A Dual Non-Banking System? Or a Non-Dual Non-Banking System?

Considering The OCC's Proposal For A Non-Bank Limited Charter For Fintech Firms, Against An Alternative Competitive Federalism System, For An Era of Fintech Banking

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Abstract

This article examines the prospect of a limited purpose federal bank charter (or "nonbank" charter) for new "fintech" firms, which provide some of the services traditionally associated with banking in new and innovative ways, currently being considered by the Office of the Comptroller of the Currency ("OCC"). It also considers the particular dynamics of this proposal in light of a recent case, *Madden v. Midland*, which both limits the powers of the OCC to preempt state law for the firms it charters (on behalf of third parties doing business with national banks) and at once increases the demand for a limited purpose bank charter for fintech firms. This article reviews how the dual banking system has functioned, and uses that analysis to predict how the OCC's proposal for a fintech charter would be expected to operate. This article also proposes a more effective alternative in the form of a competitive state fintech chartering system modeled on the competitive state chartering system for corporations. The article briefly considers whether the OCC might be able to establish a hybrid approach in which a national fintech charter might incorporate elements of state competition. It closes with a consideration of complications that will continue to inhibit the promise of a fintech charter under both an OCC national chartering system and a competitive federalism inspired system of state fintech chartering competition.

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I. Introduction

The present design of the American banking system was as much a function of state and federal law as it was a function of customer demand. This design was shaped by an evolution of law that dates back to the National Currency Act of 1863 and the National Bank Act ("NBA") of 1864. The design and evolution of the nation's banking system continues through a tapestry of legal reforms that occur at regular 10-30 year intervals. While the banking system was once shaped by a combination of state and local barriers to entry, national banking laws slowly eroded these barriers. Features of the federal system steadily increased the unavoidable and overpowering centralization of power in the Federal government culminating in the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 ("Dodd-Frank Act").

The United States banking system is often described as a "dual" system in which state and federal regulators compete with each other to charter and regulate financial institutions. This article examines a fairly old critique of the dual banking system, and shows how that critique remains forceful to this day. More importantly, this article considers how a new nascent industry will fit into the existing regime.

Fintech firms, which are in some ways like banks, but in some ways not, promise to completely reshape the industry. Some fintech innovations are futuristic, in the science fiction sense. However, many of these nontraditional providers of financial services do not fit neatly into the current regulatory scheme which was written with traditional bank products and services in mind. And yet, we know that regulation shapes the industry. Will the promise of fintech be promoted by a new regulatory architecture that encourages innovation in the industry? Or will it be boxed in by regulatory pathologies featured in a regulatory system that is path dependent, on a path that began during the Civil War when banks were prohibited from operating across county lines, and which for much of its history was characterized by in-person interaction with local financial institutions? The banking laws were slow to adapt to the advent of the internet banking era of the late 1990s and early 2000s. The pace of change promised by the future of fintech is much faster.

Regulators and legislators have responded to the rise of the fintech phenomenon with a combination of curiosity and confusion. Progressives and regulatory state defenders are suspicious of deregulatory efforts, and of federal preemption by the OCC, nevertheless are interested in the promise that fintech firms offer to expand the banking system to younger customers and to those lower income customers currently unbanked and underbanked. They also feel compelled to bring an otherwise state regulated system into federal control. Those in the fintech industry see in the promise of a new federal charter a reprieve from a multitude of fifty different, and potentially contrary, state licensing and examination regimes. Traditional conservatives are suspicious of federal chartering and of federal preemption of state law as a general matter but are sympathetic to concerns that regulatory barriers may stifle innovation and risk depriving consumers of beneficial financial services.

Adding to this calculus, a recent case decided by the Second Circuit in *Madden v. Midland* promises to upend the secondary market for bank loans, by discouraging anyone but chartered banks from participating in the secondary market for loans originated by banks. This both limits the power of the OCC to provide benefits to fintech chartered firms, and at the same time increases the need for new widespread fintech charters to increase the range of participants on this secondary market.

