checking accounts—to limit failed attempts to two before reauthorization is required—but consumers can still incur significant nonsufficient funds and overdraft even with those protections, and that rule has been stayed.

Significantly, electronic access to the account weakens lenders incentive to meaningfully underwrite. Automatic repayment enhances a lender's ability to collect but does not ensure that the consumer has the ability to make loan payments while also meeting other expenses. This is a problem not only with the highest-cost online loans but also among relatively lower-cost online lenders. Moody's has noted about one marketplace lender that "the automatic withdrawals made it more likely that 'strapped borrowers' would pay their marketplace loans ahead of other expenses."[148] The FTC enforcement actions above underscore that some lenders have made it difficult to stop electronic payments and have led to bank account closures.[149]

F. The proposal fails to consider the safety and soundness risks of predatory lending, which the FDIC has long acknowledged.

The proposal fails to consider the risk that high-cost lending poses to the safety and soundness of ILCs, despite having long acknowledged the risks of predatory lending. The FDIC's historical position has been that predatory lending poses "significant risks" for banks.[150] The examples of Fremont and Advanta discussed above make that risk clear. The FDIC has also long acknowledged this risk with respect to payday lending.

In the late 1990s and early 2000s, banks entered into agreements with payday lenders to help the payday lenders evade state interest rate caps. In 2005, the FDIC issued guidance addressing payday loans, emphasizing safety and soundness concerns. These included credit risk in light of limited analysis of ability-to-repay; transaction risk, should the non-bank misrepresent information; and reputation risk associated with facilitating loans with terms that a non-bank could not make directly. The guidance cited the federal banking agencies' general guidance on subprime lending, which identifies lending to a borrower with "little or no ability to repay from sources other than the collateral pledged" as a characteristic of abusive lending.[151]

The 2005 guidance had the impact of shutting down most FDIC-bank involvement in rent-a-bank schemes involving short-term payday loans. For those that remained, as noted above, the FDIC ended them through enforcement actions, citing "inherent risks associated with payday lending activities" [152]

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further found that 36% of borrowers with a bounced payday payment later had their checking accounts closed involuntarily by the bank. CFPB Online Payday Loan Payments at 3-4, 22 (April 2016).

[148] Pitfalls, NY Times, supra (citing a Moddy's report about Prosper).

[149] *See also* Pitfalls, NY Times, supra ("Some borrowers like Mr. Mansour said they ended up closing their bank accounts because they thought it was the only way to stop the lenders from taking out the money.").

[150] FDIC, 2005 Guidelines for Payday Lending (Revised Nov. 2015), https://www.fdic.gov/news/news/financial/2005/fil1405a.html.

[151] Interagency Expanded Guidance for Subprime Lending Programs (FIL 9-2001), January 31, 2001.

[152] *See* Republic Bancorp, Inc., SEC Form 8-K (Feb. 24, 2006), *available at* https://www.sec.gov/Archives/edgar/data/921557/000110465906011951/a06-5812_18k.htm (where Republic Bancorp discloses that its Indiana bank has exited the payday loan arrangement after the FDIC cited "inherent risks

and unsafe or unsound practices, as well as unfair or deceptive practices, involved in a supervisee's "rent-a-BIN" arrangement.[153]

The risks highlighted by the FDIC in the early-to-mid 2000s remain today. In fact, the reputation risk by bank involvement in high-cost lending is likely only higher than it was in the early 2000s. Since then, as noted in section V.A. above, the harms of high-cost lending, both short-term loans and longer-term loans, have become more fully documented and known. Several states have had statewide ballot initiatives that capped interest rates at 36% APR or less. And direct bank involvement in payday lending by a handful of banks was met with sweeping public condemnation from virtually every sphere—the military community,[154] community organizations,[155] civil rights leaders,[156] faith leaders,[157] socially

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associated with payday lending activities"); *see also*, Robert Schoenberger, *Republic to Get Out of Payday Loans; FDIC Urged Bank to Exit Business*, The Courier-Journal, Mar. 3, 2006.

[153] *See In the Matter of First Bank of Delaware, and CompuCredit Corporation*, Notice of Charges for an Order to Cease and Desist and For Restitution, Federal Deposit Insurance Corporation, FDIC-07-256b, FDIC-07-257k, https://www.fdic.gov/news/news/press/2008/FBD_Notice_of_Charges.pdf (finding that the bank had operated in violation of Section 5 of the FTC Act (unfair or deceptive practices) and "without effective oversight" of third-party lending programs and ordering the termination of the "rent-a-BIN" . . . arrangement).

[154] *See*, *e.g.*, Testimony of Steve Abbot, former President of the Navy-Marine Corps Relief Society, Before the U.S. Committee on Banking, Housing and Urban Affairs (Nov. 3, 2011) (noting bank payday loans among the "most egregious trends"); Comments of Michael Archer, Director of Military Legal Assistance, Marine Corps Installations East, to CFPB (April 4, 2012): "Most ominously, a few large banks have gotten into the business of payday loans through the artifice of calling the loans open ended credit," http://www.regulations.gov/#!documentDetail;D=CFPB-2012-0009-0056.

[155] Hundreds of groups urged the prudential regulators to stop banks from trapping borrowers in payday loans. Letters from approximately 250 groups to FDIC, OCC, FRB and CFPB, March 13, 2013 (http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2013/03/Bank-Payday-Sign-On-Letter-3-13-13-Final.pdf) and February 22, 2012 (http://www.responsiblelending.org/payday-lending/policy-legislation/regulators/Dear-Regulators.pdf). Thousands of individuals and many community groups filed comments with the OCC urging that Wells Fargo's Community Reinvestment Act rating be negatively impacted because it makes payday loans, including CRL and NCLC (http://www.responsiblelending.org/payday-lending/policy-legislation/regulators/cra-comment_wells-nov-29-2012_final.pdf).

[156] *See*, *e.g.*, Letter from Benjamin Todd Jealous, President and Chief Executive Officer, NAACP, to FDIC, OCC, FRB, and CFPB opposing bank payday lending (Feb. 21, 2013), http://www.responsiblelending.org/payday-lending/policy-legislation/regulators/NAACP-redatory-Pay-Day-Loans-to-regulators-BTJ.pdf.

[157] *See*, *e.g.*, Elaina Ramsey, Faith Groups Take On Payday Lenders, Sojourners, https://sojo.net/magazine/stub/faith-groups-take-payday-lenders (discussing a National Day of Action among faith leaders in early 2013 to address payday lending). In connection with this National Day of Action, Rev. DeForest B. Soaries, jointly with other nationally prominent African American ministers, called for "an end to enslavement to both payday lenders and the banks now offering equally dangerous products" in *An Emancipation Proclamation from Payday Lending.* Center for Responsible Lending, *Bank Payday Lending: Overview of Media Coverage and Public Concerns*, CRL Issue Brief, March 7, 2013, http://www.responsiblelending.org/payday-lending/tools-resources/BPD-media-coverage-3-7-13.pdf

responsible investors,[158] state legislators,[159] and members of Congress.[160] Moreover, the rise of online and social media make it faster and easier to garner outrage at a bank that is facilitating predatory lending.

In addition, credit risk may be even greater today, as banks may retain some ongoing interest in the loans (though nowhere near the predominant one) as lenders try out more sophisticated schemes to skirt regulators or courts.

The proposal fails to acknowledge, wrestle with, or address these concerns.

VI. The proposal gives inadequate consideration to Community Reinvestment Act concerns.

The proposal also gives inadequate consideration to the Community Reinvestment Act (CRA) obligations of ILCs, even as it poses risks to the intent of the CRA. The objective of the CRA is to ensure that financial institutions meet the banking needs of the communities they are chartered to serve, including low- and moderate-income neighborhoods and individuals.[161] This legal obligation is considered a *quid pro quo* for the valuable public benefits financial institutions receive, including federal deposit insurance and access to favorably priced borrowing through the Federal Reserve's discount window.[162]

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[158] For proxy year 2013, investors filed shareholder resolutions with the four largest banks making payday loans expressing concern about the product and requesting data, which none of the banks agreed to provide. Wells Fargo (https://trilliuminvest.com/shareholder-proposal/payday-lending-wells-fargo-2013/); Fifth Third Bank (http://www.trilliuminvest.com/resolutions/payday-lending-fifth-third-bancorp-2013/); U.S. Bank; (https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2013/dominisocial012513-14a8.pdf); and Regions (https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2013/congregationsisters011413-14a8.pdf).

[159] *See, e.g.*, "Legislative Black Caucus slams Regions Bank over payday-style loans," Raleigh News and Observer "Under the Dome," Oct. 11, 2012, http://www.cashcowadvances.com/paydayblog/legislative-black-caucus-slams-regions-bank-over-payday-style-loans.html (quoting letter from N.C. Senator Floyd McKissick, Jr., chairman of the N.C. Legislative Black Caucus, to Regions Bank, which stated: "We are deeply concerned about recent reports of Regions Bank offering its 'Ready Advance' payday loans in North Carolina . . . . High-cost, short-term balloon loans like these sharply increase the financial distress of families under economic strain"); Letter from Arizona Democratic Caucus to the prudential banking regulators, February 2012 (noting that Arizona "has spent countless state resources to study and understand the effects of [payday lending], and ultimately outlaw payday lending entirely" and calling on federal regulators to "take immediate action so that meaningful reforms taking place in Arizona and throughout the country in the name of consumer protection will not be undermined.").

[160] In January 2013, several Senators wrote the FRB, OCC, and FDIC urging action to address bank payday lending (http://www.blumenthal.senate.gov/newsroom/press/release/blumenthal-calls-on-regulators-to-act-to-stop-abusive-bank-payday-lending). In April 2013, House members did the same. For further documentation of opposition to bank payday lending, *see* Center for Responsible Lending, *Bank Payday Lending: Overview of Media Coverage and Public Concerns* at 10, CRL Issue Brief, March 7, 2013, http://www.responsiblelending.org/payday-lending/tools-resources/BPD-media-coverage-3-7-13.pdf.

[161] 12 U.S.C. 2901 *et seq*.

[162] Federal Reserve Board Chairman Ben S. Bernanke, "The Community Reinvestment Act: Its Evolution and New Challenges," Speech at the Community Affairs Research Conference, Washington, D.C. (March 30, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/Bernanke20070330a.htm#f2.

In contradiction to this obligation, the ILC proposal would facilitate the making of high-cost loans by lenders seeking to evade state interest rate limits. CRA requires that banks serve communities' credit needs.[163] But the data show that high-cost, unaffordable loans to financial distressed consumers do the opposite, leading to high-cost cycles of indebtedness that not only leave borrowers' needs unmet but leave them affirmatively worse off than before the lending began.

A significant number of ILCs will likely be involved in scurrilous online lending in which most traditional banks would not engage. In that way, the proposal would only exacerbate this irresponsible lending that is at the core of what the CRA is designed to prevent. While the FDIC has proposed to revise the CRA regulations, the CRA proposal would not prevent the risk that new ILCs pose.

VII. Any final rule should not permit the FDIC staff to waive conditions imposed upon ILCs without Board approval.

The Board resolutions for NelNet and Square both included language that would delegate to staff the authority to modify or dispose of the conditions of those charter approvals without Board approval.[164] As Board Member Gruenberg noted in his opposition to the Square proposal, this runs counter to the Board's 2007 resolution that reserves ILC approval for the Board itself.[165] The Board's current approach is likely to lead to an erosion of conditions over time. Instead, any final rule should require Board approval for any change to an ILC owner's conditions.

Further, while doing so would not adequately mitigate the broader problems with ILCs, the FDIC should retain the authority to require any additional written agreements, commitments, or conditions on or by an industrial bank or owner after an initial approval. The agency should also retain that authority as to an industrial bank that became a subsidiary of a parent company that is not subject to Federal consolidated supervision by the FRB prior to the effective date of the rule. In addition, any final rule should require disclosure to the FDIC not only of subsidiaries, but also of additional affiliates or portfolio companies of the Covered Company.

VIII. Conclusion

We strongly urge the FDIC to withdraw this proposed rule and to cease approving charter applications, in light of the lack of statutory tools the FDIC has to adequately supervise ILCs; the inherent risks of commercially-owned ILCs that cannot be supervised away; and the threat to state interest rate limits and, consequently, consumers, that the proliferation of ILCs poses. Thank you for your consideration of our concerns. We would welcome the opportunity to discuss them further.

(see next page for contacts)

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[163] 12 U.S.C. 2901.

[164] Statement by Martin J. Gruenberg, Member, FDIC Board of Directors, Application for Federal Deposit Insurance: Square Financial Services, Inc., Salt Lake City, Utah, March 17, 2020 at 5 (referencing FDIC Board Resolution bearing Seal Number 085095 (Sept. 11, 2007), https://www.fdic.gov/news/news/speeches/spmar1820b.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery.

[165] *Id.*

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(See Appendix on following page)

IX. Appendix

Below are narratives from the CFPB complaints database describing borrowers' experiences with high-cost installment loans by lenders currently engaging in rent-a-bank schemes (Personify Financial, facilitated by ILC First Electronic Bank; and Elevate, OppLoans, Enova (NetCredit brand), and LoanMart, facilitated by non-ILC FDIC-supervised banks), or who have stated that they intend to (CURO (SpeedyCash brand)). While many of these complaints so far do not involve rent-a-bank loans, they are illustrative of the type of loans these lenders make that they will bring to states that do not allow high-cost loans.

Personify Financial

- I was approved for a loan for {$3500.00} . . . . My payments are {$140.00} biweekly. To date I have paid over {$1800.00} on time. However, my current balance is . . . over the amount I borrowed. I am being told that my interest rate 98 % and if I pay according to the terms of the loan, I will pay out over {$10000.00}. I want to pay what I owe plus a fair interest rate for someone with my credit profile but I am not able to comply with the current terms of the loan. I need assistance in making sure that XXXX XXXX is fair in their loan terms and updating the current terms which are clearly predatory.[166]

- I was referred to this company through XXXX XXXX which I took to be a reputable company because of the referral. I was skeptical because I have a chapter XXXX filed 3 years ago and sub par credit. I was granted a XXXX dollar loan which I expected to be a high interest loan. My complaint is that on top of the accrued daily interest they charge me they added XXXX dollars to the balance from day one. In looking at their terms more closely their rates and fees are not fair and are considered predatory in giving loans to someone who frankly cant afford to pay it off and I feel that is their game which ends up in collections where the balance due will balloon with fees.[167]

- I started this loan on XX/XX/2019. I financed XXXX I have made 15 payments . . . . My interest rate is 98.98 % I will never pay off my balance at this rate, we are talking about 65 payments of XXXX totaling XXXX. For the consumer looking for a small personal loan, this is outstanding and incredibly insane. How can this be legal? This is getting people in trouble financially.[168]

- I have been on XXXX since XX/XX/XXXX, I needed this loan to keep current with my bills after XXXX. The loan origination date of my loan is XX/XX/XXXX. I called XXXX today to check on [] my loan balance and it turns out that after making every payment on time every 2 weeks for nearly a year I owe {$500.00} more than I borrowed. so I pay {$140.00} every 2 weeks, my original loan amount was {$3000.00} and I now owe XXXX this doesn't seem fair and due to my XXXX I am currently unable to work and these payments are strain on my ability to stay current with my other bills. Is there anything I can do about it. Please Help[169]

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[166] # 3224776, 4/27/2019 (North Carolina borrower) (appears to be a rent-a-bank loan)

[167] #3309320, 7/17/2019 (Tennessee borrower) (appears to be a rent-a-bank loan)

[168] #3326027, 8/1/2019 (Indiana borrower) (appears to be a rent-a-bank loan)

[169] 2843920, 3/15/2018 (California borrower)

