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REGULATORY POLICY

OCC vs. New York DFS: Battle for the Future of FinTech

BY JEFFREY ALBERTS AND INGRID HE

In the rapidly developing world of financial technology it often is unclear who has the legal authority to regulate the activities of newly created companies. Many of these companies do not neatly fit into any established regulatory scheme. However, answering the question of who will be creating the regulatory rules for FinTech companies is important both for regulators and the FinTech companies themselves.

Right now, a major battle is under way between state and federal regulators who are competing to draft and enforce the rules that will guide the future development of the FinTech industry. This battle recently has spilled out from behind the closed doors of bureaucratic negotiation into open public attacks and lawsuits, creating even greater uncertainty amongst FinTech companies about their future regulatory obligations.

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State Regulators Want to Regulate FinTech

To understand what brought these regulators, who usually strive to appear cooperative in the eyes of the public, to openly attack one another, it is necessary to look at how state and federal regulators have responded to developments in the FinTech industry. Over the past several years, state regulators have been staking out positions as leading regulators of FinTech companies. For example, in June 2015, New York's Department of Financial Services (DFS) promulgated rules for the licensing of virtual currency companies, which the DFS itself dubbed ''BitLicenses.'' Other state regulators, such as the Washington State Department of Financial Institutions, the Texas Department of Banking and the Connecticut Banking Department have instituted, or been granted authority to promulgate, similar regulations.

OCC Issues FinTech White Paper

During this same period, federal regulators have announced the intention to assert control over the regulation of FinTech companies. The argument for federal regulation was advanced in its most compelling form in December 2016, when the Office of the Comptroller of Currency (OCC) published a white paper (FinTech White Paper) announcing that the OCC was considering granting special purpose national bank (SPNB) charters to FinTech companies. The OCC framed its

goal in proposing these ''FinTech Charters'' as keeping up with the innovative technologies in the financial sector and responding to the rise of ''technology-driven nonbank companies offering a new approach to products and services,'' which services had previously only been available ''from traditional banks or not available at all.'' (FinTech White Paper at 1.)

The OCC indicated that its authority to grant FinTech Charters to nonbank FinTech companies stems from 12 C.F.R. § 5.20(e)(1), which states that the agency may grant such charters to institutions that conduct ''at least one of the following three core banking functions: receiving depositions, paying checks, or lending money.'' (*Id*. at 3.) In the OCC's supplemental manual for applying for FinTech Charters, the OCC made clear that it anticipates most applications to be from institutions seeking to demonstrate that they are engaged in paying checks or lending money, rather than institutions that receive deposits. (Supp. Manual at 5.) This presumably is because most companies that do receive deposits would be potentially eligible for a national banking charter through the traditional chartering process.

The underlying justification for the proposed FinTech Charters advanced by the OCC was that it would enable FinTech companies to streamline their regulatory compliance activities by focusing on only federal regulations. The White Paper nevertheless pointed out that coordination among the federal agencies such as the Federal Reserve, Federal Deposit Insurance Corporation, and Consumer Financial Protection Bureau would still be expected. (Fintech White Paper at 7.)

In response to concerns from traditional banks that certain companies receiving FinTech Charters would not be depository institutions subject to the FDIC's regulations, resulting in these FinTech companies receiving an unfairly lower regulatory burden, the OCC indicated that while it is true that in some cases an ''SPNB that does not take deposits will not be subject to certain requirements that apply only to insured depository institutions . . . [t]he OCC has the authority to impose special conditions requiring the applicant to comply with standards that generally apply only to insured banks.'' (FinTech White Paper at 7 & n.21.)

DFS's Public Criticism of the OCC

While industry insiders had predicted the possibility of inconsistency, or even tension, between the OCC and the DFS, most assumed that this would be worked out behind closed doors. After all, state and federal regulators regularly work together to regulate the same financial institutions. While their regulations are sometimes inconsistent, state and federal regulators generally resolve these issues outside of the public eye.

From its first response to the OCC's FinTech White Paper, however, the DFS made clear that it was willing to take its gloves off to defend its jurisdiction over FinTech companies. In the DFS's comment letter on the OCC's proposal, DFS Superintendent Vullo did not limit herself to making policy arguments about how national regulation can interfere with state regulatory experimentation or with the ability of state regulators to respond to unique demands of businesses in their jurisdiction. Rather, Superintendent Vullo directly attacked the OCC itself. For example, she concluded her letter by stating that ''the proposed 'fintech' charter substitutes an effort to appear innovative for a complicated, problematic new regulatory regime.'' (DFS Comment Letter at 8.) This language was tantamount to an accusation that the OCC was not only advancing a badly drafted regulation, but was promulgating it in bad faith: not as a poorly designed attempt to innovate, but rather as an attempt to *appear* innovative.

