PROS AND CONS OF THE OCC'S NEW FINTECH CHARTER

On July 31, 2018, the Office of the Comptroller of the Currency (the "**OCC**") announced that it will begin to accept special purpose national bank charter applications from financial technology ("**FinTech**") companies. Concurrently, the OCC published a *Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters* ("**Policy Statement**", available here) and *Comptroller's Licensing Manual Supplement: Considering Charter Applications from Financial Technology Companies* ("**FinTech Licensing Supplement**", available here). The OCC special purpose national bank charter for FinTech companies (the "**OCC FinTech Charter**") may be attractive to FinTech companies that provide or intend to provide technology-enabled lending and/or payment services.

This briefing outlines the pros and cons of the OCC FinTech Charter, along with certain other observations and considerations of an alternative to that charter.

Background

The OCC's announcement that it will begin to accept national bank charter applications from FinTech companies came out concurrently with the issuance of the U.S. Treasury Department's fourth report pursuant to Executive Order 13772 – titled "Nonbank Financials, Fintech, and Innovation" (the "**Treasury Report**", available here) – which included a recommendation that the OCC move forward with "prudent and carefully considered applications for special purpose national bank charters." The special purpose national bank charter for FinTech companies was first proposed by the OCC in a paper published in December 2016, *Exploring Special Purpose National Bank Charters for FinTech Companies* (the "**2016 Paper**", available here) in which the OCC solicited comments. The OCC released a draft of the FinTech Licensing Supplement in March 2017. In the OCC's recent press release announcing that it will begin accepting charter applications from FinTech companies, available here, the OCC said that its decision to proceed followed consideration of comments received on the proposal and extensive outreach with stakeholders.

OCC FinTech Charter – The Pros

State Law Preemption

The principal advantage of the OCC FinTech Charter is federal preemption of the patchwork of state money transmitter and lender licensing laws. Companies that provide technology-enabled lending services and/or payment and money transmission services should be able to provide such services under the OCC FinTech Charter[1] without having to obtain a state license to engage in such activities in every state in which such services are to be provided. The OCC FinTech Charter would also preempt certain state laws, including, for example, state usury laws, thus allowing interest rate exportation across all states. The OCC FinTech Charter should also preempt state virtual currency activity licensing laws and regulations, such as the BitLicense Regulatory Framework promulgated by the New York State Department of Financial Services.

Exemptions from the Securities Laws

Banks are generally exempted from the US securities laws. A FinTech company operating under the OCC FinTech Charter would be a special purpose national bank and, therefore, should be a "bank" within the meaning of that term under the Securities Act of 1933, as amended (the "**Securities Act**").[2] Accordingly, any security issued or guaranteed by such a company would be exempt from the registration requirements of the Securities Act. A FinTech company operating under an OCC FinTech Charter should also be a "bank" within the meaning of that term under the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940, as amended (the "**Investment Company Act**").[3] Accordingly, a FinTech company operating under an OCC FinTech Charter should be able to rely on the "bank" exemptions under these statutes. For example, such company would be excluded from the definition of "investment company" under the Investment Company Act.[4]

Single Regulator

In addition to not having to obtain licenses in a multitude of states, a FinTech company operating under an OCC FinTech Charter will have a single regulator and generally would have to ensure compliance with a single set of regulatory requirements, as opposed to maintaining relationships with multiple regulators and

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1 The OCC is offering a series of one-on-one meetings with OCC officials in New York City, September 25-27, 2018 to discuss financial technology, new products or services, partnering with a bank or FinTech company, or other matters related to responsible innovation in the federal banking system. The scope of these meetings may include questions related to the OCC FinTech Charter. The deadline to request one of these meetings is August 17, 2018.

2 *See* Section 3(a)(2) of the Securities Act (stating that the term "bank" means, among other things "any national bank").

3 The term "bank" under the Securities Exchange Act and the Investment Advisers Act includes "a banking institution organized under the laws of the United States." The term "bank" under the Investment Company Act includes "a member bank of the Federal Reserve System" (as discussed below, a special purpose national bank most likely would have to become a member bank of the Federal Reserve System).

4 *See* Section 3(c)(3) of the Investment Company Act.

ensuring compliance with varied and potentially conflicting regulatory requirements.