- I took out a loan with Personify Financial XXXX, 2017 in the amount of {$3900.00} not realizing the interest rate was 98.22 %. the pay back would be {$12000.00}. I was in desperate need of a loan. I feel I was taken advantage of. Personify Financial is nothing short loan sharks. I thought there were laws against this and consumer protection against loan companies charging such ridiculously high fees. I paid them approximately {$7000.00} then started to realize the balance was not going down. I tried to contact the company to see if this could be looked at but nothing was done. I contact the better business bureau and logged a complaint. I would have even been willing to settle at a lower and fair amount taking into consideration what I had paid already. Paying back {$12000.00} on a {$3900.00} loan is terrible business practice. The Dodd-Frank Wall Street Reform act states the lenders must engage in fair lending practices. I feel that this company is not engaging in fair business practices and they are taking advantage of consumers. I would like my case investigated.[170]

- I can not remember how I heard about XXXX. I applied for a {$3900.00} loan back in XX/XX/2017 not realizing until the other day just how much the interest rate and finance charges I am paying to them. I borrowed {$3900.00} and the total amount I will have paid back is {$12000.00}. I was in total shock. I am paying {$150.00} per pay period. I know in ignorance I did this to myself but is there a law against someone charging 98.23 % annual percentage rate. This is such an awful rip off. Please advise if there is anything that can be done about this.[171]

- I am a mother of 4. During a hard time, I took out an {$8400.00} loan from Personify Financial on XX/XX/XXXX. The original interest rate is 78.69 %. 36 month term. I have paid to date {$8500.00}. Only {$1500.00} of those payments have gone to the principal balance. The other {$7000.00} have gone to interest. I am on an automatic payment plan bi-weekly. {$260.00} comes directly out of my bank account every 2 weeks. I have never been late on a payment to this company. They offer a 3 % interest rate reduction for every 13 payments. My interest rate is currently 71 %. This is a predatory loan. This is unethical. This company is charging exceptionally high interest rates. I have paid OVER the amount that I asked for. At this point, I am throwing money out the window. I can not afford this any longer. I have called numerous times demanding supervisors, and nothing has been accomplished. I offered them {$500.00} more to close out my loan. Which would put me over {$9000.00} out of pocket when I only financed {$8400.00}. IF I pay this loan until the maturity date which is XX/XX/XXXX, I will have paid them OVER {$20000.00} for a {$8400.00} loan. This is absolutely 100 % predatory.[172]

- ...the rates are staggering and they never check to see if I could afford these loans . . . And, I have been paying on a total of (XXXX) Payday loans for well over 9 months in succession with much difficulty . . .. the huge charges were destroying our ability to live after deducting well over 90 % of my take home income for well over 3 months and I have not paid my mortgage since XX/XX/XXXX and XX/XX/XXXX for both the first and second mortgages and I am in jeopardy of foreclosure as of this date, XX/XX/XXXX . . . . several Companies did not tell me of their

[170] #3476403, 12/23/2019 (Illinois borrower)

[171] 3049302, 10/25/2018 (Illinois borrower)

[172] #3519412, 2/4/2020 (Ohio borrower) (Personify does not appear to be lending in Ohio, per its website visited on June 18, 2020)

extremely high rates they were and some also withdrew from my bank account even though I asked them to STOP future via EFT Revocation Letters. A Couple withdrew funds directly from my account even after it was Bank closed causing me to incur heavy bank fees per day of even {$50.00} or {$60.00} at certain intervals. This was a very stressful time . . . causing us to be fragmented and close to homeless situation.[173]

Elevate

- I am a single mother who is living . . . below the poverty level. I have had my share of credit problems and have owed more than I make for quite some time. I was misled by Rise Credit to believe that they were unlike other predatory loan companies. By the time I understood what I had [signed], I had paid them thousands of dollars in interest. I have recently become temporarily unemployed and called them to ask for help during my time of financial hardship. They refused any solution and my account is headed to collections now . . . . [T]he total paid is far over the amount I initially borrowed from Rise . . . . This is robbery and all of the necessities I have for myself and my children are suffering because of it . . . . How is it that they can do this? I am asking for help for not only my family, but for all of the families targeted by these predatory loans meant to target those living in poverty and struggling to live paycheck to paycheck.[174]

- [T]hey are charging me over $6000.00 interest on a simple loan for only $2600.00 . . . . i did not forsee such an impact on my monthly income for so long ... that $500.00 is supposed to be the monies I have left over after bills and survive/live on after all my other bills. They have access to my bank account and automatically take it out . . . . I do not know how to stop this madness. How can they charge me over $8000.00 for a $2600.00 loan? Is this legal?[175]

- My [] mother was solicited by a predatory lender, RISE for a personal loan. She agreed to $1300.00 loan but was told the California law stated the minimum loan amount was $2600.00. Her interest rate is 125 %, how is this legal? She is on a fixed income and RISE has set up an auto pay with her checking account with a monthly payment of $470.00 . . . . This is elder abuse! Please shut this company down.[176]

- To date I have paid well over $6900.00, almost three times the principle. I still owe close to $3000.00. Prior to accepting the loan I did read the " fine print " but it was not easy to understand. It was not explicit[ly] stated that the monthly payments would be going to the interest and not to paying down the principle, making the loan impossible to pay off quickly. I called . . . and asked specifically for an amnesty on the remaining balance because I am having a hard time paying on this exorbitantly high interest loan for over 12 months. I also explained to her that to date I had paid almost three times the principle . . . . in the end, the total paid before

[173] #2291555, 1/18/2017 (Illinois borrower)

[174] #1487339 (California borrower)

[175] #1361463 (California borrower)

[176] #1584177 (California borrower)

it is satisfied will be over $9500.00! Paying $7500.00 in interest for a $2500.00 loan is outrageous and should be illegal.[177]

- I took a loan with rise credit . . . and I was unable to make timely payments. I expected to pay it once I received my tax return. However, it went to collections and then a lawyer and they added so many penalties and fees. Now I owe XXXX for a XXXX loan. Now, they are garnishing 25 percent of my paycheck and I 'm already struggling as it is.[178]

- I am a visually impaired person, with a monthly income of less than $900. I can surely say that I had no idea that the monthly installment would not be applied to the principal loan amount. After my aid read to me just a few days ago that I was not paying off the loan all of the money was going to interest and only {$19.00} was applies to the principal. But I do not have that kind of money. I am requesting that you cease deducting {$520.00} from my bank account . . . . I have struggled for the last five moths giving RISE most of my income, and I can not make the rent, utilities, or food.[179]

- I have a high interest installment loan through Rise. I pay $220.00 every 2 weeks with $16.00 of that going to the principal. I had a medical procedure done that kept me out of work for just a little more than a month. I did not receive a paycheck during that time. This has put me a few payments behind on my loan as they come due every 2 weeks. I am trying to get this all worked out so I can catch up with them over time as I just started back to work today. My issue is when I came back today I was told by my coworkers that this number called (XXXX) so many times a day that they turned off the phone in our office. . . . . I am willing to work something out with them but calling my work to harass me and doing multiple attempt debits to my bank account that has no money in it racking up a ton of fees. This is not helping their cause as I have to pay my bank now instead of putting that money towards catching up on my loan. They tried withdrawing twice within a few minutes during XXXX attempt which racked up an instant $70.00 more to my bank account fees like the money was going to instantly appear in there after the first attempt a few minutes earlier.[180]

- We originally signed up for a $3,000 [loan] with an interest rate of 208%. I have been paying $520.00 every month and paid a total of $5500.00 . . . . This has been a burden for me and my family. As an [redacted] military member, i have reached out to my chain of command regarding this issue. I have been advised by financial counselors that in accordance with Military Lending Act says that you can't be charged an interest rate higher than 36 % on most types of consumer loans and provides other significant rights. I am currently working with my local Judge Advocate General 's Office to get some help with legal issues.[181]

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[177] #1962588 (California borrower)

[178] #2181870 (California borrower)

[179] #2202311 (California borrower)

[180] #2303749 (Missouri borrower)

[181] #2442651 (U.S. Armed Forces - Pacific borrower)

- I received a mail out stating that I was pre-approved for credit and to go online and apply. I did so and entered into a line of credit agreement in the amount of $2500 . . . . The payments are bi-weekly and the second one jumped to $240.00. My gross income is XXXX per month. I have XXXX child and simply can not afford this high of a payment. My father called . . . and tried to get the company to lower the payment. They said that they could do whatever they wanted to and refused to address my concerns. The APR on this loan was 199 %. I feel this company is operating on an unfair and deceitful basis.[182]

- Why are my payments not reducing my principal balance? My statement for month 1 states that my balance is $3800.00. It said I owed $430.00. I paid it. The next month my bill was $540.00 and I paid it. After that payment was applied (?) my total balance owed wasn$3800.00. So I asked them why my balance was only reduced by $3.00 even though I had paid them almost $1000.00 . . . . please help me. This can not be right.[183]

- I have fallen on hard times . . . . I borrowed $1200.00 and have paid back $1100.00, however due to the interest rate being so high [I owe a] balance of over $1000.00 still. I was told when I took this loan that after a period of time I would be able to refinance the loan and lower my payments. This was not true, I have attempted to refinance and the APR is the same 291 %. I would like to cancel my account and come to an agreement that works for both of us. I am a single mother and paying $160.00 every time I get paid equaling to $260.00 per month is unbearable. I have also [made] large payments over the past few months hoping this would decrease the balance and it has not.[184]

- On XX/XX/17 I needed to pay for a major repair on my vehicle and had to refinance an existing loan I had with Rise credit to an amount of $2500.00. Since that date I have been making regular payments twice a month of $230.00 and it has all been interest. I have made 21 payments, so over $4000.00 in interest and my principal balance has not gone down at all. I am at a loss of what to do, because I was in a tight spot but had I known id be living this nightmare I never would have taken out this loan.[185]

- I would have rejected/not accepted the loan if I had realized it was a 238.36% interest rate. They set up ACH installment payments of $410.00 a month which I can not afford . . . . I am on Social Security XXXX (Fixed income) with limited resources . . . . I can't believe that this is legal-this is more like loan sharking and preying on people who are not able to defend themselves. I am more than willing to pay the $2000.00 back at a reasonable interest rate and reasonable monthly payments of $200.00 a month (ie ... a credit card rate for people with limited resources perhaps 25-28 %?)[.] [N]ot 238.36 %[. H]ow can this even be legal?[186]

OppLoans

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[182] #2764858 (Kansas borrower)

[183] #2816269 (Tennessee borrower)

[184] #2858004 (Wisconsin borrower)

[185] #2942998 (North Dakota borrower)

[186] #3141291 (Wisconsin borrower)

- I am being contacted everyday, with the exception of Sunday, for a month. The[y] want the loan paid but, I am unemployed and a [] veteran. I have tried to explain this to the company. However, they continue to contact me. It's the same thing everyday.[187]

- I have been paying this loan for more than a year and the principal has not changed. I borrowed $2000.00 and have paid $4600.00 into this loan to date....[188]

- I contacted this firm opp loans several times . . . regarding the high interest[] rates being charged on my loan. I informed them that [we are] military spouses and famil[ies] . . . that we are protected against high interest rates. They informed me that they needed proof to review my interest rate. They then informed me that spouse loans are not covered under the military lending act and was notified by their legal department. My current interest rate is 159 % on short term installment loan. Please assist[189]

- This company calls me 6 times or more a day. I informed them . . . that I had lost my job and I would call them back when I start work again and get my finances back on track. They dont care they have been calling non stop. They have made it harder for my recovery.[190]

- I had a loan with this company for about $2000.00[,] now i went on short term [leave or disability] with my job and didn't get paid [and] called the company [and] explained why I couldn't make payment . . . . I really dont know what to do but i have arrangements with other companies after they knowingly understood my dilemma. Im upset that i have to pay all the fees and loan with no arrangement and still be a single mom and live. Now they are emailing and calling me saying they will garnish my bank account for 20 years and my check and so on. Im very afraid and dont want to be homeless or behind over 4500 dollars.[191]

- I work as an [] for my [daughter], who was in the Intensive care unit . . . . When my daughter is hospitalized I do not get paid. After being in the hospital for a month I signed an Opp loan for $2600.00 . . . . I have paid them over $3600.. Today they tell me that I owe them $2800.00 . . . . [192]

- I . . . took out the loan[.] I am not disputing the loan[.] I had a downfall in life and defaulted . . . . I . . . received a " Notice of Intent to Assign Wages[.]" I spoke to [a representative] who refused to assist. [H]er only option was for me to pay $560.00 now and make the original monthly payments. I stated to her I do not have that money[.] I really do not[.] I need help[.] [S]he refused to offer me any solution. I currently have $100.00 in my checking account. I asked to

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[187] #2812101 (Tennessee borrower) (appears to be a rent-a-bank loan)

[188] #3106431 (Maryland borrower)

[189] #3354050 (Michigan borrower) (appears to be a rent-a-bank loan)

[190] #3371847 (Arizona borrower) (appears to be a rent-a-bank loan)

[191] #3015405 (Illinois borrower)

[192] #3028087 (California borrower).

speak to a supervisor and she refused to allow me to speak to a supervisor . . . . I think this company has no intentions to help anyone who is struggling.[193]

- I took a payday installment loan for the sake of building my credits . . . . I then told them I am not doing it through debit card anymore . . . . as per contract, it doesn't say I have to use my debit card as a routing number was a condition for approval. This week . . . they contacted my employer and decided to garnish my wage. This is unfair to me as I wasn't informed and it is not my fault, I never refused to pay or change my account. They didn't do their responsibility to deduct money while I gave my account information (confirmed today they still have). This is unfair garnishment and punishment to me because of their fault (or their systems) . . . . I urge your help to assist me to remove this unfair garnishment on me and let the company comply with their promises. I also ask you to judge this and make Opploans repair my damaged credits that were caused by this unfair transaction. I am not delinquent to this transaction.[194]

- I emailed company . . . and then I also called and rescinded the wage assignment. I sent an email to the CEO office and also spoke to several representatives to try to reach a settlement for the principle amount of the loan. The amount when I asked for the settlement was XXXX. This would have had the company write off about 200 in interest only. There was a los[s] of income in my household. So to prevent a long term impact to my credit and finances, I asked to settle the account. I was informed that I had to be at least 61 days behind and that if I made a minimum payment of XXXX that I would stay in a positive balance. This did not make sense as this would also keep the account in a current status. This would also cause more interest to accrue over time. I wanted to settle the account, close the account and avoid negative impact on my credit, and more fees. The company refused to work with stating the contract was enforceable. This would benefit the company to continue to accrue more interest and fees over a period of time and impact the consumer in a negative light.[195]

<u>Enova (NetCredit brand)</u>

- On XX/XX/2016 I was approved for a personal loan with NetCredit. I was unaware of the future circumstances and took out a very high interest loan, 99 % interest on a $2000.00 [loan]. I have become a XXXX veteran and unemployed at the moment due to my condition. The total amount that I will be paying back on a $2000.00 loan is $7800.00. I have been paying on this loan since that date. [The complaint was filed on May 2, 2019.][196]

- Netcredit is a company that [is] not interest[ed] in listening to any complaint or trying to work with [] me to help because I can't pay the high amount of interest[,] and the very little amount going towards the principle [—] that is unfair and wrong for anybody to have to do. I am not trying to not pay them but I have a problem with them trying to lock me in a five year loan which they seek to collect three time the loan amount they gave me. I am a XXXX Veteran that

[193] #3027480 (Illinois borrower)

[194] #3190625 (Illinois borrower)

[195] #3407914 (Illinois borrower)

[196] 3229883 (South Carolina borrower)

gets a monthly check that all I have to live on[.] [F]or Netcredit to do this is shameful and disgraceful. PLEASE HELP!![197]