This paper will consider the potential paths forward in establishing an efficient regulatory regime for fintech firms. It will argue that the best approach will be a competitive federalism design, in which each of the fifty states is authorized by federal law to provide a fintech charter that will then preclude the other 49 states from regulating that state's chartered fintech firm. It will also consider, in the absence of a law providing for the optimal competitive federalism solution, the extent to which the OCC can inject a measure of competitive federalism into an OCC fintech charter regime. Lastly, the paper will also consider other obstacles that will remain in any attempt to facilitate an efficient and effective fintech chartering regime no matter which form it takes.

II. What is Fintech?

Nonbank financial technology companies ("fintechs") have emerged at an accelerated pace due to advances in technology and evolving consumer preferences.[2] Although fintechs engage in traditional banking functions such as lending, payments, wealth management and settlements, fintechs diverge from the traditional banking model by leveraging new technologies such as cloud computing, artificial intelligence and big data analytics in order to provide products and services through alternative platforms and delivery channels.[3] As a result, fintechs are able to provide their consumers with increased access to product options, the ability to tailor certain products to meet the needs of the individual consumer, and real-time cross channel capabilities.

A. Marketplace Lending

The U.S. Department of the Treasury defines online marketplace lending as "the segment of the financial services industry that uses investment capital and data-driven online platforms to

[2] OCC, *Recommendations and Decisions for Implementing a Responsible Innovation Framework*, (October 2016).
[3] OCC, *Recommendations and Decisions for Implementing a Responsible Innovation Framework*, (October 2016).

lend to small businesses and consumers."[4] By using internet-based platforms to link an applicant seeking a loan with party (or parties) willing to fund it, marketplace lenders are able to reduce the operating costs of maintaining physical bank branches. These cost reductions, in turn, make small loans to individuals and businesses more economically feasible.

Although marketplace lenders employ a variety of differing business models, many are non-balance sheet lenders and utilize alternative credit decision models.[5] Marketplace lenders that are non-balance sheet lenders sell loans shortly after origination. In so doing, marketplace lenders capture origination and service fees but are able to avoid tying up capital and exposure to credit risk.[6] Moreover, by utilizing alternative credit models, marketplace lenders are able to identify underserved or undervalued segments of the market.[7]

Marketplace lenders can be distinguished based on whether they partner with a bank in the loan origination process.[8] In the bank partnership model, a bank will do the actual loan origination, which the marketplace lender will then purchase and service.[9] Under federal law, both state and federally chartered banks are able to "export" the interest rate of the state where the bank is located across the country regardless of where the borrower actually resides.[10] Accordingly, if a bank is located in a state with no usury limitation, the bank can charge a rate of interest that would otherwise exceed the rate allowable in the borrower's home state and not risk

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[4] Public Input on Expanding Access to Credit Through Online Marketplace Lending, 80 Fed. Reg. 42866 (July 20, 2015).

[5] Bimal Patel, Jeremiah O. Norton, Jason Yan, *The Symbiosis of Banks and Marketplace Lending: Where are we and Where are we Headed?* (June 2016).

[6] Bimal Patel, Jeremiah O. Norton, Jason Yan, *The Symbiosis of Banks and Marketplace Lending: Where are we and Where are we Headed?* (June 2016).

[7] Bimal Patel, Jeremiah O. Norton, Jason Yan, *The Symbiosis of Banks and Marketplace Lending: Where are we and Where are we Headed?* (June 2016).

[8] *Online Marketplace Lending: Highlights from Public Comments in Response to Treasury's Request*, (November/December 2015).

[9] *Online Marketplace Lending: Highlights from Public Comments in Response to Treasury's Request*, (November/December 2015).

[10] *Marquette National Bank v. First Omaha Service Corporation* (1978); 12 U.S.C. § 1831(a).

violating state usury law. As non-bank lenders are unable to take advantage of this exportation doctrine, marketplace lenders have historically used the bank partnership model as a means to charge rates of interest that would otherwise not be allowable under state usury laws.[11] Whether non-banks can rely on the bank's interest rate exportation, however, has been called into question in the recent *Madden* and *CashCall* decisions.

