

Ben Saul Partner
benjamin.saul@whitecase.com

Margaux Curie Associate
margaux.curie@whitecase.com

White & Case, Washington DC and New York

FinTech regulation in the US: Policy, implementation, and future directions

Although it boasts one of the world's largest FinTech ecosystems, the US lags behind other major countries in providing a cohesive and consistent regulatory framework for FinTechs. Some US regulators have realised the need to act, launching initiatives with the aim of easing compliance burdens. But, the lack of coordination among federal as well as state regulators has spurred myriad conflicting statements, fragmented initiatives, and varying interpretations, all of which have inhibited the development of a comprehensive and uniform regulatory framework. This, as Ben Saul and Margaux Curie of White & Case explain, is the conclusion the US Government Accountability Office ('GAO') reached in its Financial Technology Report ('Report'). Ben and Margaux use the GAO Report as a springboard to evaluate FinTech regulation in the US, in terms of policy, implementation and future directions.

In March 2018, the GAO released the Report¹, which evaluates the risks and benefits, customer protections, and regulatory oversight of FinTech products and activities. The Report comes two years after Congress requested an update on FinTech activities², and builds upon previously GAO-conducted studies on the FinTech industry³. The Report explores FinTechs' risks and opportunities in four subsectors: payments; lending; wealth and financial advice; and distributed ledger technology ('DLT'), including blockchain technology.

While highlighting the many benefits FinTechs offer consumers, including lower costs, faster service and expanded access to credit, the Report points out that FinTech products and services generally pose risks that are similar, if not greater, than those posed by traditional banking products and that may not be sufficiently addressed by existing laws. Notably, the GAO stresses that the complex and uneven regulatory framework, fragmented across multiple state and federal agencies, fails to sufficiently address the unique risks presented by FinTech products - such as heightened privacy and cyber security concerns, fair lending discrimination, as well as unclear venues for consumer dispute resolution. The Report also demonstrates special concern regarding the use of DLT and the ostensible irreversibility of virtual

currency transactions, including the risk of fraud associated with the use of virtual currency mobile wallets. Token sales, or ICOs, also pose significant investor risks, according to the GAO, and remain largely outside the regulatory scope when not deemed securities or commodities.

Under the US regulatory framework, FinTechs are subject to the overlapping authority and jurisdiction of no less than ten different federal agencies that are, in some capacity, involved in FinTech regulation. In addition, state financial services regulators and attorneys general play significant roles in connection with money transmission and other licensing as well as oversight of consumer protection. This dual system of federal and state regulation poses substantial challenges for FinTechs to identify, let alone comply with, the applicable legal and regulatory frameworks. The uncertainty and complexity of this regulatory environment hinders FinTech innovation by imposing compliance approaches that are often intricate yet still fraught with regulatory and legal risk.

Accordingly, the GAO underscores the need for interagency collaboration on FinTech issues, while also acknowledging the various guidance and initiatives that have already been undertaken both at the state and federal level. Notably, the Report praises steps taken by foreign jurisdictions to facilitate interactions

between regulators and FinTechs through designated innovation offices, agency-led accelerator programs, and regulatory sandboxes. The GAO advises US regulators to consider implementing similar approaches to better understand FinTech markets and adopt an appropriate regulatory framework, as well as to help innovators develop products in limited risk environments.

Promising but inconclusive initiatives at the state and federal level

In the last decade, FinTechs have revolutionised the way finance works and revealed the many benefits their products can offer not only to consumers, but also to industry. Regulators themselves have started to embrace the notion that DLT, and blockchain in particular, have wider applications, including the potential to provide greater transparency, financial inclusion, and improve consumer facing products and services. While the US regulatory framework for traditional banking sector participants is well established, the growth of the FinTech industry calls for a reconceptualisation to properly address technology led financial innovation, which regulators have done little to tackle directly. Instead, regulators have taken a piecemeal approach, at times opting to apply existing frameworks and at other times responding incrementally to technological developments,

continued

creating a patchwork of laws and regulations for FinTechs to navigate.