- At the time, I had been struggling financially because . . . I lost the father of my [] children. I lost more than half of our income and could not keep up on my salary alone. I became in over my head with debt to many people . . . . I took out the loan through NetCredit for the amount of $3700.00 . . . I was steadily making payments every two weeks on this loan for $230.00 . . . I am a XXXX employee who was out of work and without pay for the duration of the XXXX . . . NetCredit deferred my payments without question or hesitation giving me the peace of mind that everything was going to be okay . . . . [M]y intent was to pay the balance in full. What NetCredit failed to tell me was that the payments I had made toward the loan did not go to the principle whatsoever . . . . By the time the XXXX was over, they had tacked on over $1000.00 in interest to the loan. Despite almost paying the loan off, they still reported I owed $3700.00 plus accrued interest at that time. They told me that since I had been in non-pay status for so long . . . that if I didn't make a payment immediately they would send me to collections . . . . They have yet to close the account and are continuing to rack up interest and report the balance of the loan increasing every month. They are reporting that I owe 6600.00 . . . . I am a single mother of [] children who are not even old enough to be in school yet. I can not afford what they are putting on me and they are making it so I can not provide for my family by destroying my credit.[198]

- I got a loan in the amount of $2100.00. [D]ecided to login into my account to see how much principal was left on the loan and its $2100.00. Only $57.00 paid to principal in the last year. Ive made all my payments on time, $58.00 every 2 weeks. Something can not be right with this loan. I feel as though Ive been getting robbed for the past year. I do not understand. My [fiancé] has a loan with NetCredit as well within the same timeframe . . . Loan amount $3000.00 . . . principal is only down to $2900.00. Her payments are $78.00 every 2 weeks, never missed a payment. Please help![199]

- I was contacted by netcredit advising that I was pre approved for an installment loan. As I am a single mother of XXXX and have been . . . behind on HOA fees and other bills and decided to take out the loan . . . . I checked an account that I used and realized that they were taking out the XXXX every 2 weeks . . . . I told them I could not afford the XXXX coming out every 2 weeks as this is not what I [anticipated]. This has brought my checking account seriously negative and my bank is giving me a hard time as well . . . . I feel this is very deceptive, [an] installment loan is supposed to be a monthly payment[,] a payday loan is a bi weekly payment. I really need help with this. I can [make] [monthly] payments[,] I can not make bi weekly payments of XXXX[,] that is too much and it is really creating a hardship for my family.[200]

- I took out a loan in 2014 with NetCredit for $2600.00. I paid on the loan for 40 payments . . . . I ran into an inability to pay and wanted to work with Net Credit to settle the loan. I even hired a

[197] #3251851 (Georgia borrower)

[198] #3370736 (California borrower)

[199] #3393212 (Virginia borrower)

[200] #3053313 (Utah borrower)

firm to assist. Net Credit was not willing to work with the firm nor myself and an agreement was never reached. My fear is that they are holding back wanting to work with me while late fees and interest continue to accrue at an alarming rate.[201]

- I am disputing this loan based on that it is impossible to pay it off at 98.8 % . . . I will pay over $7000.00 for a $3900.00 loan at 98.8 % . . . . I have called and spoke with them about 10 times within the last 3 1/2 weeks. NETCREDIT WILL NOT WORK WITH ME OR DISCUSS ANY OPTIONS WITH ME. All I am asking for is to take the interest away from this loan and allow me to make monthly payments that I am able to handle. I understand my responsibility of the balance of the loan but they do not work with their consumers, instead make a profit with predatory lending practices.[202]

- I offered NetCredit a reasonable settlement amount which they dismissed and demand full payment which is completely insane. I had no idea after I paid $3000.00 on $3400.00 loan that I would have to pay an additional $4000.00 to pay it off or continue making the payment and by the time it was paid off I would have paid many thousands of dollars.[203]

- I took a loan from NetCredit in the amount of $1200.00. To date I have made 11 payments at the payment amount of $100.00 each for a total paid of $2000.00 plus a check payment of $100.00 which has not been cashed or applied to my account. NetCredit states I still have fourteen more payments of $100.00 each to make. For a $1200.00 loan, I will end up paying $3600.00, more than THREE TIMES the loan amount!![204]

- [I] [b]orrowed $1400.00 . . . Paid [x]payments of $110.00 = $1100.00 . . . balance is currently $1400.0 . . . Was unable to keep up with payments due to XXXX income (was unemployed for 10 months- catching up on past debts and medical bills). Several attempts were made to set up payment agreements with NETCREDIT . . . but Net Credit didn't agree . . . . I was NOT aware the interest on $1400.00 would be $1200.00 (almost the amount of the loan). I would have NEVER agreed to this loan. I am a veteran and XXXX civilian on a tight budget. This interest charged on the loan is hideous. I could have borrowed that amount from a local bank/lender and not have that much in interest. This is a horrible way to take advantage of those that are in need![205]

- NetCredit is a company that take advantage of people ... they approve your loan on line then hit you with 98 % interest . . . . I took a loan out for $6000.00 ... once I found out the loan was to be taken out of my checking account 2x a month [] I called and asked them to adjust to 1x a month ... they said they couldn't do ... this was the biggest mistake I have ever made to take a loan out [] with them ... I was unable to pay and got in touch to work something out ... they sent gave me minimal options and then sent a letter saying that I can pay off the balance which now is $7800.00 . . . . I had been paying the monthly for a year at least??? and now I owe XXXX

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[201] #2418022 (California borrower)

[202] #2183667 (Virginia borrower)

[203] #3270880 (California borrower)

[204] #3324359 (South Carolina borrower)

[205] #2144831 (Virginia borrower)

more??? This is a company that the government should look into ... they are sharks!!!! I would recommend that people stay away from this company!!![206]

LoanMart

- I have this loan and ... being a senior citizen the payment[s] are [too] high[.] I am [p]aying $420.00 each month[,] have not paid for this month[,] and they can take my car at anytime[.] I am trying to work with them[,] my health is now becoming poor as I can not sleep . . . . I want to pay them and I will but I need the payment to be [up to] $320.00 per month[,] which would be a hardship but I could do that . . . . had I known I would not have take[n] this loan out and would have just gone homeless . . . .at least I would have had a car to sleep in and live not . . . on the street with no car or a place to live[.][207]

- I have been paying monthly, often times after . . . my due date, but I get the payment in monthly. On two occasions I was given extensions, but I have paid way more than the $1500.00 loan amount and expected to be paid off . . . . I was told because I was late many times, my loan has been extended for approx 20 more months, unless I can come up with the $1500.00 original loan amount plus $680.00 in late fees. Had I paid on time by the 11th if every month I would be paid off. When I told them that was ridiculous that it was still paid in the same month they told me too bad . . . . so now I have to pay another $4000.00 plus dollars ({$210.00} x 20) on time . . . or it may take longer . . . . I [will] never get my title back or get this loan paid off ... . I will be paying over $8000.00 on a $1500.00 loan.[208]

- My Loan charged off . . . . after i turned [in] the vehicle . . . . They auctioned off the vehicle and sent me a final charge off amount of $2600.00 . . . I received a payment settlement request in XXXX of XXXX for $1500.00 . . . As of today, they are reporting that i owe $7700.00 as the interest is still being charged on a loan they have been " charged off ". They are . . . inflating the amount owed to well over 300 % of what the original loan was . . . . They already have my car, now they want to ruin my credit. They are predatory [and] overly punitive with high interest after the charge off.[209]

- I was in need of a loan to move and the television and radio were [inundated] with advertisements from "1-800- Loan-Mart XXXX[.]" I called and they offered me a " title loan " for $10000.00 specific to my . . . Toyota Camry. The payment was and remains a staggering $850.00 per month. Also, my ex-husband bounced a check to me . . . which prevented making a payment so I called for an extension [but] they repossessed my car . . . and charged me almost $2500.00 to get the car back . . . . I have been paying the $850.00 monthly for over two years and the principle balance or payoff remains just a [little] less than the original loan. What guidelines

[206] #1998233 (California borrower)

[207] #2894498 (California borrower)

[208] #3126449 (Wisconsin borrower)

[209] #1792457 (California borrower)

regulate the loan industry and why are they permitted to be rude, abusive and lend money like . . . loan sharks?[210]

- 1 800 Loan Mart has repeatedly called me 30 times a day for the last 7 months[,] also have incorrectly reported negative things on my credit report, also called and threatened me with imprisonment lawsuit . . . [A]fter I paid them $4000.00 and they took my vehicle[,] now they're saying I still owe them $5000.00[.] [T]he original amount of loan was $2500.00.[211]

- I needed money to pay for my moving expenses. I took a title max car loan. I 've tried to keep up with the payments but fall short so my payments are late and include a hefty penalty payment in addition to interest . . . . My plan is to pay the entire bill with large lump sum payments. The problem is the amount that is added to the principal balance makes it difficult to pay the loan off. My car was reposed this morning. In order to get my car back, I must pay them $900.00 which includes towing, paying for personal property left in the car and making a trip to the police department to obtain a [repossession] receipt. This is robbery.[212]

- I took out a loan in . . . 2014 for $5700.00. I've made payments of $450.00 since then [totaling] about $8000.00. I just recently got a payment history to see my balance due and almost none of my payments have applied to principal balance, almost all of it has gone towards interest! I spoke with a customer service rep today and they still want $7000.00 to close [the] account. I told them I no longer have a steady job or income and have been going through health/medical issues and have been in and out of the hospital. I just want to settle amount of another $1000.00 to close account. I 've already paid back the $5700.00 and interest of more than $2000.00 and still going to give $1000.00 to settle. I 'm trying to be honest with them and get a settlement and close my account.[213] (This complaint was submitted on August 12, 2016).

CURO (SpeedyCash brand)

- Speedy Cash took money from my . . . debit card without my authorization. I receive my social security SSI payments in the amount of $730.00 on this card . . . my card was debited by Speedy Cash for the amount of $520.00. When I called them they stated that my account was past due . . . and that it had gone into collections . . . . They also said that there was nothing they could do because the third party collector was involved . . . When I called [the third party], the representative told me that they were not involved in collecting on this account any longer because Speedy Cash had taken the loan back. I am confused by the back and forth. Now, I am in a horrible position. My account was basically drained which leaves me with no money for the entire month. No money for rent, utilities, doctor visit, or prescriptions. I . . . have no idea what I am going to do.[214]

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[210] #1867122 (California borrower)

[211] #2356677 (California borrower)

[212] #2157776 (Nevada borrower)

[213] #2958482 (California borrower)

[214] #2657445 (Missouri borrower)

- I have paid $1600.00 on the account and all payments have gone towards the interest and late fees. I have given seven payments at $220.00 each month since the loan and I owe at this time $2800.00 at this rate the loan will cost more than I borrowed. I need help because this is a car title loan and I can't afford losing my car over this. I have called the corporate office and . . . they all say the same thing (—) there is nothing that can be done except keep making the payments . . . It's like I borrowed the monies from [someone] in a street alley.[215]

- I borrowed $750.00 . . . .First month repayment . . . $240.00 . . . . Remaining balance over $1000.00. Next installment $240.00 . . . remaining balance over $1000.00. Payments increase as does amounts owed. Decline in principal is offset by increase in fees or 'interest.' . . . . Never ending cycle.[216]

- [I] borrowed $1300.00 from speedy cash and the first payment was ok ($77.00) and after that they were $140.00 every other week and [I] am now unable to make these ridiculous payments [because] my hours have been cut at [work]. I notified them . . . I am in default and [I] have sent emails . . . . [T]hey say to contact them if [you can't] make a payment and they will work with you. All they do is extend it 4-5 days out and [that don't] help either! I am desperate[, I] have called about filing bankruptcy and [I] may have to and [I don't know what else to do.[217]

- Speedy Cash stopped the payday loans and changed to the installment loans . . . . If your payment is due on a certain day they could move it up by 4 days but it [doesn't] help if that 4th day is not a payday. I have paid so many overdraft and bank fees until I feel ashame[d] and stupid. I needed the money but once you get it [it's] hard to get rid of it. I [don't] understand [what's] hard about reasonable payment arrangements. Your 4 day extension is not realistic to customers.[218]

- I currently have an installment loan in the amount of $2600.00 from Speedy Cash . . . . At the same time, I also have [x] $300.00 payday loans from [x] different storefronts in my neighborhood, including Speedy Cash. So basically, I have both a $300.00 payday loan from Speedy Cash and a $2600.00 installment loan. Is that legal? I am drowning in debt and I can't handle it anymore. I need some relief. This is very stressful and expensive for me, and I don't know what to do . . . . . I 've been paying about $140.00 every two weeks on the Speedy Cash installment loan, and I 've already paid $2200.00 . . . but my total balance is still $2600.00! How is this even possible? Are all my payments going toward interest only? I can't keep paying on all these loans. I need to prioritize my rent ($1100.00), car payment ($320.00), insurance ($180.00) and my other basic needs like food and utilities. After taxes, I only bring home about $1800.00 a month. So this is really hurting me and I 've reached my breaking point . . . . I don't want to default on the loan, but at this point I'm not seeing another alternative. I recently received XXXX

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[215] #2792493 (California borrower)

[216] #2772146 (Utah borrower)

[217] #3046440 (Tennessee borrower)

[218] #2718087 (Mississippi borrower)

utility disconnection notices from my gas, water and light companies[.] To make matters worse, I'm also facing being laid off from work in the next few months. I need help.[219]

- I could not get Speedy Cash to stop taking payments out of by bank account using my debit card. I called them, I wrote them. I tried to set up payments. I told my bank to not authorize any more payments. Didn't help. Finally I had to shut down all my accounts at my bank and go to another bank. I could not believe it when I when, at my new bank, Speedy Cash withdrew $100.00, the next day $60.00. I have no idea what that amount is for. I'm disputing the charges Can you help me?[220]

[219] #1377341 (California borrower)

[220] #2158561 (Kansas borrower)

STATEMENT FOR THE RECORD

FROM THE

CONFERENCE OF STATE BANK SUPERVISORS

TO THE

TASK FORCE ON FINANCIAL TECHNOLOGY

OF THE

U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

HEARING ON

"LICENSE TO BANK: EXAMINING THE LEGAL FRAMEWORK GOVERNING WHO CAN LEND AND PROCESS PAYMENTS IN THE FINTECH AGE"

SEPTEMBER 29, 2020

I. Introduction

The Conference of State Bank Supervisors (CSBS) thanks the House Financial Services Task Force on Financial Technology for convening this important hearing entitled "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age." CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, American Samoa and the U.S. Virgin Islands. CSBS was established in 1902 to support and improve the dual banking system by bringing state banking regulators together and promoting state-federal regulatory coordination.

State regulators charter and supervise 79 percent of all U.S. banks and are the primary regulators of a diverse range of nonbank financial services providers, including mortgage lenders, money transmitters and consumer lenders. CSBS, on behalf of state regulators, also operates the Nationwide Multistate Licensing System (NMLS), a regulatory licensing platform for state-licensed nonbank financial services providers in the money services, mortgage, consumer finance and debt industries.

The United States benefits from a diverse array of bank and nonbank entities (namely, entities that do not take deposits) providing lending and payments services today. These companies operate in a regulated environment defined by federal and state laws, with state regulators performing robust, responsive and tailored oversight of each of these company types:

- State regulators oversee nonbank payments companies responsible for $1.4 trillion in annual payments activity, encompassing small brick-and-mortar companies to large, internationally active corporations moving billions of dollars.
- Similarly, state regulators license and supervise a wide variety of nonbank consumer lenders extending credit to borrowers all across the country.
- Finally, state regulators charter and supervise banking organizations that play an important role in facilitating payments and extending credit to consumers and businesses.

CSBS appreciates the opportunity to share how states regulate these companies, as well as how the state system encourages creativity, experimentation, diversity and choice, all of which enhance local economic development, market competition and business flexibility.