1. The Current Regulatory Landscape for Marketplace Lending

Currently, marketplace lenders must contend with a comprehensive set of state and federal laws and regulations. If a marketplace lender chooses not to employ a bank partnership model, the marketplace lender will need to comply with various state lender licensing laws and usury restrictions. The requirements and costs associated with state lender licensing vary from state to state. In addition, marketplace lenders will need to comply with other state law including: debt collection practices law, privacy law and unfair or deceptive acts or practices ("UDAP") authority.

At the federal level, marketplace lenders must comply with the Bank Secrecy Act (BSA), the Truth in Lending Act ("TILA"), the Equal Credit Opportunity Act ("ECOA"), Fair Credit Reporting Act ("FCRA"), the Electronic Funds Transfer Act ("EFTA"), the Securities Act of 1933, the Electronic Signatures in Global and National Commerce Act, and the Consumer Financial Protection Bureau's ("CFPB") unfair, deceptive, or abusive acts or practices authority ("UDAAP").

B. Money Transmission

[11] John L. Douglas, *New Wine Into Old Bottles: Fintech Meets the Bank Regulatory World*, (March 2016).

A money transmitter can be broadly defined as an entity that provides the transfer of money or value from one person to another. However, the definition of a "money transmitter" differs state-by-state and at the federal level. When the activity of a business falls within the state and federal definitions of a money transmitter, the business must register for a money transmitter license.[12]

1. The Current Regulatory Landscape for Money Transmission

Money transmitters are regulated at both the state and federal level but for distinct reasons. At the state level, money transmitter laws are centered on safety and soundness concerns as well as consumer protection.[13] State regulation is ultimately concerned with preventing loss to the individual consumer. Conversely, federal money transmitting laws were enacted to prevent money laundering and terrorist financing. If an entity conducts activity that comes within the definition of a "money transmitter" the entity must be licensed in all states where they have customers (with a few limited exceptions). Although the licensing process varies from state to state, it generally includes: a detailed application, a proposed business and anti-money laundering ("AML") plan, application fees and bonding. If an entity meets the definition of a "money transmitter" under state law it must register with the Financial Crimes Enforcement Network ("FinCEN"), a federal bureau within the United States Department of the Treasury.

Under FinCEN regulations, a "money transmitter" is defined as a person that provides money transmission services. Money transmission services is further defined to mean "the acceptance of currency, funds or other value that substitutes for currency from one person *and* the transmission of currency, funds, or other value that substitutes for currency to another

[12] *See* 18 U.S.C. § 1960.
[13] Lawrence Trautman, *Virtual Currencies Bitcoin & What Now After Liberty Reserve, Silk Road, and Mt. GOX?* (2014).

location or person by any means"[14] Whether an entities activities come within the definition of a money transmitter is a matter of facts and circumstances.[15] The BSA and its implementing regulations require that money service businesses ("MSB") register with FinCEN as well as implement an effective AML compliance program.[16] As FinCEN has made clear that money transmitters are a category of MSBs, money transmitters must also comply with the BSA and AML requirements. BSA requirements include, but are not limited to: filing Currency Transaction Reports ("CTRs"); Suspicious Activity Reports ("SARs"); performing customer due diligence; and retaining records. In addition to the BSA, money transmitters must also comply with other federal laws including: EFTA, as implemented by Regulation E; the Remittance Transfer Rule; and UDAAP.

C. Virtual Currency

Virtual currency has grown in popularity as an alterative to traditional currencies[17] and is defined as a "digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction."[18] Unlike real money, virtual currency is not controlled or backed by a central bank or government.[19] Virtual currency also has no intrinsic value and is worth only what a buyer is willing to pay for it.[20] Nevertheless, virtual currency enjoys several benefits over that of

[14] 31 C.F.R. § 1010.100
[15] 31 C.F.R. § 1010.100
[16] 31 U.S.C. 5330(a)(1)
[17] Treasury Inspector General for Tax Administration, *As the Use of Virtual Currencies in Taxable Transactions Become More Common, Additional Actions are Needed to Ensure Taxpayer Compliance,* September 21, 2016 2016-30-083.
[18] CFTC, Order, Coinflip, Inc. d/b/a Derividan, and Francisco Riordan, CFTC Docket No. 15-29, at 2 n.2 (Sept. 17, 2015).
[19] Meghan E. Griffiths, *Virtual Currency Businesses: An analysis of the Evolving Regulatory Landscape*
[20] Meghan E. Griffiths, *Virtual Currency Businesses: An analysis of the Evolving Regulatory Landscape*

traditional currencies including lower transaction fees, faster transfer of funds, and anonymity of the user.

