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Treasury Department Issues Regulatory Report on Fintech and Innovation

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Reforms that expand horizons for nonbank financial companies were recently recommended in the Treasury Department's July 31, 2018 report entitled "A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation" (the "Report").[1] With the Treasury Department's support, the pace of technological advances in the delivery and digitization of financial services and the economy, and capital inflows to the financial technology ("fintech") sector, will accelerate. This Alert highlights elements of the Report that are of special interest to investment and asset management professionals.

Noting emerging trends in financial intermediation, such as rapid advances in technology, increased efficiencies from the rapid digitalization of the economy and the abundance of capital available to propel innovation, the Report addresses the regulatory landscape for certain nonbank financial firms, newer business models employed by technology-based firms and the ability of banks to innovate both internally and in partnership with technology-based firms. The Report identifies opportunities to modernize regulation that embrace the use of data, encourage the adoption of advanced data processing and other techniques to improve business processes and support the launch of alternative product and delivery services. Certain key themes and specific recommendations are discussed below.

1. Embracing Digitization, Data and Competitive Technologies. The Report highlights the evolution of digitization, data and scalable technologies in connection with innovation in financial services areas such as lending, financial advice and payments. The report makes recommendations intended to improve consumers' access to data and its use by third parties that would support better delivery of services. Specific recommendations include:

    - Removing legal and regulatory uncertainties currently holding back financial services companies and data aggregators from forming data-sharing agreements to allow for more secure and efficient methods of data access.

    - Coordinating with public and private sector actors to develop a solution that addresses data sharing, standardization, security and liability issues.

    - Enacting a federal data security and breach notification law to protect consumer financial data and ensure notification of breaches in a timely and consistent manner.

    - Streamlining of "digital legal identity" initiatives to improve financial inclusion and enable the use of scalable, competitive technologies.

[1] Available at *https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation.pdf*. The Report is the fourth and final report to the President under Executive Order 13772 on Core Principles for Regulating the United States Financial System. The first three reports addressed Banks and Credit Unions (June 2017), Capital Markets (Oct. 2017) and Asset Management and Insurance (Oct. 2017).

- o Further development and incorporation of cloud technologies, machine learning, and artificial intelligence into financial services.

2. Aligning the Regulatory Framework to Promote Innovation. The Report encourages modernizing and harmonizing state and federal financial regulation to address evolving characteristics of the financial services industry. Specifically:

   - o Harmonizing State Laws: The Report urges state financial regulators to harmonize regulations to ease the challenges of varying state-specific licensing requirements by drafting new model laws that could be uniformly adopted. The Report also encourages states to coordinate examinations and encourages joint examinations of individual firms where appropriate.

   - o OCC Special Purpose National Bank Charters for Fintech Companies: The Report encourages the Office of the Comptroller of the Currency (the "OCC") to develop its special purpose national bank charter (the "SPNB Charter")[2] for non-deposit-taking financial companies, which would consolidate regulatory oversight with a single primary regulator. As proposed, the SPNB Charter would allow fintech companies that make loans or engage in payments activities to:

     - Adhere to a uniform set of national banking rules, rather than seeking state-by-state lending or money transmission licenses or partnering with banks to access bank charter benefits (*e.g.*, the ability to export interest rates);

     - Operate without FDIC deposit insurance, to the extent that applicants would not take deposits; and

     - Be subject to the same standards and level of supervision as similarly situated national banks, including with respect to capital, liquidity, consumer protection, and financial inclusion requirements based on the business model and risk profile.

     As proposed, the SPNB Charter could preempt certain state laws and trigger baseline supervisory expectations that apply to any national bank, including, for example: a business plan that must assess risks comprehensively; capital adequacy; liquidity; compliance risk management; consumer protection and fair lending compliance; finan-cial inclusion; recovery and resolution planning; governance; and Bank Secrecy Act/anti-money laundering requirements.

   - o Encouraging the Partnership Model to Promote Innovation and Redefining "Control" under the BHC Act: The Report encourages banking regulators to tailor and clarify guidance relating to bank partnerships with nonbank financial firms, in particular smaller, less-mature companies with innovative technologies that do not present a material risk to the bank. The Report recommends certain changes to permissible activities, including bank activities relating to acquiring or investing in nonbank platforms.