The U.S. economy and financial system do not suffer from a lack of innovation or an environment in which innovation is stifled. Indeed, the staggering variety of innovative companies, activities, products and services in the U.S. financial services space is unique among peer nations, and this is a direct result of our federalist financial regulatory system. Just like our federalist dual banking system fosters the most diverse and vibrant banking industry in the world – over 5,000 banks of all shapes and sizes – the state nonbank regulatory system has encouraged and facilitated unparalleled innovations in the payments, consumer lending, mortgage and debt industries. Financial services innovation, including in the payments and consumer lending space, is a key feature and result of our existing financial regulatory system.

Regulations and regulatory systems must certainly adapt to keep pace with the innovation already occurring in the U.S. financial services industry. The state regulatory system has proven that it promotes innovation, ensures market stability and protects consumers. State regulators believe our federalist regulatory framework should serve as the foundation and be reinforced through any potential regulatory changes.

This statement discusses state regulators' perspectives on ways the U.S. regulatory system can adapt to continue fostering innovation in the financial services system, particularly in the payments and consumer lending industries. In particular, this statement details:

- How state payments and consumer lending regulation encourages innovation and flexibility and protects consumers.
- How state regulators' Vision 2020 initiatives are improving payments and consumer lending regulation.
- How state regulators oversee payments and lending activities conducted by banks.
- Why the Office of the Comptroller of the Currency's efforts to charter fintech and payments firms is problematic.

II. State Regulation of Payments and Lending Activities

The state regulatory framework is a strong feature of our federalist system of government and financial regulation. Corporate formation and business regulation are the domain of state law, except in extremely limited circumstances. This principle has been reaffirmed by Congress and the U.S. Supreme Court time and time again.

Under our federalist construct, states are the primary regulator of nonbank companies that wish to engage in payments and consumer lending activities. State oversight of businesses engaged in payments and lending activities supports innovation and flexibility, while at the same time ensuring consumers are well protected.

State Regulation Encourages Financial Innovation & Business Flexibility

Generally, states require nonbank companies to obtain a license if they wish to offer financial services to residents within their state. These licensing laws are "activities-based," as opposed to "entity-based," and cover such financial activities as money transmission, consumer lending, mortgage lending and debt collection. Since state licensing laws are activities-based, they provide businesses with flexibility and appropriately scaled regulation. Companies engaging in certain, discrete financial activities are licensed and supervised according to their choice of activity and how it fits within their broader business model.

Many nonbank companies wish to engage almost exclusively in one (or several) of these state-licensed financial activities. For example, a money transmitter (licensed as a money services business, or MSB) facilitates transfers of funds between individuals, whether online or through an agent at a physical location. This money transmitter's business is virtually all financial in

nature. However, many other companies' financial activities are incidental to their core business functions. For example, an online retailer may offer a payments service (again, licensed as an MSB) to expedite the checkout and payment process for its merchants and consumers. The retailer's regulatory obligations are limited, just like its financial activities are limited, to state-licensed payments activities.

The state regulatory system accommodates a diverse array of companies seeking to enter the marketplace, including brand new startups and firms looking to scale their operations quickly. In 2019, 92 companies acquired their first money transmission license via the state nonbank licensing platform, NMLS. Today, 67 of those companies are licensed in only one state, 10 are now licensed in two to nine states, and another 15 are licensed in 10 or more states.

Innovation also means that companies might want to evolve their business plans or might even fail. State regulators enable experimentation while protecting the market and consumers, facilitating a company's exit in an orderly manner. In the payments space, 35 companies who held state money transmitter licenses a year ago are no longer licensed. Of these companies, 27 had three or fewer licenses a year ago. This includes large companies that might have had a change in business model or business plan that resulted in not needing to be state licensed, as well as startups or small businesses that explored money transmission and then opted to exit the activity for a variety of business reasons.

State Regulation Protects Consumers

Critically, state licensing laws and regulation empower state officials to protect consumers and police state-licensed companies for bad behavior. This is a foundational authority provided to states under our federalist system. For example, state usury laws establish limits around the terms of credit offered to consumers, and state consumer lending licensing laws outline the standards a company must meet to extend credit to consumers within the state. State regulators are the "boots on the ground," protecting consumers from companies that run afoul of or seek to circumvent state law.

Additionally, state regulators' consumer protection approach differs from that of their federal regulatory counterparts, and it is often more effective. They are closer to the consumer and they are locally accountable, a dynamic that greatly benefits consumers in need of regulatory assistance. When state regulators receive a consumer complaint, they work directly with consumers and companies to address and resolve the issue. State regulators treat individual consumer complaints like casework, rather than waiting to collect volumes of complaints and finally acting once a problem has been deemed "systemic" in nature.

III. State Regulators are Modernizing Payments and Consumer Lending Regulation

State regulators appreciate that technology has sparked and accelerated significant changes in the financial services industry, and that these changes present novel challenges for state regulators and the state regulatory system. State regulators have been addressing these market

and regulatory challenges for many years. For example, CSBS established a first of its kind regulator working group called the Emerging Payments Task Force in December 2013. Through this task force, state regulators issued a "Model Consumer Guidance on Virtual Currencies" and "Model Regulatory Framework for Virtual Currency," leading their federal counterparts in providing regulatory answers to novel fintech questions for consumers and businesses.

In the years since, state regulators have expanded their focus to encompass a wider array of fintech activities, companies, consumer and state regulatory issues. Through a series of initiatives called CSBS Vision 2020, state regulators are reengineering the state system of supervision. It is a regulatory mindset – a clear vision of how the states are working together to advance nonbank licensing and supervision. It is the states' commitment to work toward a more consistent, coherent and networked system of state regulation, leveraging technology and data, while reinforcing strong consumer protection regulation and enforcement.

State regulators are not "going it alone" as they work to reengineer the state system. They are working closely with industry, other regulators and consumer advocates to ensure improvements to state regulation benefit both consumers and companies at the same time. Indeed, CSBS formed a Fintech Industry Advisory Panel (FIAP) made up of 33 fintech firms, primarily from the payments and consumer lending industries, to help state regulators identify problems and develop solutions in the 50-state licensing and supervisory system. CSBS frequently meets with consumer advocacy groups to ensure strong state consumer protections remain front and center as states make changes to regulation and supervision.

Several Vision 2020 initiatives are highlighted below that will bring more efficiency and standardization to licensing and supervision for payments and consumer lenders, while strengthening consumer protections and local accountability.

Improvements in State Payments Regulation

Harmonization through a Model State Payments Law: In response to recommendations from fintech and payments company members of the Fintech Industry Advisory Panel, state regulators are currently developing a model state law for money transmitters with uniform, risk-based licensing and regulatory requirements. Though each state generally uses the same framework for money transmission laws, each statute has its own unique definitions and requirements for money transfers. States also might interpret and implement laws differently, even when the statutory language is the same. A model law will enable money transmitters to build national scale more easily, improve state supervision and ensure consumer protections.

Single Exams for National MSBs: Beginning in 2021, money transmitters operating in 40 or more states will benefit from streamlined state supervision through the recently announced Money Service Businesses (MSB) Networked Supervision program. Qualifying nationwide payments firms will undergo a single comprehensive exam to satisfy all state regulatory requirements, significantly reducing their regulatory burden. The "one company, one

exam" initiative will apply to 78 of the nation's largest payments and cryptocurrency companies that combined move more than $1 trillion a year in customer funds.

MSB Networked Supervision will also help state regulators improve their processes – a crucial element of states protecting consumers while promoting national business models – and fine tune a risk-based approach to each company's operations. This approach builds on years of substantive multistate coordination that will improve oversight of large payments firms.

The single exam will be led by one state overseeing a group of examiners sourced from across the country. By relying on experts across the state system — including in cybersecurity and anti-money laundering — regulators will gain more insight while also freeing up state resources.

Streamlined MSB Licensing: State regulators recognize the pain points MSBs experience when seeking licensure in individual states, including different legal requirements, resources and turn times, procedural requirements and interpretations and satisfying these similar requirements in each state. To address these challenges, state regulators launched a Multistate Money Services Businesses Licensing Agreement (MMLA) program to create a more efficient MSB licensing process by curbing duplications in the state licensing process. To date, 28 states have signed onto the MMLA program. If one of these signatory states reviews key elements of state licensing for a money transmitter, other participating states agree to accept the findings. The process has shown to reduce the time to for a company to obtain a license by two-thirds.

The MMLA program utilizes NMLS, which is the state regulators' regtech platform. Companies can submit most license application materials only once through NMLS instead of submitting them separately to individual states. For licensing requirements that are common among the states, the applicant will also have a single point of contact with the state selected to review the common licensing requirements.

Centralized MSB Data Reporting: NMLS also facilitates state regulators' Money Services Business Call Report, which is the first and only nationwide report of its kind. The MSB Call Report yields important information about the size and nature of the industry, including cryptocurrency and money transmission, and helps state regulators to risk scope their MSB exams. Additionally, the MSB Call Report benefits companies by creating a standardized reporting requirement across all participating states.

Improvements in State Consumer Lending Regulation

Tools for Navigating the State Consumer Finance System: CSBS has developed a survey of state consumer finance licensing laws that allows users to see similarities and differences across all 50 states and Washington, DC, and gives companies, particularly new entrants, a clear look at state compliance requirements. Additionally, CSBS will soon release an updated, comprehensive catalog of state usury laws to accompany its survey of state consumer finance licensing laws.

Improving Consumer Finance Reporting: Unlike the mortgage and MSB industries, there are no national reporting standards or requirements for consumer finance companies. In response to a recommendation from the Fintech Industry Advisory Panel, the states are developing a consumer finance call report that would be deployed through NMLS. The consumer finance call report will improve the information reported to state regulators while promoting greater consistency across state reporting requirements.

Improve State-Federal Coordination of Bank & Nonbank Partnerships

Coordinate State-Federal Supervision of Bank Third Party Service Providers: Banks partner with a variety of third-party companies to provide and deliver core products, such as when banks partner with nonbank lenders to extend credit to consumers. The Bank Service Company Examination Coordination Act (H.R. 241/S. 4154) would amend the Bank Service Company Act to allow state and federal regulators to coordinate their oversight of third-party service providers (TSPs). Improved TSP supervision will support both banks and nonbank companies that partner together to deliver innovative products and services to consumers. State regulators are pleased that the House approved H.R. 241, the Bank Service Company Examination Coordination Act, in a unanimous vote a year ago and hope the Senate swiftly approves the companion bill, S. 4154, that was introduced in July.

IV. State Regulation of Banks Engaged in Payments and Lending

State Regulators Provide Robust Oversight of Bank Payments and Lending Activities

In addition to licensing and regulating discrete financial activities conducted by nonbank companies, such as payments or consumer lending activities, state regulators are also "entity-based" regulators in that they charter and supervise 79 percent of all U.S. banks. Bank charters provide these organizations with a much broader array of business powers, including the ability to accept deposits, facilitate payments and extend credit to consumers and businesses. Banks also expose taxpayers and the federal government to the risk of losses in the event of failure, and are therefore subject to more rigorous "cradle-to-grave" regulations, such as stringent capital and liquidity requirements, community reinvestment requirements, merger and affiliation restrictions, and prior approval or notice requirements for a significant portion of their activities. State regulators supervise banks' payments and consumer lending activities as part of a comprehensive prudential regulatory and consumer protection framework, ensuring these particular activities do not pose undue risks to the broader organization or harm consumers.

State Regulators Provide Robust Oversight of Unique Bank Charters

Throughout history, Congress has recognized and reaffirmed the role states play as "laboratories of innovation," including in the bank chartering space. For example, Congress has authorized and retained exemptions in the Bank Holding Company Act (BHCA) that allow nonbank parent companies to own insured bank subsidiaries. Commonly referred to as

industrial loan companies (ILCs) or industrial banks, commercial firms can own an ILC without being subject to the activity restrictions of the BHCA.

Despite these parent holding company exemptions, ILCs are subject to the same banking laws and regulations as other depository institutions. ILCs undergo the same comprehensive exam events as all banks, namely: safety and soundness, BSA, IT, consumer compliance, CRA and, where applicable, service provider exams. These exams are performed by the state chartering authority and the Federal Deposit Insurance Corporation (FDIC). The ratings framework, exam cycle and exam procedures used at ILCs are the same used at every other bank.

When an ILC missteps, regulators use the same enforcement tools to drive corrective action. ILCs must comply with anti-tying regulations and the limits on affiliate transactions required by Sections 23A/B of the Federal Reserve Act. Insured depository institutions, not their parent companies, access the federal safety net (i.e., deposit insurance, the payment system and the Fed's discount window). Because of this, the ILC charter is a useful, statutorily authorized, option to allow innovation to develop safely inside the bank regulatory system, while simultaneously ring-fencing that exposure to an insured depository.

V. State Regulators' Concerns with the OCC's Proposed "Fintech" and Payments Charters

The OCC Lacks the Requisite Legal Authority to Charter Nonbank Firms

State regulators strongly oppose the Office of the Comptroller of the Currency's (OCC) efforts to accept applications for special purpose national bank charters from nonbank fintech companies that do not and would not engage in receiving deposits or be insured by the FDIC. State regulators have made that point in court filings and are pleased that a New York federal court ruled against the OCC in its attempt to license fintech firms. In July, CSBS filed an amicus brief supporting the New York Department of Financial Services in the Second Circuit as the OCC appeals the federal court decision.

Recent statements suggest that the OCC may seek to offer charters to payments companies that do not take deposits. This purported "payments" charter is substantively the same "fintech charter" that, as noted above, a federal court has invalidated.

We have a federated financial system that has been affirmed by Congress. Federal and state laws determine how financial entities are regulated and are the reason the New York federal court ruled against the OCC in its attempt to license fintech firms.

First, the OCC does not have the statutory authority to issue federal banking charters to nonbanks. Congress decides what a bank is, and in our view, what the OCC is trying to do with the fintech charter is inconsistent with the banking laws that Congress has enacted. Second, a federal fintech charter would distort the market by picking winners and losers, by only drawing from a handful of large, established entities and giving them a competitive advantage over new market entrants that have historically injected innovation into our financial system. Third, a

federal fintech charter would preempt important state consumer protections. Fourth, such a charter would dismantle the separations of banking and commerce put in place by Congress and extend the federal safety net to a wide swath of commercial institutions, potentially exposing taxpayers to losses.

There is no difference between the OCC's proposed fintech charter that the New York federal court invalidated and the OCC's new payments charter proposal. Both are invalid because the OCC does not have blanket authority or power to define what it means to be a bank. A federal charter — or really, the federal authorization to do business — is the exception, not the rule under the U.S. Constitution. Congress must establish the authority to confer such a charter and does so only to serve compelling public policy goals. Congress has repeatedly left supervision of nonbank companies to the states.

An OCC Nonbank Fintech or Payments Charter Would Lead to Consumer Harm

State licensure and supervision of nonbank financial companies provides greater consumer protection through a combination of state usury laws, state licensing requirements and other state consumer protection laws. An OCC fintech or payments charter would seek to preempt these critical, state-level consumer protections, leaving consumers with less recourse and fewer options if they are the victim of predatory business activities.

State Usury Laws Protect Consumers from Harmful Credit: State usury laws cap the interest rates and finance charges that a business can charge in lending money. States have set these interest rate caps at different levels in balancing the competing policy priorities of credit access and credit affordability. With the fintech charter and other efforts, the OCC is seeking to extend to nonbanks the ability to export interest rates which is currently reserved to banks.