Although there are currently 250 active virtual currencies, bitcoin, introduced in 2009, is by far the most common and comprises approximately 82% of the virtual currency market.[21] Between May 2013 and April 2016 the number of daily transactions related to bitcoins has grown from 58, 795 to approximately 220,804, while the number of bitcoins in circulation increased from approximately 11.2 million to more than 15.4 million.[22]

1. The Current Regulatory Landscape for Virtual Currency

Although the regulatory landscape is evolving and somewhat uncertain, virtual currency business may be deemed to be money transmitters and thus subject to applicable requirements and obligations as MSBs. At present, it is unclear how many states will treat virtual currency. Recent developments show that some states have issued guidance and regulations affecting virtual currency businesses.[23]

At the federal level, FinCEN has issued several administrative rulings detailing the requirements and obligations for virtual currency businesses. On March 18, 2013 FinCEN issued guidance stating virtual currency would not constitute “currency” under the BSA’s implementing regulations. Nevertheless, FinCEN made clear that certain virtual currency businesses would meet the definition of “money transmitters” under the BSA and would therefore be subject to

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21 Treasury Inspector General for Tax Administration, *As the Use of Virtual Currencies in Taxable Transactions Become More Common, Additional Actions are Needed to Ensure Taxpayer Compliance*, September 21, 2016 2016-30-083.

22 Treasury Inspector General for Tax Administration, *As the Use of Virtual Currencies in Taxable Transactions Become More Common, Additional Actions are Needed to Ensure Taxpayer Compliance*, September 21, 2016 2016-30-083.

23 www.washingtontimes.com/news/2014/nov/27/states-differ-on-need-for-bitcoin-oversight/?page=all (last visited Apr. 1, 2015), archived at http:// perma.cc/P4FP-8VTG

regulation as MSBs.[24] FinCEN defined three different actors in the virtual currency market: (1) users, who obtain virtual currency to purchase goods or services; (2) exchangers, who engage in the business of exchanging virtual currency for real currency, funds or other virtual currency; and (3) administrators, who engage in the business of issuing virtual currency and who have the authority to withdrawal virtual currency from circulation.[25] While FinCEN deemed "users" to not be "money transmitters," the guidance made clear that "exchangers" and "administrators" would be deemed "money transmitters" and thus subject to BSA requirements as MSBs.[26]

III. Differences in Fintech and the Traditional Banking Model

Fintech entrepreneurs have predicted their innovations stand to replace traditional banking products and services. Predictions that alternative financial services providers would eventually replace traditional banking have been proclaimed for a long time. Butler and Macey noted in 1988 that "the 1970s and 1980s have witnessed the encroachment of nonbanking firms into the traditional domain of banks…unless regulators implement some changes, banks will continue to see their position of primacy in the financial system deteriorate."[27] Incumbents in the banking industry observe that these technologies are more likely to develop in partnership with, or as subsidiaries of, existing banking firms than to displace banks. When they do work with existing banks, however, they can potentially be subject to regulation by the banking regulators

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[24] FinCEN, Guidance on Regulation of Virtual Currency; 31 C.F.R. § 1010.100(m) defines "real currency" as "the coin and paper money of the United States or of any other country that is designed as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance.

[25] FinCEN, Guidance, March 18, 2013

[26] FinCEN, Guidance, March 18, 2013

[27] Jonathan R. Macey and Henry N. Butler, The Myth of Competition in the Dual Banking System, 73 Cornell L. Rev. 677, 711 (1988).

as third party service providers under the Bank Service Company Act ("BSCA").[28] The recent *Madden* and *CashCall* decisions, however, have brought the viability of these partnerships into question.