     The Report notes that the restrictions on bank holding companies' ("BHC") permissible activities and investments present several interrelated challenges to innovation efforts. In particular, the current application of the BHC definition of "control" can discourage investments by banks in fintech-related firms because (1) under the current framework, fintech firms receiving BHC investments could be deemed to be a BHC

[2] The OCC SPNB Charter was proposed through a series of OCC announcements. See Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies* (Dec. 2016), available at *https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf*; *Summary of Comments and Explanatory Statement: Special Purpose National Bank Charters for Financial Technology Companies* (Mar. 2017), available at *https://www.occ.gov/topics/responsible-innovation/summary-explanatory-statement-fintech-charters.pdf*.

affiliate, subjecting them to BHC-related regulations, including certain activities restrictions; and (2) "control" can be difficult to determine because it relies upon Federal Reserve discretion under a process that is not entirely transparent. The Report recommends that the Federal Reserve consider how to reassess the definition of control to provide a simpler and more transparent standard to facilitate innovation-related investments.

3. <u>Updating Activity-Specific Regulations</u>. The Report suggests specific recommendations for regulatory reform for various activities and industries, including, among others:

   - <u>Marketplace Lending</u>: The Report recommends that Congress codify the "valid when made" doctrine and the role of the bank as a "true lender" of loans it makes, and for federal banking regulators to use available authorities to address challenges, in order to eliminate constraints brought about by recent court cases that may inhibit the functioning of U.S. credit markets.

   - <u>Mortgage Lending and Servicing</u>: Noting that nonbank financial firms' early adoption of financial technology innovations (*e.g.*, speeding up and simplifying loan applications and approvals of mortgage applications) has dramatically increased the market share of nonbank lenders in the primary residential mortgage market since the financial crisis, driven in part by the post-crisis regulatory environment, the Report recommends that policymakers address regulatory challenges that discourage broad primary market participation and inhibit the adoption of technological developments with the potential to improve the customer experience, shorten origination timelines, facilitate efficient loss mitigation and generally deliver a more reliable, lower cost mortgage product, allowing traditional deposit-based lender services to compete on an equal playing field.

   - <u>Student Lending and Servicing</u>: The Report recommends that the Department of Education help set expectations about how the servicing of federal loans is regulated, including by establishing and publishing minimum effective servicing standards that provide clear guidelines to the extensive network of nonbanks currently providing servicing and debt collection services. Specific recommendations relate to greater use of technology in communications with borrowers, enhanced portfolio monitoring and management by the Education Department and increased institutional accountability for schools participating in federal financial aid programs.

   - <u>Short-term, Small-dollar Lending</u>: The Report recommends that the Consumer Financial Protection Bureau (the "CFPB") rescind its Payday Rule, which applies to nonbank short-term, small-dollar lenders, because states already maintain the necessary regulatory authorities and the rule would restrict consumer access to credit. The Report also recommends that federal and state banking regulators take steps to encourage prudent and sustainable short-term, small-dollar installment lending by banks.

   - <u>Payments/Money Transmitters</u>: The Report recommends that states work together to harmonize money transmitter requirements for licensing and supervisory examinations, and urges the CFPB to provide more flexibility regarding the issuance of remittance disclosures. Further, the Report encourages the Federal Reserve to work to facilitate a faster retail payments system (*e.g.*, by developing a real-time settlement service that would increase access to innovative technologies and payment services).

   - <u>Wealth Management and Digital Financial Planning</u>: The Report notes the increased costs and potential for unnecessary barriers to the development of digital financial planning services posed by the patchwork of regulatory authority—many financial planners are regulated by the SEC or state securities regulators but may also be regulated by the CFPB, federal or state banking regulators, state insurance commissioners, state boards of accountancy or state bars—and recommends that an appropriate existing regulator of a financial planner be tasked with primary oversight of that financial planner and other regulators defer to that regulator.

For investment and asset managers, the Report spotlights regulatory support for rapid technological disruption in segments of the financial services industry. It should accelerate the already quick pace of investment in new financial technologies and fintech entrants.

For further information about how the issues described in this Alert may impact your interests, please contact Mark Nuccio, Gideon Blatt or Michael Tierney or your regular Ropes & Gray contact.