If nonbanks are allowed to export interest rates, then consumers will no longer be able to exercise control through democratic processes over the cost of credit offered within their state. In recent years, democratic participation has enabled consumers to lower the interest rate caps in their states, even to the point of banning payday lending within their state. For example, in 2010, Arkansas citizens voted to pass a ballot initiative to amend their state constitution to establish a 17 percent annual rate cap for consumer credit extended to Arkansas residents. This effectively banned payday lending in Arkansas. If the OCC is to succeed in its project to extend interest rate exportation to nonbanks, then initiatives like those seen in Arkansas will be no more, for the Comptroller will have taken away the ability of consumers, as citizens, to play a role in setting policies that significantly impact their economic destiny.

State Licensing Laws Limit Potential Consumer Harm: State licensing laws require nonbank financial services providers to adhere to restrictions on their business practices and restrictions on product terms, limiting the universe of potential harm consumers could experience at the hands of inexperienced or unscrupulous businesses. The state licensing process serves a critical "gatekeeping" function for the financial services industry, giving state regulators an opportunity to fully vet applicants who wish to conduct financial activities with consumers in their states.

State Fair Lending and Anti-Discrimination Laws: Unlike a state regulator, the OCC is not directly accountable to state legislatures for not applying State Fair Lending and Anti-Discrimination Laws, and, because state oversight is preempted, state regulators cannot check or fill the regulatory void left by the OCC's non-enforcement of the laws. Such a void is likely based on the OCC's record of non-enforcement of state fair lending and anti-discrimination laws in the years leading up to the 2008 financial crisis.

VI. Conclusion

State regulators applaud the Task Force on Financial Technology for convening this important hearing on the legal framework for lending and payments activities. We have a financial regulatory system grounded in cooperative federalism that has served as the foundation for incredible innovations in payments and lending. We appreciate Congress's repeated affirmation of this structure and of the important regulatory role of the states. State regulators look forward to partnering with Congress and with the members of the Committee and this Task Force in ensuring effective and locally accountable oversight that protects consumers and promotes economic development in our communities.

Credit Union National Association
CUNA

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September 29, 2020

The Honorable Stephen Lynch
Chairman
House Financial Services Committee
Task Force on Financial Technology
Washington, DC 20515

The Honorable Tom Emmer
Ranking Member
House Financial Services Committee
Task Force on Financial Technology
Washington, DC 20515

Dear Chairman Lynch and Ranking Member Emmer:

On behalf of America's credit unions, I am writing to express credit unions views ahead of the hearing titled "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age." The Credit Union National Association (CUNA) represents America's credit unions and their 120 million members.

CUNA appreciates the Committee's commitment to oversight of the financial services sector by holding this hearing. The scope of this hearing, examining the legal framework and regulatory scope governing the oversight of traditional banks and other commercial businesses that are engaged in financial activity, is appropriate and timely. Credit unions are concerned that non-regulated companies are engaged in financial activities by offering products and services that are traditionally offered by credit unions and banks. These non-bank providers often strive to offer these products and services without being subject to robust consumer protection laws and regulations in place for banks and credit unions. Furthermore, we are concerned that recent rulemaking and statements from the Acting Comptroller Office of the Comptroller of the Currency (OCC) seek to make changes to rules and modify the bank charter in ways make it easier for non-bank lenders and payment companies to bypass consumer protection rules and regulations.

We understand the attraction of financial technology companies (fintech) to consumers as they seem to create novel products and services at a rapid pace. Some of these products and services are truly new while others may be a repackage of mature products and services wrapped in a thin veneer of technology and supported by venture capital that allows for pricing that undercuts traditional service providers to rapidly gain market share. While credit unions welcome competition, we are concerned that many products and services offered by fintechs skirt state and federal consumer protection regulations by exploiting loopholes in regulations or entering into partnerships with banks where the fintech company is able to leverage a partner banks regulatory structure to its advantage.

It would seem the solution to these problems would be a federal charter for fintech companies and that is exactly what the OCC has proposed in different forms. In 2016, the OCC proposed a Special Purpose National Bank Charter for Fintech Companies (fintech charter), which would allow fintech companies to engage in banking activities. The proposal is currently mired in litigation. Recently, Acting Comptroller of the Currency, Brian Brooks, has proposed what has been called a "Payment Charter,"[1] but this appears to be a national money transmitter license that preempts state licenses requirement and provide a possible onramp for nonbanks to directly access to the Federal Reserve's payment clearing system. The Acting Comptroller has indicated in several forums that the OCC does not need to pursue rulemaking for the payments charter and that the Acting Comptroller can approve this charter at any time.

[1] Victoria Guida, "Top regulator pushes ahead with plan to reshape banking, sparking clash with states", *Politico* (Aug 31, 2020) https://www.politico.com/news/2020/08/31/currency-comptroller-reshape-banking-406393.

CUNA opposes the so-called payments charter. We believe the OCC should undertake an open and transparent process in considering new charters. This process was followed with the notice and comment rulemaking process for the fintech charter, but has not been done with payments charter. The absence of public process surrounding the payments charter concerns CUNA and its members. The lack of specificity around this charter leads to questions about how the OCC would regulate such entities and what the broad implications this charter would have on the banking sector. Furthermore, this narrow-purpose charter could introduce serious risk into the payment system

We continue to have serious concerns with banks partnering with fintechs for lending, especially when these relationships seem designed to avoid consumer protection laws. At the state level, there are licensing or registration requirements to operate within a state, state-specific interest rate limits, state-specific loan value caps, and other consumer protections. State requirements are largely enforced by state financial regulatory authorities and state attorneys general. Fintechs can use a bank as a lending partner to avoid many of the state-specific regulations, which rob state regulators of their ability to properly regulate financial activities.

In what looks like a blatant attempt to weaken state laws, in July 2020, the OCC issued a Notice of Proposed Rulemaking (NPRM) related to determining the "true lender" in partnerships between national banks and third parties, including marketplace lenders. Under the proposal, a national bank would be considered the true lender of the loan if, as of the date of origination, it is named as the lender in the loan agreement or funds the loan. CUNA has significant concerns with the "true lender" proposal as it could be exploited to promote "rent-a-charter" arrangements between payday lenders and national banks, which can be used to evade state restrictions on high interest rates or loan terms. We believe the OCC's proposal is not in the best interest of consumers and should be withdrawn. Instead, the OCC, in coordination with its sister banking regulators, should focus its relief efforts on facilitating and promoting the fair and reasonable loan options that are offered by local-community based lenders like credit unions.

CUNA's has long held the position that similar products and services should be regulated similarly so that consumers protection runs with a product or service, not with the entity providing the products or service. Credit unions and banks are subject to most of the same consumer protection laws. While not perfect, these consumer protection requirements do help protect consumers. Unfortunately, clever fintechs can use partnerships with banks and possibly a banking charter to avoid consumer protections with the approval of the OCC. The Committee should continue to stay focused on the OCC as their actions could cause irreparable harm to consumers and cause consumers to lose trust in the banks, which could also impact our members credit unions by association.

On behalf of America's credit unions and their 120 million members, we look forward to further discussing privacy issues with you and the members of this Task Force.

Sincerely,

Jim Nussle
President & CEO

STATE OF UTAH
Gary R. Herbert
Governor
Spencer J. Cox
Lieutenant Governor

DEPARTMENT OF FINANCIAL INSTITUTIONS
G. Edward Leary
Commissioner
Darryle P. Rude
Chief Examiner
R. Paul Allred
Deputy Commissioner

STATEMENT FOR THE RECORD
FROM THE
UTAH DEPARTMENT OF FINANCIAL INSTITUTIONS
TO THE
TASK FORCE ON FINANCIAL TECHNOLOGY
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U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES
HEARING ON
"LICENSE TO BANK: EXAMINING THE LEGAL FRAMEWORK GOVERNING WHO CAN LEND AND PROCESS PAYMENTS IN THE FINTECH AGE"
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I. Introduction

The Department of Financial Institutions for the State of Utah thanks the House Financial Service Committee Task Force on Financial Technology for convening today's important hearing entitled "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age."

The Department of Financial Institutions ("Department") is the state banking regulator for Utah and has more than one hundred years of experience supervising and examining financial services provided by depository institutions chartered by the state of Utah. The Department also regulates non-depositories, such as money service businesses, consumer lenders, and money transmitters.

Since the founding of this nation, the states have chartered, regulated, and supervised financial services. For those entities pursuing a bank charter, the choice of charter remains a vital component of the checks and balances of the dual banking system. Over their long history, state chartered institutions have fostered creativity and experimentation. State chartered institutions innovate in a controlled environment that limits systemic risks.

Supervision of non-bank financial services companies is also an important part of the state supervisory system. CSBS President John Ryan noted in a September 21, 2020 OpEd in the American Banker, "The state system of supervision aims to keep the bad players out and give the compliant financial entities room to innovate and grow, regardless of whether they are a large company or small startup."

Advancements in financial technology ("fintech") are driving a wave of innovation in the methods by which consumers solicit and receive financial services. The strength of the state supervisory system is that it permits such innovation and experimentation to occur responsibly, under the watchful eye of a network of state supervisors who are committed to holding entities accountable to safety and soundness, while enforcing consumer protections. State supervision of fintech companies is robust and evolving to efficiently meet the needs of the modern financial services landscape.

The Department is submitting this comment today because the rise of fintech companies is sparking a discussion about the role of bank charters in the financial services industry. As fintech companies explore how to best meet the needs of their customers in a safe, efficient, and reliable manner some have decided to pursue bank charters. Others are content with their current licensing and supervisory regimes. Others have chosen to partner with depository institutions. Others still are watching to see if proposals suggested by the Office of the Comptroller of the Currency ("OCC") for special purpose charters, like a "payments charter," come to fruition.

In the Department's experience, it is not uncommon for the industrial bank charter to be included in recent discourse about the intersection of fintech and banking. Since 14[1] of the nation's 23 open and operating industrial banks are chartered in Utah, and are regulated by the Department (alongside our partner in supervision the Federal Deposit Insurance Corporation ("FDIC")), it seems prudent for the Department to provide some comments and context regarding the history, legitimacy, operating experience and performance of this industry. Such clarifications are especially warranted because misconceptions about industrial banks continue to persist in the marketplace.

II. Background Information

Utah has been chartering industrial banks since the 1920s. In 1986, Utah law was changed to require Federal Deposit Insurance for industrial banks. As state-chartered, FDIC-insured institutions, industrial banks are currently operating in the states of Utah, California, Colorado, Hawaii, Indiana, Nevada and Minnesota. No state permits industrial banks to engage in activities that are not permissible for other state-chartered banks.

The Department has and will continue to defend our regulation and supervision of the industrial bank industry. Industrial banks are sometimes characterized by outside observers as having a lighter regulatory burden than other institutions. As the regulator that supervises a majority of these institutions, and the overwhelming majority of its assets, the Department states, for the record, such an assertion is a gross mischaracterization of this industry's regulatory burden.

At the bank level, industrial banks are subject to the same banking laws, and are regulated in the same manner, as other banks. Historically, all industrial banks have been nonmember banks, and

[1] On March 17, 2020, the Department granted conditional approval of the de novo industrial bank applications submitted by Square, Inc. and Nelnet, Inc. While approved, these two banks are not yet open. Once opened, these banks will increase the count for Utah industrial banks from 14 to 16.

therefore have been supervised and examined both by the states that charter them and by the FDIC. They are subject to the same – and in many cases higher[2] – safety and soundness standards. In addition, industrial banks are subject to the same consumer protection laws, deposit insurance assessments, Community Reinvestment Act obligations, legal lending limits, and other requirements, as every other FDIC-insured bank.

The Department's supervision program for industrial banks mirrors the program conducted at commercial banks. Like all banks, industrial banks are subjected to recurring and regular safety and soundness examinations, consumer compliance examinations, Bank Secrecy Act examinations, information technology examinations, and Community Reinvestment Act examinations. Like all banks, when an industrial bank exceeds $10 billion in total assets it is subjected to a large bank supervision framework of heightened supervision. Like all banks, an industrial bank becomes subject to oversight by the Consumer Financial Protection Bureau when the institution reaches $10 billion in total assets.

For industrial banks, the Department and the FDIC place special supervisory emphasis on compliance with Sections 23A and 23B of the Federal Reserve Act, and its implementing regulation, Regulation W. These regulations set regulatory standards for parent and affiliate company transactions to ensure that there is a limit to the amount of "covered transactions" between the affiliated entities, and that such transactions are contracted on an "arm's length" basis and on terms favorable to the bank.

Finally, the technology service providers of an industrial bank, sometimes affiliated entities, are similarly examined by the Department and the FDIC under FFIEC guidelines.

III. Industrial Banks Are Authorized By Statute

The primary differentiating feature of industrial banks is how the parent companies of these banks are treated under federal law. The Bank Holding Company Act ("BHCA") explicitly memorializes the will of Congress by exempting the parent companies of industrial banks from bank holding company status, and thereby from supervision by the Federal Reserve. Far from an accidental "loophole," the exemption is an intentional, Congressionally-approved feature of the charter.

Unlike the novel charter proposals recently introduced by the OCC, an industrial bank charter represents a legal and lawful option for bank organizers to consider. This choice of charter is authorized, in statute, by both the state legislatures that approved this class of institution for their states, and, at the federal level, by Congress when it placed the exemption in the BHCA as part of the Competitive Equality Banking Act of 1987. Congress has repeatedly chosen to retain the exemption ever since.

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[2] The Commissioner and the FDIC each often impose higher capital requirements on industrial banks to compensate for certain idiosyncrasies, for example: uniquely focused business plans, or greater than normal use of brokered deposits.

While the BHCA exempts industrial bank parent companies from consolidated, federal supervision at the holding company level, Section 616 of the Dodd Frank Act codified the Federal Reserve's source of strength doctrine, and made it applicable to the corporate owners of industrial banks, just as it is for bank holding companies. The statutory obligation of a corporate parent company to provide support to its subsidiary bank that has access to the federal safety net is identical for industrial banks and commercial banks alike.

IV. Bank Centric Supervision

It is important to remember that despite the BHCA exemption, the applicable states and the FDIC apply the same supervisory rigor to these institutions as is deployed at commercial banks. In the Department's view, that rigor is applied where it matters most: at the entity with exposure to the federal safety net, namely, the federally insured depository institution. Banks hold insured deposits, not holding companies. Banks have direct access to the nations' payment system, not holding companies. Banks borrow from the Federal Reserve's discount window, not holding companies. This is precisely the reason the Department follows a bank centric model for supervising industrial banks.

While the Department's overall approach to regulating industrial banks is bank centric, the Department is authorized by Utah law to examine the holding companies of state chartered institutions. This includes bank holding companies and the parent companies of industrial banks. The Department takes this responsibility seriously and regularly conducts holding company inspections at these entities. Examiners assess the parent companies' capital strength, earnings capability, liquidity resources, asset quality, the quality of risk management practices, and the impact the parent's operations may have on the Utah-chartered bank. Ultimately, the goal of these inspections is to ascertain the degree to which the holding companies serve as a source of financial and managerial strength to the subsidiary bank.

This bank centric approach to supervision has been effective for the Department, consumers, and the industry. In rare instances when an industrial bank parent company has experienced extreme financial distress, the Department and the FDIC have moved to protect the federal safety net by isolating the bank from the parent's hardships. In all cases but one, despite a parent company's financial distress (up to and including a bankruptcy filing) a subsidiary industrial bank has either emerged unscathed and healthy, or was subsequently wound down and the charter extinguished with no loss to the deposit insurance fund. In the sole instance of a Utah-chartered, FDIC-insured industrial bank's failure, conditions were such that the bank and parent company were distressed simultaneously. The Department observes that this is commonly the case with most commercial bank failures, where a bank holding company is also in a weakened state and is incapable of providing support.