IV. Present Impediments to Fintech Innovation

A. The Reality of the Dual Banking System and the Role of Federal Preemption in Banking Law

The American banking system is often described as a dual system in which state and federal regulators compete with each other to charter and regulate financial institutions. The promise of the dual banking system was that it would promote competition and innovation in regulatory approaches to banking. The banking system however evolved into one in which the federal government tended to outcompete the states as a source of charters, particularly with respect to larger banks, as a result of regulatory power rather than through competitive means.

The banking system at the state level was also never given a chance to effectively compete, as the Supreme Court noted early on "national banks have been National Favorites."[29] In light of the lack of state competition in bank chartering, federal preemption of state banking laws for federally chartered banks became a vital and necessary condition to the creation of a national banking system.

[28] Eve though the BSCA does not clearly give the Federal Regulators authority to examine and pursue enforcement actions against third parties, the agencies have taken the view that it does.

[29] *Tiffany v. National Bank of Missouri*, 85 U.S. 409 (1874) ("It was expected they [national banks] would come into competition with state banks, and it was intended to give them at least equal advantages in such competition…national banks have been National Favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for loans of the General government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the States, or to ruinous competition with State banks.")

This section will explore the failures in the dual banking system. It will consider the important role that preemption has played in the system since the landmark case *McCulloch v. Maryland* was decided in 1819. It will also set the stage for subsequent consideration in this article of whether federal preemption can serve, in an analogous financing system that is presently at a nascent stage in the fintech industry, as a means to facilitate competitive federalism in financial institution chartering.

1. Did Our Dual Banking System Live Up to Its Promise of Competition and Innovation?

The United States has a dual banking system in which state and federal governments compete to charter and regulate financial banks. The federal charter is issued by the OCC whereas the state charter is issued from the state banking regulator of the applicable state.[30] The dual banking system however decidedly leans in favor of federal power, as state chartered banks that join the Federal Reserve System end up with a primary federal regulator in the Federal Reserve, and state banks not joining the Federal Reserve system but obtaining federal deposit insurance end up with the FDIC as a primary federal regulator.[31]

The dual banking system does not resemble the state corporate chartering system, in that there is no analogous "internal affairs doctrine" to require that out of state jurisdictions respect the right of the chartering state to solely regulate the institutions it charters. Supporters of the dual banking system argued that it would allow competition between the states, and between states and the federal government, that would encourage innovation and experimentation.[32]

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[30] Jonathan R. Macey and Henry N. Butler, The Myth of Competition in the Dual Banking System, 73 Cornell L. Rev. 677 (1988).
at 677.
[31] Jonathan R. Macey and Henry N. Butler, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677 (1988).
[32] Bob Scott, The Dual Banking System: A Model of Competition in Regulation, 30 Stan. L. Rev. 1, 13 (1977).

Butler and Macey show that the dual banking system never obtained the necessary preconditions to make regulatory competition effective.

State bank charters solely apply to a particular jurisdiction.[33] Further, the process of obtaining a state or federal charter is an extensive one, in which the bank regulator conducts an extensive diligence of the individuals founding the bank.[34] The OCC can deny a charter if it believes a bank's business prospects are not particularly good or otherwise simply does not have confidence in the prospective bank managers.[35] Charter conversions to other jurisdictions are also not granted without an additional set of reviews, and state banks hoping to switch charters have only one option if they want to continue to operate in that jurisdiction…namely switching to an OCC federal charter.[36]

Therefore the necessary preconditions to competitive state federalism are not present in the dual banking system. A lack of free entry and exit by chartered institutions inhibits charter competition. In order for a non-bank charter system to be competitive, federal law must pre-empt application of state law to out-of-state charters. It must also facilitate the free conversion of charters between states by affording chartered institutions a right to leave one jurisdiction. Otherwise, chartering states may trap non-bank lenders in their state thereby inhibiting a competitive system, particularly if one state manages to establish a dominant position in chartering and subsequently decides to inhibit chartered institutions from leaving the jurisdiction to obtain charters from other jurisdictions.