Similarly, Superintendent Vullo went beyond touting the experience of state regulators in overseeing FinTech companies to accusing the OCC of failing to do its job as a banking regulator. Perhaps most shockingly, Superintendent Vullo suggested that the OCC's ineptitude as a regulator permitted HSBC Bank US to engage in the money laundering transactions that resulted in HSBC being fined $1.9 billion in 2012. (*Id.* at 2- 3.) She noted that ''HSBC Bank US was chartered by NY DFS until June 2004 when it became regulated by the OCC'' and further noted that at the time HSBC obtained an OCC charter, ''HSBC was under a Written Agreement with the NY DFS . . . due to shortcomings in its BSA/AML program.'' (*Id.* at 3 n.2.) She then pointed to the imposition of the $1.9 billion fine on HSBC for money laundering violations and concluded, ''[i]n short, the switch in regulators did not enhance supervision of HSBC's faulty compliance program or encourage remediation of the flaws that NY DFS had identified.'' (*Id.*) In other words, Superintendent Vullo was implicitly arguing that the OCC should not start issuing FinTech Charters to FinTech companies regulated by the DFS because the OCC previously failed to properly oversee HSBC when it took over from the DFS as HSBC's regulator.

The Lawsuit

The DFS did not limit itself to criticizing the proposed FinTech Charters. On May 12, 2017, the DFS filed a lawsuit against the OCC in the District Court for the Southern District of New York, alleging that the OCC's proposed FinTech Charters exceeded the agency's statutory authority under the National Banking Act and violated the Tenth Amendment. Based on these claims, the DFS sought declaratory and injunctive relief that would declare the proposed FinTech Charters to be unlawful and prohibit the OCC from creating or issuing these charters in the absence of express authorization from Congress.

As in the DFS's previous attacks on the OCC's proposal, the filed Complaint did not pull any punches. In the second paragraph of the Complaint, the DFS described the OCC's decision to issue FinTech Charters as ''lawless, ill-conceived, and destabilizing of financial markets that are properly and most effectively regulated by New York State,'' further noting that it ''puts New York financial consumers – and often the most vulnerable ones – at great risk of exploitation by federally-chartered entities improperly insulated from New York law.'' (Complaint at ¶2.) This paragraph concluded with the inflammatory declaration: ''The OCC's reckless folly should be stopped.'' (*Id.*)

This litigation is pending, and the OCC has not yet filed an Answer to the Complaint.

Where Things Stand for FinTech Companies

While streamlining and clarifying the regulatory framework may have been the OCC's goal, in some

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ways the regulatory landscape has become more confusing for FinTech companies.

First, as the DFS asserts in the pending lawsuit, it is questionable whether the OCC has statutory authority to issue SPNB charters to nontraditional banks. If the DFS prevails in its lawsuit, then the OCC may never issue SPNB charters to FinTech companies.

Second, regardless of the ultimate outcome of the DFS's lawsuit against the OCC, there will still be no clarity on the proposal while the lawsuit is pending. The current lawsuit may not be resolved before the district court this year, and appellate litigation could further delay the ultimate resolution of this issue.

Third, even if the OCC prevails and begins granting FinTech Charters, state agencies such as the DFS will still attempt to regulate FinTech companies. This could lead to future disputes over the nature and scope of the federal preemption of state regulations, which will add to the confusion over which regulations apply to which FinTech companies.

Fourth, the requirements of the proposed FinTech charters are themselves unclear. Although the OCC published a licensing manual supplement to guide potential applicants on the FinTech chartering process, the manual provided limited detail and practical guidance. For example, the OCC indicated that it "will not approve proposals that are contrary to OCC policy or other established policy" and set forth several very general factors that it will consider in evaluating applicants, such as whether the entity:

- has organizers and management with appropriate skills and experience.
- has adequate capital to support the projected volume and type of business and proposed risk profile.
- has a business plan that articulates a clear path and a timeline to profitability.
- includes in its business plan, if applicable an FIP that has an appropriate description of the proposed goals, approach, activities, and milestones for serving the relevant market and community. (Supp. Manual at 6-7.)

While these guidelines have relatively well-defined meanings for traditional banks, it is much less clear how regulators will apply requirements such as adequate capitalization and sufficiently detailed profitability milestones to FinTech companies, many of which are relatively small start-ups.

As if the stated requirements were not themselves sufficiently vague, the OCC made clear that it was not limited to these requirements and would "impose special conditions in connections with the charter approval," including "special conditions requiring [a non-depository] applicant to comply with standards that generally apply only to insured banks [under the Federal Deposit Insurance Act (FDIA)]." (*Id.* at 7 & n.21.) FinTech companies can only speculate as to what these additional requirements will be and whether they will be less burdensome than alternative state requirements.

Furthermore, because these "special conditions" are non-public, it will be difficult for unchartered FinTech companies to predict what conditions to expect even after the OCC starts imposing them on chartered FinTech companies. The special conditions that accompany FinTech Charters are "[n]on-public information" under 12 C.F.R. § 4.32(b)(1)(i)(A), which means they may not even be subject to disclosure under the Freedom of Information Act (FOIA). This lack of transparency surrounding the requirements that accompany a FinTech Charter makes it difficult for FinTech companies to decide whether to pursue such charters and to begin preparing to become compliant with these regulatory requirements in anticipation of applying for FinTech Charters.

As a result of these issues, FinTech companies have little idea what the future regulatory terrain will look like. This uncertainty makes it difficult for companies to predict the future regulatory cost of business decisions they would like to make today. It also concerns investors, who are worried that regulatory burdens could severely impact the profitability of FinTech companies. For now, those in the FinTech industry are hoping that state and federal regulators will resolve their differences and clarify the regulations that will apply to FinTech companies. Until then, regulatory uncertainty will continue to impede the growth of FinTech companies in the United States.