As a means of ensuring the Department's bank centric supervision aligns with autonomous, bank centric decision making, the Commissioner historically has installed additional safeguards when approving industrial bank applications. Typical safeguards include: requiring the board of directors of an industrial bank to consist of a majority of unaffiliated outside directors, higher than normal, heightened capital standards, limitations on business plan changes, and local bank management. The FDIC has also historically installed similar, non-standard approval conditions

when acting on industrial bank applications; the FDIC recently proposed enshrining such conditions through rulemaking. The Department is supportive of the FIDC's proposed rule.[3]

V. Limited Scope of Industrial Banks and Strong Historical Performance

Industrial banks continue to represent a tiny fraction of the U.S. banking system. As of June 30, 2020, the FDIC reported 5,066 FDIC-insured institutions. By count, the nation's 23 industrial banks represent 0.45 percent of insured institutions, or less than one half of one percent of insured banks.

By total assets, the industry is also relatively small. As of June 30, 2020, all industrial banks reported a combined total of $169.5 billion in total assets. The FDIC reported total assets for all FDIC-insured institutions at $21.138 trillion. By size, industrial banks therefore represent less than one percent, or 0.80 percent, of the U.S. banking system's total assets.

Since some have expressed concern about the absence of consolidated, federal supervision at the holding company level for industrial bank parent companies, it is worth noting that, ironically, 45 percent of nationwide industrial bank assets are controlled by a corporation that has the Federal Reserve as the primary federal regulator for this parent company's U.S. operations. As a result, the percentage of actual industrial bank assets not under Federal Reserve supervision at the holding company level is just 0.44 percent of the U.S. banking system's total assets.

Historically, industrial banks have outperformed their peer institutions on key metrics like capital and earnings. As of June 30, 2020, the Department calculates an average Leverage capital ratio of 11.75 percent for the over 5,000 FDIC-insured depositories that are not industrial banks. For the 23 industrial banks, that average is 17.51 percent. Measured differently, on a total industry dollars basis, the Department calculates the total dollar volume of bank equity capital as a percentage of the banking industry's total assets at 10.15 percent. Whereas industrial banks total capital dollars represent 11.27 percent of total industrial bank industry assets. Similarly, the Department calculates an average Return on Average Assets ratio of 1.04 percent for FDIC-insured depositories, whereas industrial banks average 2.48 percent.

VI. Intersection with Fintech

As noted above, advancements in technology are motivating companies across the financial services landscape to develop new and innovative ways of delivering financial services. This change is not unique to banking. Regulators across multiple industries (e.g., insurance, asset management, investment advisory, payment processing, money transmission, non-bank business lending, non-bank consumer lending) are all grappling with the question of how to protect consumers while also encouraging innovation and efficiency as consumer preferences shift to digital channels. These issues pose questions not just for regulators, but for the regulated entities themselves who see a shifting landscape and have a duty to their shareholders to assess the future and strategically plan for a meaningful role in the future of financial services. Like all banks, industrial banks are prudently considering their role in the future of banking. Some are active in

[3] https://www.fdic.gov/news/press-releases/2020/pr20031a.pdf

exploring fintech related opportunities. Others are comfortable with their current business models.

The Department is aware that some industry observers have concluded that fintech companies are somehow uniquely aligned with the industrial bank industry. This perception may stem from a small number of industrial banks that, early on, partnered with fintech companies to deliver financial services to customers. Some of those fintechs grew to become household names and their industrial bank partnerships became prominent. It should be noted, however, that these fintech partnerships are not unique to industrial banks, are not unique to Utah, and are not unique to lending. Nationwide, banks from across the spectrum of charter types (e.g., state nonmember banks, member banks, national banks) have also partnered with fintech companies for the delivery of a variety of financial services and products, including consumer lending, small business lending, deposit products, and payment processing.

The industrial bank charter is also often mentioned in media articles discussing fintech companies who may elect to pursue their own bank charter. The Department has seen interest in the industrial bank charter from a few fintech companies. SoFi applied in 2017, but withdrew the application. Square applied in 2017 and was ultimately approved in March of 2020. But the Department is also seeing interest in industrial banks from non-tech related companies. The Department is also seeing interest in commercial bank charters from new organizers.

The Department noted with interest that fintech Varo Money pursued and received a national bank charter. Upon recently reapplying for a bank charter, SoFi this time applied for a traditional national bank charter from the OCC. Fintech Jiko recently acquired a Federal Savings Bank in Minnesota. It is also important to note that the Department has received additional industrial bank applications in recent months from traditional, well established financial services companies that would not meet a customary definition of "fintech."

In short, assertions that fintech companies may be looking exclusively to the industrial bank charter in an attempt to exploit an imagined scenario where they will somehow be less lightly regulated are unfounded by the facts and circumstances observed in the variety of charter choices recently made by fintechs in de novo applications, and in the new bank approvals issued by the various agencies.

In the Department's view, this mixture of interest in lawfully available, statutorily approved charters of all types is a positive, healthy trend that underscores the most important strength of the dual banking system: that organizers have a choice in pursuing the charter and regulatory environment best suited to their particular needs.

VII. Conclusion

As fintech companies interact with consumers to provide efficient, technology-driven financial services some have determined to establish a wholly-owned insured depository institution in order to provide such services directly. In considering their options, fintech companies assess the landscape of what charter choices are available to them. Recent application activity demonstrates that fintech companies are benefiting from the breadth of lawfully available options under our nation's dual banking system. Some are pursuing traditional state or federal commercial bank

charters, some are choosing to register existing parent companies as bank holding companies. A few have opted to pursue the industrial bank charter; in doing so, those entities encounter an high performing industry that is well regulated, and properly constrained by the same laws and regulations governing affiliate transactions applicable to all banks. The supervisory regime for industrial banks is as rigorous as those experienced by commercial banks. State and federal regulators have a proven track record of protecting and limiting exposure to the federal safety to the entities that receive access: the insured depository institution.

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September 29, 2020

The Honorable Stephen Lynch
Chairman
Task Force on Financial Technology
Committee on Financial Services
Washington, DC 20515

The Honorable Tom Emmer
Ranking Member
Task Force on Financial Technology
Committee on Financial Services
Washington, DC 20515

Dear Chairman Lynch, Ranking Member Emmer, and Members of the Task Force:

The Electronic Transactions Association ("ETA") appreciates the opportunity to submit this statement for the record before the Task Force's hearing, "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age."

ETA is the leading trade association for the payments technology industry, representing over 500 companies that offer electronic transaction processing products and services. ETA's members include financial institutions, mobile payment service providers, payment processors, mobile wallet providers, financial technology companies, and non-bank online lenders that make commercial loans, primarily to small businesses, either directly or in partnership with other lenders. ETA member companies are creating innovative offerings in financial services, revolutionizing the way commerce is conducted with secure, convenient, and rewarding payment solutions and lending alternatives – employing millions of Americans and enabling over $21 trillion in payments in 2019.

Regulators and Laws that Govern Payments

The payments industry is dedicated to providing consumers and businesses access to safe, convenient, and affordable payment services. Although the payments and fintech industries have received considerable attention in recent years as "new" and "innovative" industries, it is important to recognize that these services are regulated by a host of federal and state laws bodies. To highlight these current regulations, ETA has published a white paper[1] that underlines regulators, such as the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Consumer Financial Protection Bureau, ETA member companies comply with.

Additionally, the white paper outlines the numerous federal and state laws that apply to payments and related financial products and services. A few relevant federal laws are outlined below, but depending on the circumstances other federal and state laws address money transmission, customer due diligence, credit reporting, information security, data protection, privacy, and prohibitions on unfair, deceptive, or abusive acts or practices. Furthermore, most payments companies work closely with banks and other regulated financial services providers, which means they are oftentimes contractually obligated to comply with bank regulatory requirements.

- **Bank Secrecy Act:** The BSA establishes various requirements for covered financial institutions (including money services businesses) to assist the government in identifying and combatting money laundering and terrorist finance, such as by establishing anti-money laundering programs and reporting suspicious information.

- **Electronic Fund Transfer Act (Regulation E):** Provides consumer rights regarding the electronic transfer of funds to and from consumers' bank accounts.

[1] Electronic Transactions Association (2020). *Overview of Federal and State Laws and Regulations Governing Payments and Related Services*. [online] Available at: https://www.electran.org/wp-content/uploads/ETA-WP-FedStatePayments-1.pdf

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- **Gramm Leach Bliley Act:** The GLBA requires financial institutions to explain their information-sharing practices to customers and safeguard sensitive data.

- **Federal Trade Commission Act**: Section 5 of the FTC Act prohibits unfair or deceptive business acts or practices, including those relating to privacy and data security.

- **Truth in Lending Act (Regulation Z):** Requires creditors to provide disclosures concerning certain terms and conditions of their loan and credit transactions with consumers; regulates the advertising of credit and gives borrowers, among other things, certain rights regarding updated disclosures, billing error resolutions and the treatment of credit balances.

Online Small Business Lenders

Small businesses are vital for America. However, these businesses routinely lack access to necessary capital to maintain and expand operations. Online small business lending fills this critical gap for small businesses. Indeed, the innovation and affordability of online small business lending products serves to complement, rather than replace, traditional funding sources. Online lenders fund small and short-term loans to business owners very quickly. Access to capital allows small businesses to purchase inventory, cover operational costs, or provide capital to expand.

The bank partnership model provides services for an issuing depository institution to process loans and then purchase the loans to hold on their books or for sale to investors as whole loans or by issuing securities such as member-dependent notes. Under this model, lending platforms are not the lender because they do not originate the loans. Rather lending platforms are technology or outsource vendors rather than the actual lender. The issuing depository institution, expressed as a lender in the borrower's contract, is expected by its banking regulator to oversee the lending platform as a vendor.

Without clarity, small business lending through the bank partnership model would be hampered and could reduce the availability of credit for borrowers with lower FICO scores. According to a study[2] by law professors from Stanford, Columbia, and Fordham, approvals for borrowers, in Second Circuit states, with credit scores under 625 have seen a 52% reduction in credit availability. Outside the Second Circuit states, loan volume for those borrowers grew by 124%.

Digital Financial Services

The unprecedented recent advancements in technology continue to show great benefits for underserved consumers, as well as the broader economy. ETA members are constantly developing and deploying new products and services, bringing together traditional players and new participants. The innovation in this space delivers new products and services quickly, less expensive, and supports an inclusive financial system that provides high quality, responsible, secure, and affordable financial services for the broadest possible set of consumers.

A goal of ETA member companies is to continually enhance the electronic payments and financial ecosystem so that it is accessible for all consumers, while ensuring their transactions can be completed securely, efficiently, and ubiquitously. A key driver to achieving such a system is the development of new technologies that allow traditionally underserved consumers to access financial products and services.

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[2] Honigsberg, Colleen and Jackson, Jr., Robert J. and Squire, Richard C., How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment (August 2, 2017). The Journal of Law and Economics, Forthcoming. Available at SSRN: https://ssrn.com/abstract=2780215 or http://dx.doi.org/10.2139/ssrn.2780215

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Financial institutions and financial technology companies have transformed the financial landscape through the introduction of new technologies that expand access to and the number of financial offerings for consumers, lower costs, improve financial management, and increase transaction security. These products and services are continuing to evolve, offering innovative new financial opportunities for all consumers. A modern, flexible framework capable of evolving along with the technology it oversees is ideally suited to fostering continued innovation for the benefit of all.

Many of the most exciting developments emerge from partnerships between banks and FinTech companies. That partnership would be enhanced by clarity and guidance on the bank partner model, particularly when it comes to third-party payment providers. Payment providers often lack direct ownership of their product, and direct relationships with the national regulators. Instead, they must increasingly rely on intermediaries. ETA supports the goal of a national payments charter, and recommended that a carefully constructed, transparent approach to regulation that accounts for differences in risk-profile of each entity and business model while preserving the safety and soundness of the payments system is adopted.

Conclusion

ETA encourages policymakers to focus on a framework that ensures a positive policy environment – encouraging growth and innovation governed by common principles but tailored appropriately to a company's particular risk profile. Additionally, as companies increasingly offer a wide variety of products and services to reach a broad spectrum of consumers, especially low- to moderate-income consumers, and businesses, we encourage an intentional effort toward harmony. Financial technology is highly regulated at the federal and state level, and harmonization between regulatory schemes and prudential regulators and public policy is critical to fostering an environment where companies and consumers can flourish as digital banking continues to evolve. As the industry continues to evolve it is imperative the regulatory framework is equipped to embrace emerging capabilities without stifling progress. Providing the proper safeguards will both protect consumers and reassure the industry that they have the flexibility to innovate in a manner consistent with the principles of safety and soundness.

* * *

ETA would like to thank the Task Force for this opportunity to provide comments and to recognize your leadership handling these important issues. If you have any questions, please feel free to contact me directly or ETA's Senior Vice President of Government Affairs Scott Talbott at stalbott@electran.org.

Sincerely,

Jeff Patchen
Manager of Government Affairs
Electronic Transactions Association

cc: Members of the Financial Services Committee Task Force on Financial Technology



September 29, 2020

Preserving the Integrity of the Bank Charter: The Community Bank Perspective

The Independent Community Bankers of America, representing community banks across the nation with more than 52,000 locations, appreciates the opportunity to provide this statement for the record for today's hearing, "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age." We appreciate you raising the profile of fundamental questions that will determine the future of the American financial services landscape. We are pleased to share the community bank perspective on these critical questions.

Congress Must Assert its Authority Over the Fundamental Legal Framework of Banking

This is a time of transformative change in the financial services marketplace. Community banks welcome technological innovation, but we must also recognize that technological change underscores the importance of a robust legal framework to ensure consumer protection as well as the safety and soundness of our institutions and of the system as a whole. In addition, we must not allow technological change to erode the long-standing U.S. policy of separating banking and commerce, a policy created in the 1930s and in response to concerns about concentration of economic power. Separating banking and commerce ensures that the allocation of credit is independent and impartial. Mixing banking and commerce inevitably creates market distortions and leads to cross-sector consolidation. In the age of big data, social media and e-commerce conglomerates, this threat is greater now than it was in the 1930s.

Because the legal framework of banking is fundamental and the stakes are far reaching and significant, any changes to it should be debated and deliberated in Congress, not merely through oversight but through the legislative process. Only Congress has the requisite authority as well as the power to ensure consistent regulation and oversight across charters issued by different agencies. Agencies should not infringe upon congressional authority by, for example, creating new charters and conferring powers on non-depository institutions that have traditionally and with sound reason been reserved for such institutions. As we argue below, the Office of the Comptroller of the Currency's (OCC's) proposed fintech charter and payments charters are examples of "charter slippage" that carry harmful, unintended consequences. In addition, the industrial loan company (ILC), though not a new charter, has historically been limited and is offered by only a handful of states. A state chartered ILC has the power to operate nationwide. Prior to 2020, the FDIC had not approved deposit insurance for a new ILC for more than 10 years. As discussed below, we urge Congress to reexamine the significant risks posed by the ILC charter.

Policy Must Promote Innovation

Innovation in financial services is critical to a modern, and increasingly digital, economy. Innovation offers financial consumers the choices they have come to expect and the speed and ease of transactions that today's technology makes possible. Such innovation is also the key to the United States' international competitiveness. But we must not envision a false tradeoff between financial innovation and fundamental consumer and systemic protections. Significant financial innovation is occurring today within traditionally chartered institutions and in partnership with

cutting edge technology companies. As discussed below, the OCC's proposed rule to clarify which party is the "true lender" would promote such partnerships. Public policy can encourage this form of innovation by creating more flexible regulation for depository institutions.

Limited Purpose Charters: General Skepticism is Warranted

ICBA urges Congress to take a skeptical view of the creation of new limited purpose charters. In view of the evolution of other limited purpose bank charters—such as the ILC which is discussed more fully below—ICBA is concerned that any limited purpose fintech bank charter could end up having all of the advantages and benefits of a full-service bank charter without commensurate supervision and regulation. What begins as a narrow charter crafted to serve a particular demographic or a niche form of banking has the potential to grow and reshape the financial services landscape. Again, this potential calls for the intervention of Congress.