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[33] Jonathan R. Macey and Henry N. Butler, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 684 (1988).
[34] Jonathan R. Macey and Henry N. Butler, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 685 (1988).
[35] Jonathan R. Macey and Henry N. Butler, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 685 (1988).
[36] Jonathan R. Macey and Henry N. Butler, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 685 (1988).

The present bureaucratic process for approving new charters will likely be streamlined as states start to compete in chartering, but a federal requirement facilitating exit from unwanted chartering regimes will be a vital component to facilitating competitive federalism.

2. Why Preemption in Banking and Financial Services Promotes Markets and (Counter-intuitively) Federalism

Preemption of contrary state law for federally chartered banks has long been a core feature of the banking system set up by the NBA. The drafter's intent behind the NBA in 1864 was to create a national banking system free of state interference, owing to the need to facilitate a national currency through the banking system.[37] Part of the reason preemption became so necessary was that during much of banking history local jurisdictions discriminated against nationally chartered banks to favor local banks.[38]

Another reason preemption became so essential was that a lack of an internal affairs doctrine in banking law to give the chartering bank sole authority to govern the relationship between a bank and its customers made it all but impossible to establish a national market in which banks could operate. The multitude of competing state regulations hindered development of national markets in bank services without the presence of strong preemption.

Advocates of federalism tend to be suspicious of legal doctrines; laws or regulations, which preempt state law. Ribstein and O'Hara for example argue that in order to establish a competitive law market at the state level, "the federal government ought to generally defer to state law as long as the states are able to coordinate their regulation through the law market."[39] They admit "in order to facilitate interstate trade (in the law market), the federal government can

[37] Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CH. L. REV. 101 (2016).
[38] *See Veazie Bank* v. Fenno
[39] See Larry E. Ribstein and Erin Ann O'Hara, *Corporations and The Market for Law*, 2008 U. ILL. L. REV. 661, 666 (2008).

always preempt these states' refusal to enforce choice-of-law clauses."[40] Greve puts a finer point on the matter, arguing, "The last line of defense, and the central battlefield along federalism's frontier, is federal pre-emption. In that theatre, the Rehnquist Court's state's rights defenders have handed the false federalist a deadly weapon…"[41]

In the banking law context preemption was essential to establish a national banking system. Counter-intuitively, federal preemption will also be required if any kind of competitive state system is to be established in the nascent field of "fintech" or non-bank institutions which participate in some, but not all, of the bundle of services which has traditionally come to be described as banking.

Critics of preemption have urged, in addition to traditional arguments about federalism, that preemption, particularly in the financial services context, has various economic costs. They argue that preemption tends to favor larger banks over smaller, which leads to industry consolidation, that it tends to result in diminished protection against harmful predatory lending practices against consumers, and that preemption by the OCC helped to contribute to the financial crisis of 2008.

One study of federal banking preemption conducted by the OCC examined four instances of bank preemption, and found that state banks competing with national banks did not experience any decrease in stock value as a result of the preemption advantages for national banks.[42] Instead it found that smaller national banks, which lacked the economies of scale enjoyed by

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[40] See Larry E. Ribstein and Erin Ann O'Hara, *Corporations and The Market for Law*, 2008 U. ILL. L. REV. 661, 667 (2008).
[41] See Michael S. Greve, *Federalism's Frontier*, 7 TEX. REV. L. & POL. 93, 110 (2002).
[42] Joseph R. Mason, Robert Kulick and Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 788-789 (2010).

larger banks in compliance costs, experienced the greatest benefits from preemptive actions, which relieved them of compliance with 50 different state regulatory regimes.