Still, while they may fall short of offering a comprehensive regulatory framework, there remain some notable efforts on the part of US regulators to balance oversight with the promotion of innovation. For instance, the Consumer Financial Protection Bureau ('CFPB') launched Project Catalyst in 2012 to promote the agency's collaboration with startups, nonprofits, and banks to test new products that foster innovation. As part of this project, the CFPB introduced a 'No-Action Letter' policy, which allows FinTechs to seek a statement from the agency and offer its innovative products to consumers without fear of enforcement. Yet, Project Catalyst has failed to entice FinTechs: its no-action letters are nontransferable, subject to amendment and revocation, and do not shield participants from enforcement by other regulators or private litigation. Only one letter has been released since the program was created in 2014, and it is unclear where the new CFPB leadership stands on this issue.

In May 2017, the Commodity Futures Trading Commission ('CFTC') also started its own FinTech initiative, LabCFTC, designed to serve as a point of contact for financial innovators, and to explore new FinTech possibilities in a variety of ways, including conducting studies and establishing a safe testing environment. Falling short of establishing a formal regulatory sandbox, LabCFTC nonetheless represents the most proactive step taken by a US regulator to spur financial innovation. In February 2018, the agency also announced a cooperative partnership with the UK's Financial Conduct Authority ('FCA'), which commits the regulators to collaborate and support FinTechs through their respective programs, LabCFTC and FCA Innovate. This partnership, however, is largely for information sharing purposes and does not create any legally binding obligations.

US banking regulators have also begun to express interest in incorporating FinTechs into their respective oversight framework. In 2016, the Office of the Comptroller of the Currency ('OCC') announced its plans to issue a special purpose national bank charter that would provide FinTechs with direct access to the US payment system infrastructure,

and exempt them from many state regulations under the doctrine of federal preemption. The new OCC leadership, however, has put the project on hold, pending the resolution of a lawsuit by state regulators and assessment of the benefits of such charter. It further remains unclear that its requirements would be less stringent than a traditional bank charter, thereby *de facto* disqualifying many, if not most, FinTech applicants.

More recently, the new chairwoman of the Federal Deposit Insurance Corporation ('FDIC'), Jelena McWilliams, signaled some receptivity to the possibility of having the FDIC grant Industrial Loan Company ('ILC') charters to FinTechs. If implemented, this shift would allow FinTechs to offer banking-related products and services to compete with traditional banks, without being subject to many of the banking sector's restrictions, including oversight by the Federal Reserve. The Federal Reserve Board's chief regulator also recently showed openness to such possibility. However, FinTech ILCs would still fall under the oversight of the FDIC, a level of scrutiny that only mature FinTechs could likely sustain.

At the state level, the Conference of State Bank Supervisors ('CSBS'), composed of state financial regulators, also launched Vision 2020, a program committed to fostering FinTech innovation by redefining and easing the state supervisory process. In February 2018, seven states⁴ agreed to standardise their approaches to approving FinTechs for money business licences, generally required by cryptocurrency exchanges and payment related businesses. As part of this multi-licensing pilot program, participating states will accept licences from each other's jurisdictions, resulting in faster licensing time and less redundancy for FinTechs that currently have to make identical submissions to each state in which they want to expand. The strength of the program, however, will depend on whether the remaining 43 states choose to opt-in - an uncertain outcome.

Building a regulatory framework for FinTechs in the US *Interagency coordination*

A key obstacle to financial innovation in the US is the lack of interagency coordination. Many FinTech areas are still facing considerable uncertainty as

to which agency is the proper regulator. For example, both the SEC and the CFTC have claimed overlapping jurisdictional authority over cryptocurrencies. In the absence of any new regulation clarifying this issue, courts have begun to issue conflicting decisions⁵.