OCC Fintech Charter Would Distort Financial Marketplace

In 2018, the OCC indicated that it was open to accepting applications for national bank charters from non-depository fintech companies engaged in the "business of banking," though to date the agency has received none. While such a charter would subject online lenders and fintech companies to more oversight and regulation than they now have—particularly in the area of consumer protection—these companies would be subject only to limited safety and soundness supervision and examination and would not be subject to the Community Reinvestment Act (CRA).

A special-purpose national bank charter for fintech firms would create an unlevel regulatory playing field. ICBA supports the development of a fintech regulatory framework that is no less stringent than that which applies to insured depository institutions. The OCC should publish transparent capital and liquidity requirements for these firms that specifically address minimum levels considered appropriate for a fintech firm to be well capitalized. Fintech capital and liquidity requirements should be no less rigorous than those that apply to insured depository institutions. Such a framework would promote a fair regulatory system, protect consumers, and support safety and soundness at these companies.

ICBA strongly supports a District Court ruling that the National Bank Act "business of banking" clause only allows the OCC to issue charters to depository institutions. The OCC is appealing that decision to the 2nd Circuit Court of Appeals. ICBA has filed an amicus brief in support of the New York Department of Financial Services.

OCC Payments Charter Could Compromise the Federal Reserve Payments System

This summer, Acting Comptroller Brian Brooks announced his intent to launch a special payments charter before the end of 2020, which could be used by non-depository companies to access the Federal Reserve payments system and safety net.

The special payments charter raises many of the same concerns raised by the fintech charter. It could be used to access the Federal Reserve payment system and avoid state consumer protection laws. In addition, such a charter, which could be owned by commercial companies, could violate the long-standing principle of the separation of banking and commerce. Would the non-bank parent company of a new special purpose payments bank be subject to the Bank Holding Company Act (BHCA)? If not, the parent company would not be subject to capital and liquidity requirements and would not be required to act as a source of strength to its subsidiary payments bank. For these reasons, the special payments charter would create more risk in the Federal Reserve payments system.

Without explicit authority from Congress, OCC should not proceed with the issuance of these charters.

Industrial Loan Company Loophole Should be Closed

The ILC loophole allows commercial companies to own institutions, which are the functional equivalent of banks and effectively mix banking and commerce.

While no new ILC applications for deposit insurance were approved since the Dodd-Frank Act moratorium expired in 2013 until March of this year when the FDIC approved the applications of Square and Nelnet, we expect more technology and social media companies to seek to exploit the ILC loophole. This would shift the American financial landscape and give rise to a whole new dimension of risk, a threat not only to our prosperity and economic diversity but to consumer privacy and fraud on a massive scale. What's more, commercial owners of ILCs, unlike bank holding companies, are not subject to consolidated supervision. This constitutes a dangerous gap in financial safety and soundness oversight.

A Senate bill, the Eliminating Corporate Shadow Banking Act (S. 2839), would amend the Bank Holding Company Act to close the ILC loophole and grandfather existing ILCs. In addition, ICBA is advocating for a moratorium on ILC applications so that Congress can consider permanent closure of the loophole.

ICBA Supports "Valid When Made" Doctrine and OCC "True Lender" Proposal

The decision of the U.S. Court of Appeals for the Second Circuit in Madden v. Midland Funding LLC has created considerable uncertainty about the validity of interest-rate terms after a national or state bank sells, assigns, or otherwise transfers a loan.

In response to this decision, both the FDIC and the OCC are proposing regulations that would clarify that when a bank sells, assigns, or otherwise transfers a loan, interest permissible at the time the loan was made continues to be permissible following the transfer. ICBA strongly supports both the OCC and the FDIC proposed regulations regarding federal interest rate authority. We agree that the bank's power to make loans implicitly carries with it the power to assign loans, and therefore a national or state bank's authority to make loans at particular rates necessarily

includes the power to assign the loans at those rates. Denying an assignee – be it a bank or a non-bank – the right to enforce a loan's terms would effectively reduce the salability of loans, make lenders less willing to originate loans and thereby curtail access to credit, a critical ingredient of the economic recovery.

ICBA supports the "valid-when-made" doctrine which holds that if a loan is valid when it is made, with respect to the interest rate and other terms of the loan, then the loan remains valid and enforceable when assigned to another party.

The OCC has recognized that the "valid-when-made" doctrine cannot be fully implemented without clarification of the "true lender" in such loan transfers. For this reason, the OCC has issued a proposed regulation concerning when a national bank or a Federal savings association makes a loan and is the "true lender" in the context of a partnership between a bank and third party, such as a marketplace lender. Specifically, the OCC is proposing that a bank makes a loan if, as of the date of origination, it is named as the lender in the loan agreement or funds the loan.

ICBA endorses the OCC's proposed rule since it provides a clear and simple standard to determine when a bank makes a loan and is a "true lender" and thereby allows banks to fully exercise the authority granted to them under Federal law without incurring significant legal risks.

Moreover, if this proposal is adopted, it will allow the OCC to ensure that consumer regulations are not evaded once a national bank is considered the true lender. ICBA remains concerned with "rent-a-bank" schemes that are often set up for the sole purpose of avoiding state usury laws and other state consumer protections. Clarity surrounding the true lender doctrine would promote accountability and should not absolve either a bank or its third-party partners of their regulatory responsibilities.

Closing

Thank you again for convening today's hearing. The questions before the committee are fundamental to the future direction of American financial services and should be exclusively within the purview of Congress not the agencies. We urge you to assert your authority over these important questions and offer to work with you to develop and advance appropriate legislation.

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NAFCU

National Association of Federally-Insured Credit Unions

September 28, 2020

The Honorable Stephen F. Lynch
Chairman
Task Force on Financial Technology
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

The Honorable Tom Emmer
Ranking Member
Task Force on Financial Technology
Committee on Financial Services
United States House of Representatives
Washington, D.C. 20515

Re: Tomorrow's Hearing, "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age"

Dear Chairman Lynch:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to share our comments related to tomorrow's hearing, "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age." NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve 121 million consumers with personal and small business financial service products. NAFCU advocates for competitive equality between traditional financial institutions and fintech companies, which we generalize as nonbank institutions that reach consumers through digital channels. Both industrial loan company (ILC) charters and the Office of the Comptroller of the Currency's (OCC) payment charter frustrate the goal of establishing a level playing field by permitting recipients of either license to reduce the extent of federal supervision compared to traditional financial institutions.

At the supervisory level, both the OCC's special purpose payments charter and the existing ILC charter present the same problem. In each case, a nonbank company can evade regulation under the *Bank Holding Company Act* (BHCA), either because of a statutory loophole unique to ILCs, or because the entity does not accept deposits. Lack of BHCA coverage raises serious concerns regarding the quality and extent of supervision for these specialized banking entities. Chartering additional ILCs or granting new licenses to nonbank payments companies could also weaken the safety and soundness of the wider financial system.

Special Purpose Fintech Charter

The emergence of new, fintech-powered business models has accelerated the disaggregation of bank services. This has not only increased competitive pressure but also challenged depository-centric models of financial supervision. The diversity of fintech companies and their role in the broader financial sector may necessitate reconsideration of existing models of regulation in the long run; however, an immediate focus for regulators and Congress must be to ensure that fintech companies are operating on a level playing field relative to traditional financial institutions,

including credit unions. NAFCU has defined this focus in terms of compliance with federal consumer financial law, but adequate supervision is an equally important consideration.

Research suggests that fintech mortgage lenders may enjoy structural advantages as nonbanks; in essence, benefiting from reduced regulatory burden which corresponds with relaxed federal safety and soundness standards. One report presented at the Federal Deposit Insurance Corporation's (FDIC) April 2019 Fintech Symposium posited that 60 to 70 percent of "shadow bank" (i.e., nonbank lender) growth is likely due to regulatory arbitrage, and the rest due to advances in technology.[1] Other fintech companies may be enjoying reduced supervisory oversight even if they are subject to federal consumer financial law.

NAFCU recognizes that innovation depends on a fair, but flexible, regulatory regime for financial technology. Many credit unions partner with fintech companies to improve member service and historically these partnerships have proven invaluable to the growth and competitiveness of our industry. Accordingly, NAFCU has advocated for expanding opportunities for credit unions to access pilot programs or regulatory sandboxes to test new products or services. At the same time, we have cautioned that frameworks designed to encourage innovation must not favor certain market participants at the expense of others.

When the OCC first introduced its general plan for a special purpose charter for fintech companies, NAFCU recommended that the OCC retain the core features of a national bank charter; namely, capital and liquidity requirements. Our position then assumed what we believe now, which is that the recipient of a specialized charter must be supervised as if it were *bank*, even if its particular business model places greater emphasis on services other than deposit-taking or lending. In this regard, NAFCU remains skeptical of the OCC's assertion that it can offer a charter to a nonbank licensee which confers the benefits of national preemption, interest rate exportation, and other privileges that have traditionally supported banks' deposit taking and lending roles.

Payments Charter

The OCC's payments charter has been marketed as one way to bring payments companies within the supervisory fold, an idea premised on the assumption that payments companies are willing to subject themselves to OCC supervision in exchange for certain privileges. While preventing "leakage" of financial services activities into unregulated areas is a commendable goal, the reality of a specialized payments charter may be the same as with the OCC's general fintech charter.

Companies that have the ability and desire to operate with fewer regulatory constraints will continue doing so until regulatory barriers are lowered, possibly to such an extent that there is no meaningful containment of risk. In the absence of legislative action, the OCC must entice new entrants to accept additional oversight—a balancing act that is hardly conducive to maintaining a safe and sound banking system.

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[1] *See* Piskorski, Tomasz, Fintech and Shadow Banking (April 2019), available at https://www.fdic.gov/bank/analytical/fintech/presentations/piskorski.pdf.

The OCC's strategy for managing safety and soundness risks associated with its payments charter has also been obscured from public view. The Acting Comptroller introduced the payments charter informally, without notice and comment, and then determined—after hearing from a coalition of financial services trades that a transparent rulemaking should be preferred—that a discrete proposal was not required. [2]

NAFCU has also expressed concern with the OCC's view of traditional banking services. Public comments from the Acting Comptroller predict a future where institutions "that lack scale [...] will find themselves under pressure to consider unbundling or spinning off various functions." NAFCU finds that this perspective overlooks the important benefits of a full-service banking model and, more significantly, presumes that smaller, community institutions will not be able to provide a full range of services in the future. NAFCU disagrees with this assertion, but if the OCC is interested in testing the validity of its assumptions then it should put its new licensing proposals out for public comment. In this regard, Congress should encourage the OCC to work with other Federal Financial Institutions Examination Council (FFIEC) member agencies, including the National Credit Union Administration (NCUA), if it intends to perpetuate specialized chartering options that could impact overall financial sector stability.

Industrial Loan Companies

An ILC charter can offer certain nonbank parent companies the opportunity to skirt registration as a bank holding company and avoid consolidated supervision by the Federal Reserve.[3] This reduced oversight is further exacerbated by the fact that the FDIC lacks a complete range of statutory authority to fully supervise certain parent companies of ILCs.[4] As a result, the relationship between a nonbank parent and its ILC subsidiary lacks the degree of transparency and accountability intended by the BHCA while at the same time inviting potentially hazardous comingling of banking and commercial activities. In other words, the ILC charter frustrates a core principle of prudential regulation: that a bank's parent company should serve as a transparent source of strength rather than an opaque source of risk.

NAFCU believes that approving new ILC deposit insurance applications at this time could severely weaken the stability of the financial system and we have urged the FDIC to suspend further chartering activity for at least three years so that a fully informed analysis of supervisory risks can be conducted. Furthermore, given technology companies' interest in acquiring banks, the FDIC should also take heed of the unique privacy risks that might exist should consumer financial records find their way into the hands of nonbank parent companies through affiliate data sharing

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[2] *See* Cocheo, Steve, "Fintech Charters Signal a Tectonic Realignment in Banking," July 22, 2020, available at https://thefinancialbrand.com/98636/occ-comptroller-brian-brooks-fintech-charter-payments-innovation-crypto-branch/. *See also* Guida, Victoria, " Top regulator pushes ahead with plan to reshape banking, sparking clash with states," August 31, 2020, available at https://www.politico.com/news/2020/08/31/currency-comptroller-reshape-banking-406393.

[3] Cocheo, Steve, "Fintech Charters Signal a Tectonic Realignment in Banking," July 22, 2020.

[4] Under Section 10(b)(4) of the FDI Act, the FDIC is permitted to examine any insured depository institution, including an ILC, to examine the affairs of any affiliate, including the parent holding company, "as may be necessary to disclose fully (i) the relationship between the institution and the affiliate; and (ii) to determine the effect of such relationship on the depository institution." 12 U.S.C. § 1820(b)(4). However, this limited grant of authority is no substitute for the full range of examination powers necessary for consolidated supervision.

arrangements. A moratorium would also give Congress appropriate time to consider whether the ILC charter is conducive to advancing the goals of financial inclusion given the nonbank parent's limited accountability to its banking subsidiary.[5]

Today, with the pandemic continuing to place unique strains on financial institutions and their customers, it would be prudent for Congress to support a moratorium on new ILCs. The FDIC should be focused on helping ordinary consumers instead of devoting analytical and legal resources towards advancing the financial ambitions of technology giants.[6]

Conclusion

NAFCU believes that regulators should not give preference to fintech as a *new* model of banking ready to replace traditional institutions, but rather seek to modernize traditional supervisory frameworks to ensure that the promise of better, more efficient service and expanded access to credit is predicated on responsible innovation rather than regulatory arbitrage. In addition, we believe that regulators should not seek to introduce specialized chartering options without a full and transparent rulemaking process that invites careful consideration of how recipients of fintech-specific charters might impact the safety and soundness of the financial sector.

We ask that Congress consider a moratorium on future consideration and approval of ILC deposit insurance applications for at least three years so that the banking regulators can devote appropriate resources to help facilitate the nation's economic recovery from the COVID-19 pandemic.

NAFCU appreciates your attention to these important issues. Should you have any questions or require additional information, please do not hesitate to contact me or Sarah Jacobs, NAFCU's Associate Director of Legislative Affairs, at (571) 289-7550 or sjacobs@nafcu.org.

Sincerely,

Brad Thaler

Brad Thaler
Vice President of Legislative Affairs

cc: Members of the Committee on Financial Services Task Force on Financial Technology

[5] In contrast to BHCA banks, a non-BHC parent company would not be prohibited from commencing "new activities" if a subsidiary depository institution has a CRA rating that falls below satisfactory. See 12 CFR § 225.84.
[6] Hrushka, Ann, "Rakuten to continue ILC charter pursuit, subsidiary CEO says" (August 26, 2020), available at https://www.bankingdive.com/news/rakuten-to-continue-ilc-charter-pursuit-subsidiary-ceo-says/584189/.





The Honorable Stephen F. Lynch
Chairman
Task Force on Financial Technology
Committee on Financial Services
United States House of Representatives

The Honorable Tom Emmer
Ranking Member
Task Force on Financial Technology
Committee on Financial Services
United States House of Representatives

September 29, 2020

Dear Chairman Lynch and Ranking Member Emmer,

The National Association of Industrial Bankers[1] and the Utah Bankers Association[2] appreciate the opportunity to submit this statement for the record to the Task Force on Financial Technology, Committee on Financial Services, Hearing on "License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age".

I. Introduction

We applaud the efforts of the Task Force members to investigate the changing dynamics of financial services in America. It is important that Congress ensure that American businesses and families have access to basic financial services, but with robust consumer protections.