Critics of federal banking preemption have argued that it was responsible for the rise of subprime mortgage originations that precipitated the financial crisis of 2008.[43] They also argue that it led to a rise in predatory lending practices[44] and precluded state attorney generals from enforcing their states' consumer protection laws. What the critics fail to mention, however, is that even the author of the Dodd-Frank Act, Barney Frank, has admitted that the majority of the subprime loans featured in the financial crisis were made outside of the regular banking system.[45]

Arthur Wilmarth argues that the OCC was lax in its enforcement of consumer protection laws in the years leading up to the financial crisis by citing what he believes is a relatively low number of public enforcement actions against banks.[46] What he fails to appreciate is that banking enforcement is subject to a high degree of nonpublic informal action by regulators, and informal settlement by regulated banks.[47] Wilmarth also lists a number of financial options in debt instruments that were prohibited by state laws as predatory, such as prepayment penalties and balloon payments, as evidence that OCC regulation was ineffective.[48]

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[43] See Joseph R. Mason, The Economic Impact of Eliminating Preemption of State Consumer Protection Laws, 12 U Pa J Bus Law 781, 790 (2010).
[44] Id.
[45] Dori K. Bailey, *A Defense of the Doctrine of Preemption: Revealing the Fallacy That Federal Preemption Contributed to the Financial Crisis*, 16 U. PA. J. CONST. L. 1041, 1099 (2014).
[46] Arthur E. Wilmarth, *Cuomo v. Clearinghouse: The Supreme Court Responds to the Subprime Financial Crisis And Delivers A Major Victory for the Dual Banking System*, in The Panic of 2008: Causes, Consequences, and Implications for Reform (Edward Elgar Publishing, 2010), at p. 21.
[47] 12 U.S.C. § 1818(u) (Formal enforcement actions are required to be made public; informal enforcement actions are not subject to the publication requirements of 12 U.S.C. § 1818(u)).
[48] Arthur E. Wilmarth, *Cuomo v. Clearinghouse: The Supreme Court Responds to the Subprime Financial Crisis And Delivers A Major Victory for the Dual Banking System*, in The Panic of 2008: Causes, Consequences, and Implications for Reform (Edward Elgar Publishing, 2010), at p. 21.

In making that argument, Wilmarth ignores a wealth of literature that demonstrates hybrid loans such as these helped both borrowers and lenders to efficiently manage financial risk.[49] Opponents of federal preemption have also advanced a behavioral economics argument that preemption has in the past tended to permit financial institutions to insert terms into financial contracts which customers aren't able to fully understand.[50]

Critics of preemption in financial services also miss the principal benefit it offers. Preemption is also vitally important to ensure that national markets in securitized loans can function. In order for a securitized loan to trade on a national market, the legitimacy of the bundle of contractual rights that make up the loan cannot be subject to 50 different and potentially conflicting laws governing the terms of the underlying loan contracts.[51]

A uniformity of standards is essential for the creation of a national market. As the OCC has previously observed, three major changes in the last few decades have precipitated heightened demand for a national market in financial services and a demand on the part of consumers for functional uniformity in the financial system. Those include technological innovations like marketplace lending and virtual currencies, the steadily diminishing role of state barriers to entry in the form in interstate branching restrictions, and social mobility.

B. Preemption Under the NBA Takes Punches under *Madden v. Midland* and the Dodd-Frank Act, But Isn't Knocked Out Yet

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[49] See generally Zywicki.
[50] See Oren Bar-Gill and Elizabeth Warren, Making Credit Safer, 157 U. Pa. L. Rev 1 (2008). See Eric A. Posner, Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Ability to Contract, 24 J. Legal Stud. 283 (1995). See also Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CH. L. REV. 101, 113 (2016).
[51] Joseph R. Mason, Robert Kulick and Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 797 (2010).

Despite the vitally important role that preemption has played within the national banking system, the OCC's preemptive powers are under threat from a recent case in the Second Circuit, *Madden v. Midland*, as well as from limitations contained in the Dodd-Frank Act.

The Second Circuit's decision declining to apply preemption of state usury laws on behalf of participants in the secondary loan market has two important implications for this paper. It will show the limits that OCC preemption could provide to a new class of non-bank limited purpose fintech firms. It also shows that providing a limited purpose charter is vitally important in the post-*Madden* environment to ensure that this new class of market participants is able to participate in the secondary loan market and alleviate the damage to the secondary loan market created by the *Madden* holding. The restrictions that Dodd-Frank has placed on the OCC's authority to preempt state law will also have important implications for how valuable the OCC's new proposal for a limited purpose non-bank charter for fintech firms will actually be to them.