Several options are available to improve federal and state coordination. One possible avenue would be to appoint a cross-agency regulatory taskforce to revise regulators' rules, consider benefits and burdens, and promote specific guidelines for the FinTech industry. As many FinTechs operate, in essence, in a cross border capacity, it appears crucial to not only promote interagency coordination and communication domestically, but also internationally. Aside from the CFTC-FCA partnership - a first step in that direction - US regulators have done little to promote cross border cooperation on FinTech issues. By contrast, numerous countries have already established bilateral partnership agreements, designed to facilitate cooperation between relevant authorities concerning FinTech and innovation⁶. In March, the FCA further supplemented its existing partnership with the Australian financial regulator with an Enhanced Cooperation Agreement that, among other things, expedites the licensing process for FinTechs that have already received approval from either regulator⁷.

Regulatory sandboxes

In an effort to keep pace with the rapid evolution and growth of FinTechs, many foreign jurisdictions, including the UK, Singapore, and Australia, have taken the 'sandbox' approach, where FinTechs can collaborate and communicate in a protected and standardised environment to test and eventually enter the financial services market with some degree of regulatory oversight and support⁸. Building upon the success of its own domestic sandbox, the FCA is now seeking feedback on its latest and most ambitious project: launching a global sandbox program that would enable FinTechs to test new products and services in multiple jurisdictions⁹. Among many benefits, regulatory sandboxes are a valuable tool to reduce the time and cost of getting innovative ideas to market, help FinTechs navigate the regulatory process, and get the regulators involved from the onset.

In an effort to keep pace with the rapid evolution and growth of FinTechs, many foreign jurisdictions, including the UK, Singapore, and Australia, have taken the ‘sandbox’ approach.

The US regulatory environment constitutes the main obstacle to creating national FinTech sandboxes: the multiplicity of financial regulatory bodies prevents regulators from working collaboratively to create a safe innovation zone while balancing their respective key regulatory objectives. Initiatives like creating a sandbox may also not align with each regulator’s statutory mandate. For example, the CFPB is mandated to ‘regulate the offering and provision of consumer financial products or services’ under federal consumer financial laws¹⁰. The OCC’s mission, on the other hand, is to ensure that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations¹¹. By contrast, the FCA is statutorily mandated to adopt a pro-competition approach to regulation and promote market competition. Legislative changes in the US, thus, may be warranted. States, with the notable exception of Arizona¹², have also failed to take initiatives to create local sandbox programs.

Streamlined money licensing requirements

The reality of the FinTech space is that many of these innovative products and services are likely to fall under federal and state money transmission laws, which generally impose stringent

registration or licensing requirements on business entities that provide money transfer services or payment instruments. Because state money transmission laws are extraterritorial, a FinTech soliciting US customers must in effect comply with all 50 states’ divergent licensing requirements, even if such FinTech has no physical presence in these states. The burden imposed by the licensing process promotes a regulatory environment more suited to dominant monopoly, where smaller firms cannot meet the costs that compliance requires.

The lack of guidance - or conflicting interpretations - from state regulators as to what constitutes ‘money transmission’ also significantly contributes to this pervasive uncertainty. For instance, while a FinTech dealing in virtual currencies will not be subject to licensure in Texas and Illinois, regulators in most other states will likely reach the opposite conclusion¹³. It, therefore, appears paramount to develop a state level coordinated and streamlined licensing process to reduce compliance costs, and retain valuable companies in the US.

Alternatively, financial regulators could introduce exemptions from regulation (known as *de minimis* exemptions) for FinTechs too small to pose non-trivial consumer risks, as well as ‘on ramp’ regulations, which would afford FinTechs

graduated levels of regulation as they grow, two proposals adopted by the Uniform Law Commission in an attempt to develop a common framework for regulating virtual currencies¹⁴. If expanded to additional areas, such exemptions may provide a flexible risk based regulatory framework in which regulators could monitor FinTechs while not stifling innovation.

Conclusion

The US is trailing many counterparts in laying out a clear path for regulating FinTechs. Despite several initiatives launched by both federal and state regulators to provide a clearer framework for, and to engage with, FinTechs, the US is struggling to properly address the growth of these disruptive actors. Recent developments, however, suggest that US regulators recognise the need to act, and appear more inclined to find a place for FinTechs in their existing oversight framework. FinTechs should seize on this opportunity and push for increased interagency coordination, clearer guidance, and streamlined licensing requirements. On their end, US regulators should seek to emulate successful foreign initiatives, including regulatory sandbox programs and formal partnership agreements, in order to build a structure receptive to innovation and retain valuable companies domestically, while ensuring the safety and soundness of the US financial system.

1. Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight, GAO-18-254 (Mar. 22, 2018), <https://www.gao.gov/assets/700/690803.pdf>
2. See Letter from Senators Jeff Merkley (D-OR), Sherrod Brown (D-OH), and Jeanne Shaheen (D-NH) to Gene L. Dorado, Comptroller General of the United States, requesting an updated report on the financial technology marketplace (Apr. 18, 2016), <https://www.merkley.senate.gov/imo/media/doc/Letter%20to%20Gene%20L.%20Dorado%204.18.16.pdf>
3. See Financial Technology: Information on Subsectors and Regulatory Oversight, GAO-17-361 (Apr. 19, 2017), <https://www.gao.gov/assets/690/684187.pdf>; Financial Technology: Information on Subsectors and Regulatory Oversight, GAO-17-806T (Sept. 12, 2017), <https://www.gao.gov/assets/690/684187.pdf>. See also Person-to-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows, GAO-11-613 (Jul. 7, 2011), <https://www.gao.gov/new.items/d11613.pdf>
4. Georgia, Illinois, Kansas, Massachusetts, Tennessee, Texas and Washington.
5. In *SEC v. Shavers*, the US District Court for the Eastern District of Texas held that investments in an entity that would provide returns in the form of bitcoins were securities. See No. 4:13-cv-416, 2013 U.S. Dist. LEXIS 110018, at *6 (E.D.

6. Examples of countries include the Australian Securities and Investments Commission (‘ASIC’), the UK Financial Conduct Authority (‘FCA’), the Monetary Authority of Singapore (‘MAS’), the Hong Kong Monetary Authority (‘HKMA’), and the Canadian Securities Administrators (‘CSA’). See Lev Bromberg, Andrew Godwin, Ian Ramsay, Cross-Border Cooperation in Financial Regulation: Crossing the Fintech Bridge, Columbia Law School Blue Sky Blog (Feb. 13, 2018), <http://clsbluesky.law.columbia.edu/2018/02/13/cross-border-cooperation-in-financial-regulation-crossing-the-fintech-bridge>
7. Reshel Mashraky, FCA and ASIC Sign Enhanced Cooperation Agreement for Fintech Innovation (Mar. 23, 2018), <https://www.financemagnates.com/fintech/news/fca-asic-sign-enhanced-cooperation-agreement-fintech-innovation>
8. Regulatory sandboxes now exist in Abu Dhabi, Australia, Canada, Hong Kong, Lithuania, Singapore, Switzerland and Thailand. The European Union also recently proposed a possible EU-wide regulatory sandbox. See Todd Ehret, Insight: Sandboxes vs. Labs: LabCFTC Offers Blueprint For Regulatory Engagement

9. Najiyya Budaly, FCA Proposes Global Fintech ‘Sandbox’ To Boost Innovation, Law360 (Feb. 15, 2018), https://www.law360.com/banking/articles/1012868/fca-proposes-global-fintech-sandbox-to-boost-innovation?nl_pk=c3a7f6a4-14c2-4d08-bbad-467bcab747da&utm_source=newsletter&utm_medium=email&utm_campaign=banking
10. 12 U.S.C. § 5491.
11. 12 U.S.C. § 1.
12. Arizona H.B. 2434, 53rd Leg. 2nd Regular (2018).
13. Texas Dep’t of Banking, Supervisory Memorandum 1037 (Apr. 3, 2014), <https://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf>; Illinois Dep’t of Fin. Professional Regulation, Digital Currency Regulatory Guidance (Jun. 13, 2017), <https://www.idfpr.com/Forms/DFI/CCD/IDFPR%20-%20Digital%20Currency%20Regulatory%20Guidance.pdf>
14. Uniform Law Commission, Uniform Regulation of Virtual-Currency Businesses Act, http://www.uniformlaws.org/shared/docs/regulation%20of%20virtual%20currencies/URVCBA_Final_2017oct9.pdf