New Business Model Feasibility

For some FinTech companies it may simply not be feasible to operate under a bank license, because banks and all of their affiliates are generally subject to supervision and regulation under the U.S. Bank Holding Company Act (the "**BHC Act**"). The BHC Act contains certain activity restrictions, with which, as a practical matter, many FinTech companies are unable to comply. The OCC FinTech Charter would not trigger issues under the BHC Act, however, because a FinTech company operating under such a charter would not take deposits and would not be deemed to be a "bank" within the meaning of that term under the BHC Act. Accordingly, FinTech companies that otherwise could not acquire a "bank" may be able to operate, or acquire a subsidiary or affiliate that operates, under an OCC FinTech Charter.

Also, FinTech companies providing technology-enabled lending and/or payment services in partnership with banks could potentially re-evaluate their business model and may find that an alternative model based on the OCC FinTech Charter is feasible and more profitable. Such model may enable a FinTech company to capture fee revenue that it currently is sharing with a third-party partner bank.

OCC FinTech Charter – The Cons

Uncertainty

The principal uncertainty surrounding the OCC FinTech charter stems from potential legal challenges to its validity by state banking regulators. The New York State Department of Financial Services ("**DFS**") and the Conference of State Bank Supervisors ("**CSBS**") filed suits challenging the OCC's FinTech Charter after it was first proposed, but those suits were dismissed on ripeness grounds. The DFS and the CSBS will likely re-file their legal challenges now that the OCC has announced that it will accept applications for a FinTech Charter.

In addition, it is not yet entirely clear how the OCC would apply a number of regulatory requirements applicable to national banks to entities operating under an OCC FinTech Charter. For example, even though the FinTech Licensing Supplement discusses capital and liquidity requirements, it is unclear how OCC's extensive and complex regulatory capital and liquidity requirements would apply to an entity operating under an OCC FinTech Charter. Such uncertainty is certainly a disadvantage of the OCC FinTech Charter option.

Onerous Regulatory Requirements

While entities operating under an OCC FinTech Charter will benefit from state law preemption, they will have to generally comply with regulatory requirements to which national banks are subject that could be substantially more onerous than the requirements applicable to state-licensed money transmitters and lenders. The Policy Statement and the FinTech Licensing Supplement indicate that a FinTech company operating under an OCC FinTech Charter will be subject to the same laws, regulations, and high standards of safety and soundness and fairness that apply to all federally chartered banks, but note that the OCC will tailor these standards based on the bank's size, complexity and risk profile, consistent with applicable law. The Policy Statement also states that the OCC will supervise FinTech companies that it charters like similarly situated national banks, including with respect to capital, liquidity, and risk management. As noted above, it is not yet clear how such requirements might be tailored to the operations of a FinTech company operating under the OCC FinTech Charter.

In addition, as noted by the OCC in its 2016 Paper, all national banks, including insured and uninsured trust banks and other special purpose national banks, are generally required to be members of the Federal Reserve System. National banks become member banks by subscribing for the stock of the appropriate Federal Reserve Bank. Thus, a FinTech company operating under an OCC FinTech Charter most likely would become a Federal Reserve member bank, and would be subject to the statutes and regulations that apply to member banks. For example, member banks are subject to certain inter-affiliate transactions restrictions under Sections 23A and 23B of the Federal Reserve Act. Accordingly, transactions between a FinTech company operating under an OCC FinTech Charter and its affiliates most likely would be subject to quantitative and qualitative restrictions set out under Sections 23A and 23B of the Federal Reserve Act, as implemented by Regulation W.

Further, a FinTech applying for an OCC FinTech Charter will need to, among other things:

- demonstrate that its managers and directors have the requisite experience and qualifications;
- develop a business plan;
- describe its "commitment to financial inclusion," including proposed goals, approaches, activities, milestones, and metrics for serving the anticipated market area and community; and
- develop, implement and adhere to a contingency plan addressing significant financial stress that could threaten the viability of the bank.

Limits on Preemption

While an entity operating under an OCC FinTech Charter should be able to rely on federal preemption of state money transmitter and lender licensing laws, not all state laws would be preempted. In particular, "state consumer financial laws"[5] generally are not preempted by federal law and any activities subject to such state consumer financial laws would have to be conducted in compliance with such state laws (e.g., state fair lending and anti-discrimination laws). Also, as noted in the Treasury Report, in *Madden v. Midland Funding, LLC*, the Second Circuit held, in part, that the National Bank Act, which preempts state usury laws with respect to the interest a national bank may charge on a loan, did not preempt state-law usury claims against a third-party debt collector that had purchased the loan.[6]

[5] The term "State consumer financial law" is defined under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") as "a State law that does not directly or indirectly discriminate against national banks and that directly and specifically regulates the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in), or any account related thereto, with respect to a consumer."