[1] First chartered in 1910, industrial banks operate under a number of titles – industrial banks, industrial loan banks, industrial loan corporations and thrift and loan companies. Industrial banks provide a broad array of products and services to customers and small businesses nationwide, including some of the most underserved segments of the U.S. economy. NAIB members are chartered in California, Nevada and Utah.

[2] The Utah Bankers Association is the professional and trade association for Utah's commercial banks, savings banks and industrial banks. Established in 1908, the UBA serves, represents and advocates the interests of its members, enhancing their ability to be preeminent providers of financial services.

We are also grateful that Industrial Loan Corporations (ILCs) are included in the discussion for this hearing. The purpose of this statement is to provide key facts regarding ILCs for the Task Force to consider and to correct certain misleading arguments made by the detractors of ILCs.

In this regard, we ask the Task Force to note the information we provide is based upon quantitative sources such as FDIC call reports, premier academic analysis and judgments of state regulators. We encourage the Task Force to review the statement submitted by the Utah Department of Financial Institutions. Furthermore, we recommend "A New Look at the Contribution and Performance of Industrial Loan Companies to the US Banking System" by James R. Barth and Yanfei Sun, Department of Finance, Auburn University, July 2017
(Link: http://industrialbankers.org/wp-content/uploads/2018/10/ILC_REPORT_BARTH_2018.pdf)

II. ILCs are among the safest, strongest financial institutions in the nation

For decades, FDIC call reports have consistently confirmed ILCs are well capitalized, safe and strong. This FDIC data shows that in comparison to commercial banks, ILCs are better capitalized, have a higher return on assets (ROA), and are generally more profitable. The statement filed by the Utah Department of Financial Institutions emphasizes "the Department calculates an average Return on Average Assets ratio of 1.04 percent for FDIC insured depositories, whereas industrial banks average 2.48 percent." These numbers are not just a snapshot in time; ILCs have consistently outperformed other banks in both ROA and capital-to-assets ratios for the past 35 years.

During the Great Recession, all but one ILC survived (most remained profitable). The Federal Reserve did require several entities to close the operations of the ILC they owned as a condition of receiving TARP funding. All of these ILCs were sound prior to the closure - none required assistance.

Yet, despite the incontrovertible evidence, there are voices who continually claim that ILCs present a threat to the FDIC banking system. Please note, these allegations are frequently made without any documentation. There is no evidence which disputes the strength of the ILC model.

III. ILCs are an intentional creation of Congress.

The ILC exemption from the Bank Holding Company Act ("BHCA") was an intentional creation of Congress when it enacted the Competitive Equality Banking Act of 1987 (CEBA). This status was not an accidental oversight. Congress made that decision in order to allow the continuing development of industrial banks, which were subject to regulatory oversight as banks but were owned by companies exempt from the BHCA's activity restrictions. In the 33 years since the enactment of CEBA, Congress has repeatedly visited and modified the regulatory structure for our nation's banks and chosen to leave the regulatory structure for ILCs intact. Congressional intent in this area is clear. Gramm-Leach-Bliley, which ended commercial ownership of unitary thrift holding companies, left ILCs untouched. During negotiations of what became the Dodd-Frank Act, the Administration recommended removing the ILC exemption from the BHCA, but Congress chose not to do so.

IV. ILCs are highly regulated by federal and state regulators

The FDIC and state regulators have broad authority over both ILCs and their parent companies to take any and all actions necessary to protect the bank, its depositors and the deposit insurance fund. The FDIC has frequently affirmed its authority to regulate the industrial banks and their transactions and relationships with their parents and affiliates.

First and foremost, the ILCs are regulated by both their chartering state and the FDIC and must comply with all relevant safety and soundness regulations, and all consumer protection regulations.

The FDIC's recent rulemaking to codify existing regulatory practices further highlights the agency's ample authority to ensure that the parent company of an ILC, be it financial or commercial, does not pose a risk to the institution or to the U.S. financial system. Both the state regulators and the FDIC have the authority to examine for compliance with Federal Reserve Act Sections 23A and 23B and ensure that the ILC and its parent interact in a safe and sound manner. They can also require that the parent serve as a source of strength to the bank should it become distressed. The regulators can examine the parent company's records and management of the ILC as needed should concerns arise. Finally, as former FDIC Chairman Martin Gruenberg noted, the FDIC and the appropriate state banking regulator can limit the activities an ILC can engage in with a parent or affiliate if they are concerned about those activities' impact on the institution.

Many critics also raise concerns about conflicts of interest between an ILC and its affiliates but fail to understand how Sections 23A and 23B of the Federal Reserve Act - applicable to all industrial banks and their affiliates under provisions of the Federal Deposit Insurance Act - effectively prevent any such conflicts of interest. ILCs operate as fully independent entities and can only engage in transactions with affiliates that benefit the bank.

V. ILCs are innovative partners

The ILC model allows for innovative but safe products for American consumers. Fintechs and other financial service companies continually seek partnerships with ILCs to provide these services. These are partnerships that should be encouraged by Congress. In all cases, the regulators require the ILCs treat all loans the same, even if that loan is sold. The ILC is responsible for full legal compliance through advertising to servicing to collections regardless of whether it holds the loan.

Also, some innovative financial service companies may seek an ILC charter. The rules promulgated by the FDIC and state authorities make this extremely difficult and require a number of commitments from the parent company. Our association fully supports such rigorous demands. The ILC model has worked because it is heavily regulated and requires intense capitalization. Yet, they remain innovative and flexible.

Some "fintech" companies have considered applying for an ILC charter. One such company, Square, was recently approved for an industrial bank charter and federal deposit insurance. It is important to understand that this represents an opportunity only for a company with well-developed products and services that is ready to comply with the broad range of standards and requirements applicable to all

banks to help ensure they operate safely. Companies in the early stage of development do not qualify. For various reasons including the restrictions in Sections 23A and 23B, mega technology companies such as Amazon cannot own a bank offering loans and other financial services to customers of an affiliate. Those large tech companies can offer a full array of banking services to their customers – the activities critics say pose a systemic risk to the economy and banking industry – by partnering with an independent bank, and many do that now.

VI. ILCs benefit American consumers with safe innovative financial services

In summary, ILCs are among the safest and soundest banks in the U.S. system, and they do not create systemic risk. What they do create is competition and innovation in the U.S. banking system. ILCs are small, innovative banks that help create and test new products for consumers and businesses.

Again, we appreciate the opportunity to submit this statement for the record and are grateful for the efforts of the Task Force members and staff. Please let us know if you have any questions or need additional information.

Sincerely,





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President

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Varo

September 28, 2020

Chairman Stephen Lynch
House Financial Services Committee,
Fintech Task Force
2109 Rayburn House Office Building
Washington, DC 20515

Ranking Member Tom Emmer
House Financial Services Committee,
Fintech Task Force
315 Cannon House Office Building
Washington, DC 20515

Dear Chairman Lynch and Ranking Member Emmer,

Varo Money, Inc. (Varo) is interested in the Task Force's virtual hearing entitled "License to bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age." Varo thanks the Chair for allowing us the opportunity to submit this letter and Varo respectfully requests to have this letter entered into the hearing record. Varo is the first fintech that has obtained a de novo full-service national bank charter from the Office of the Comptroller of the Currency ("OCC"), deposit insurance from the Federal Deposit Insurance Corporation ("FDIC") and approval to be a bank holding company from the Federal Reserve. Varo Bank was established on August 1, 2020.

Varo is proud to be the first fintech to have met the exacting and rigorous standards of the U.S. banking agencies to become a full service national bank. Varo is committed to developing and offering new, state of the art products designed to meet consumers' needs for financial services in a fair, transparent and efficient manner. Varo will fully deploy our new technology to offer the best solutions to hardworking, everyday American consumers.

Varo and its Mission

Varo's mission since its founding in 2015 has been to provide American consumers with the tools, products, and insights to achieve greater financial resiliency and prosperity, regardless of their current financial situation or geographic location within the US. I had spent decades in traditional banking seeing a system of haves and have nots that left many consumers with little economic opportunity while big banks catered to customers with higher levels of wealth and income. Financial inclusion was talked

about, but action was limited. As I designed Varo, I made sure inclusion and impact were integrated into the core business of the company.

Decision and Process to Become a National Bank

Prior to obtaining the bank charter, Varo offered deposit products and services through a sponsor bank relationship, i.e. Varo was the marketing partner for a state chartered bank pursuant to which Varo accounts were marketed and serviced by Varo but were deemed for legal purposes to be originated and owned by the state chartered bank. The sponsor bank relationship allowed Varo to begin offering affordable demand deposit and savings products and gain valuable insights into the financial problems everyday Americans are trying to solve.

Varo pursued the national bank charter for the following reasons:

(1) To become part of the regulated national banking system as a chartered bank, allowing Varo to directly access the payment systems and become a direct member of the FDIC without dependence on a sponsor bank;
(2) To allow Varo to offer a full spectrum of banking products such as deposit products (including checking, savings, certificates of deposits) and loan products (including installment loans, open end lines of credit, credit cards and mortgages) to better meet its customers financial needs, and;
(3) To operate on Varo's own state of the art technology stack[1], enabling Varo to reduce its operating costs and bring true financial innovation to millions of Americans who need a better bank.

With the charter, Varo is building on its current offering of premium transaction banking services with new innovative products designed around the key financial pain points of everyday American consumers.

Varo evaluated various chartering options and concluded a de-novo OCC national bank charter was the best course of action given its primary business is banking and operates with a national footprint.

The national bank chartering process was a journey that took three-and-a-half years. Varo received approval from three separate regulatory authorities to obtain the bank charter, provide insured deposits

[1] Varo's technology stack is a suite of technology solutions/services that Varo uses to build and run its applications.

and have a bank holding company. Each of these authorities have their own stringent requirements, processes, and timelines. To obtain approval in connection with a bank charter, Varo had to provide all three of the regulatory authorities with detailed information about its business plans, policies and procedures, senior management teams, capital adequacy, and risk-management infrastructure. In addition, all of the Varo senior executive officers and board of directors had to provide detailed financial information and detailed information about their qualifications to operate the bank, as well as undergo stringent background checks. This information is not required from companies that are not overseen by these three regulatory authorities even if they are providing financial products to consumers.

As a regulated bank, Varo is subject to the Community Reinvestment Act. Varo has submitted to and had approved a Community Reinvestment Act Strategic Plan by the Office of the Comptroller of the Currency. Varo is committed to helping to meet the financial services needs of low and moderate income consumers in its core business and as part of fulfilling its CRA Plan.

Other fintechs have started to follow Varo's playbook to pursue a banking charter and move away from the sponsor bank model, but there are no shortcuts and no guarantees as some have tried and withdrawn their applications.

Varo Bank, N.A.

Varo is the first consumer fintech to operate directly within the US national bank regulatory framework. In other markets around the world, regulators have chartered fintech banks ("challenger banks") notably in the UK, Europe and Asia. Varo's charter is an example of the US regulators commitment to remain competitive in a dynamic, rapidly changing financial services market.

Varo is powered by a combination of seasoned bank executives who are familiar with banking regulations and also technology executives who are building a bank with the latest technology. With the business model and the technology in place, Varo is able to meet the demands of the millions of hardworking, everyday Americans who need a better bank.

Varo Bank, N.A. is a fully digital bank, accessible anytime on a smartphone, tablet or computer. This allows Varo to provide banking services across the US without regard to geographic location and also allows consumers to access banking services 24/7 and not tied to hours that branches are open.

According to the Pew Research Center's Mobile Factsheet,[2], 81% of Americans own a smartphone and over 75% own a computer. Roughly 71% of Americans earning less than $30,000 per year own a smartphone, rising to 95% for Americans earning over $75,000. Access to a smartphone or computer has steadily risen over the past few years - unlike access to physical bank branches, which declined 12%[3] from 2010-2019 as banks closed 12,000 branches. These branch closures are effectively creating banking deserts in many lower income and minority communities across the country - making digital banks like Varo all the more valuable to these communities. This is a trend that Covid-19 is accelerating.

Varo offers products to address the core needs of consumers including transaction accounts, savings and credit products. Varo is able to meet customers where they are on their own financial journeys and help them climb the ladder to achieve greater resilience and prosperity. Varo's highly-efficient, modern technology means we can serve consumers with premium banking products profitably and sustainably.

Varo is the first and only fully digital bank that is built from the ground up on the latest technology. Varo's modern technology enables advanced personalization, leveraging real-time data and operating sophisticated risk management capabilities including fraud detection, anti-money laundering, and cybersecurity.

Varo's technology and products support the bank's continued expansion to meet a broad set of key customer needs, wholly centered on financial wellbeing with an inclusive design. Varo provides all of its services digitally (including an account opening and servicing process that is paperless), including the ability to deposit, withdraw and transfer money. Varo offers U.S. phone and email-based customer service seven days a week.

Varo's Impact

Varo is having a substantial impact on helping the everyday American consumer.

For example:

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[2] https://www.pewresearch.org/internet/fact-sheet/mobile/
[3] https://www.bankingdive.com/news/us-bank-branch-closures-coronavirus/578860/

- Varo offers transaction and savings accounts with no minimum balance or account fees, access to 55,000 free ATM's and free mobile check deposit. These products include auto savings features such as "Save Your Change" and "Save Your Pay".

  With the Save Your Change Feature, every time the customer makes a purchase with the debit card, the purchase amount is rounded to the nearest dollar, and the difference between the purchase amount and the rounded amount is deposited into the customer's savings account. With the Save Your Pay feature, every time the customer receives a payroll direct deposit, an amount selected by the customer is swept from their checking account into their savings account.

  Varo has helped many customers start saving for the first time. These savings accounts and auto savings features have allowed our customers to save over $100 million. With 40% of Amerians lacking the savings to cover a $400 surprise expense, Varo is making it easy to save and build financial resilience.[4]

- In August of 2019, Varo introduced a No Fee Overdraft feature that allows a qualified customer to overdraw their account by $50 with no interest or fees for 30 days. After just one year in the market, this feature has saved customers over $100 million in overdraft fees. To compare, big banks assessed over $11 billion in overdraft fees in 2019 alone.

- Varo offers an early paycheck feature that allows customers to receive their paycheck up to two days earlier. In Q2 2020 alone, Varo processed over $280 million in early payroll deposits, putting more money into customers' hands faster and giving our customers more control over their finances.

  During the COVID crisis, Varo proactively identified account holders likely to receive stimulus funds and in some cases reached out to them directly to ensure they had a valid debit card in order to access those funds when they hit their account. Using Varo's early payday technology, we processed those checks two days early, meaning that customers could access and use that money

[4] FRB, Report on the Economic Well-Being of U.S. Households in 2017, at May 2018, page 2, available at https://www.federalreserve.gov/publications/files/2017-report-economic-well-being-us-households-201805.pdf.

sooner. When 59% of Americans used that money for food, utilities, and other core expenses, according to the Bureau of Labor Statistics, two days can mean a big difference.

- Varo offers customers an instant peer-to-peer payments service, where Varo customers can transfer money to other Varo customers in real time. This is a popular feature within the Varo community.

- In addition, Varo has built a network of 18 partners in Varo's "Offers tab" who can help customers with insurance, credit building and repair solutions, bill reduction, earning cash back, and finding additional income or a new job.

As more Americans than ever are living paycheck to paycheck, and with nearly 30 million people drawing unemployment benefits due to the COVID-19 pandemic, a bank that acts as a true partner in the financial health of its customers has become more necessary than ever. Varo is that partner.

We believe that Varo is demonstrating how fintechs can operate within the bank regulatory ecosystem and provide to consumers a wide range of products and services that will help them build greater financial resiliency and afford them robust consumer protections. Varo is expanding financial inclusion and working hard to improve the financial health of individuals, households and communities across the country.

We thank the Task Force for their interest and for inviting Varo to submit this statement.

Sincerely,

Colin Walsh
CEO and Chairman, Varo Bank, N.A.

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