[6] In *Madden*, the Second Circuit did not refer to the "valid when made" common law doctrine, which provides that a loan contract that is valid when it was made cannot be invalidated by any subsequent transfer to a third party. In an amicus brief at the certiorari stage, the

Activity Limits

Even though a FinTech operating under the OCC FinTech Charter would not be a full-service national bank, such special purpose bank itself would still be subject to the activity limits to which national banks are subject. Accordingly, a FinTech company that operates under the OCC FinTech Charter would need to ensure that its non-banking activities (e.g., activities other than lending or payment services) comply with the activity restrictions that apply to national banks.

No Deposit Funding

The OCC has indicated that a FinTech company that wishes to take deposits will need to apply for a full-service national bank charter. The special purpose OCC FinTech Charter would not permit deposit taking activities, and entities operating under such charter would not be insured by the Federal Deposit Insurance Corporation ("**FDIC**"). Insured deposits are a stable low-cost funding source, and the inability to accept insured deposits seems to be a noteworthy disadvantage of the OCC FinTech Charter, particularly considering that:

- entities operating under the OCC FinTech Charter would generally be subject to the same extensive bank regulatory requirements that apply to insured banks; and
- there are potentially viable state chartering options that may permit a FinTech company to operate an insured depository institution without being subject to the BHC Act (as discussed below).

Certain Other Observations and Considerations

The OCC FinTech Charter certainly seems attractive in light of its state law preemption powers and regulatory feasibility for FinTech companies. Considering the uncertainty surrounding the Charter and the onerous regulatory requirements that accompany it, however, it may not be the best option for FinTech companies seeking to provide technology-enabled banking services. FinTechs with existing licensing arrangements or operating under a bank partnership model may have little incentive to switch to an OCC FinTech Charter, particularly at this time, when doing so would entail entry into uncharted waters. The OCC FinTech Charter seems more attractive from the perspective of FinTech companies contemplating a *de novo* venture for the provision of technology-enabled payments and/or lending. But such new entrants may have difficulty meeting OCC's chartering standards and complying with the relevant ongoing regulatory requirements.

As an alternative to the OCC FinTech Charter, FinTech companies seeking to provide technology-enabled banking services could explore the potential viability of an industrial bank charter. An industrial bank generally is a state-chartered depository institution eligible for FDIC insurance that can engage in the full scope of banking activities, including deposit taking. Similarly to the OCC FinTech Charter, an industrial bank charter provides an exemption from the definition of the

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United States took the view that the court of appeals "erred in holding that state usury laws may validly prohibit a national bank's assignee from enforcing the interest-rate term of a debt agreement that was valid" when made under the applicable state law. The Supreme Court declined to hear the case. Because of *Madden*, the ability of nondepository third parties (e.g., marketplace lenders) to collect debts originated by depository institutions in reliance upon federal preemption of state usury law limits could be limited in the Second Circuit.

term "bank" under the BHC Act, and FinTech companies that acquire an industrial bank do not become subject to the activity restrictions of the BHC Act. A state issued industrial bank charter does not preempt the licensing laws of other states, but the state money transmission laws generally exempt any bank. Accordingly, a state industrial bank charter should de-facto address the patchwork of state money transmitter licensing laws that could be triggered by the provision of technology-enabled payment services. Also, a state industrial bank license should generally permit interest rate exportation to other states.

In addition to state charter approval, the establishment of an industrial bank must be approved by the FDIC. The FDIC has been reluctant to approve the establishment of an industrial bank for a number of years.[7] However, the newly appointed FDIC chairman, Jelena McWilliams, who was sworn in on June 5, 2018, has promised swift review of applications for industrial bank charters. Thus, FinTech companies seeking to provide banking services should consider and weigh the pros and cons of an industrial bank charter as a potential alternative to the OCC FinTech Charter. The ability of an industrial bank to take insured deposits is an advantage that is worth serious consideration when weighing the pros and cons of potentially viable chartering options.

Clifford Chance closely monitors developments that may be of interest to FinTech companies. Our team would be happy to help you navigate the various chartering options and assist you with the chartering process, as necessary.

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7 In 2006-2008, the FDIC implemented a moratorium on the approval of industrial banks and then informally continued it after it formally ended. In 2010, Section 603 of the Dodd-Frank Act imposed another formal three-year moratorium on the FDIC approval of industrial bank applications. While the Dodd-Frank Act moratorium expired in 2013, the FDIC has not yet approved any applications for the establishment of industrial banks.

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