The new Dodd-Frank restrictions will also have important implications for the alternative advanced later in this paper that a competitive, 50-state charter system for limited purpose fintech firms, with mutual recognition among the states achieved via federal preemption, would be superior to a unified federal OCC charter system. This paper will consider in part whether the OCC could, in the absence of legislation, advance some of the aspects of a competitive state system by grafting elements of state law into its rules for a limited purpose charter, and the limits placed by Dodd-Frank on the OCC's preemptive authority will be important to that consideration. But first a review of the *Madden* case, prior cases related to *Madden*, and the preemption provisions in Dodd-Frank is appropriate.

The OCC has procedural limitations contained in the Dodd-Frank Act that govern its use of preemptive powers in the consumer finance context. It must make preemption decisions with respect to specific rules, rather than in a blanket manner, and judicial review of its decisions is subjected to a subjective list of factors including whether the preemption decision is valid, whether the OCC's reasoning is valid, whether the determination is consistent with other determinations by the OCC, and including any other factors a court sees as relevant and persuasive.[52]

The OCC retains power to preempt consumer financial protection laws for banks to the extent that those state consumer financial protection laws directly conflict with powers granted to national banks.[53] The OCC does not have the power to preempt state consumer financial protection laws for bank subsidiaries however.[54] Baily predicts that as a result of the Dodd-Frank Act's limitation on OCC preemption for bank subsidiaries, national banks will likely merge their subsidiaries into parent companies, or roll up their relevant divisions that require preemption protection, in order to obtain the benefit of preemptive protection.[55]

The Consumer Financial Protection Bureau ("CFPB") is also granted preemptive powers under Dodd-Frank, but it can only preempt state consumer protection laws if they are inconsistent with federal law, and the Dodd-Frank Act specifically states that any state law that provides greater protection than federal law cannot be preempted.[56]

Thus the Dodd-Frank Act explicitly ensures that the CFPB cannot stand in the way of a "race to regulate" or otherwise alleviate anticompetitive regulations adopted by states under the

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[52] Michael Hamburger, *The Dodd-Frank Act and Federal Pre-emption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 14 (2011).
[53] Michael Hamburger, *The Dodd-Frank Act and Federal Pre-emption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 10 (2011).
[54] Michael Hamburger, *The Dodd-Frank Act and Federal Pre-emption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 10 (2011).
[55] Dori K. Bailey, *A Defense of the Doctrine of Preemption: Revealing the Fallacy That Federal Preemption Contributed to the Financial Crisis*, 16 U. PA. J. CONST. L. 1041, 1085 (2014).
[56] Michael Hamburger, *The Dodd-Frank Act and Federal Pre-emption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 10 (2011).

guise of consumer protection. The OCC can only preempt consumer financial protection laws to the extent it is doing so for a bank. Thus it would appear that unless the Dodd-Frank Act is altered, the OCC's proposal to create a non-bank charter would be limited by its inability to pre-empt state consumer financial protection laws for bank affiliates.

The Dodd-Frank Act codified the preemption standard contained in *Bank of Marion County v. Nelson*, which is essentially a conflict preemption standard.[57] State consumer protection laws, which interfere with a national bank's exercise of powers granted by the National Bank Act, can be preempted. The Dodd-Frank Act however vitiated the Supreme Court's holding in *Watters v. Wachovia*, which had previously found that the OCC could extend preemption to operating subsidiaries of national banks.[58] In its reasoning, the *Watters* Court found that the determination of preemption focuses "on the exercise of a bank's powers, not on its corporate structure."

Baily argues that the new preemption standard created by the Dodd-Frank Act amounts to the less deferential *Skidmore* review of agency decision-making.[59] In *Baptista*, decided post-Dodd Frank, the Eleventh Circuit didn't allude to *Skidmore* when granting deference to OCC preemption. In *Baptista*, the Eleventh Circuit interpreted the preemption provisions in the Dodd-Frank Act to find that the conflict preemption test of *Barnett* survived, and that even state consumer protection laws that were important to a state could be preempted merely for significantly interfering with a power granted to a national bank.

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[57] Michael Hamburger, *The Dodd-Frank Act and Federal Pre-emption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 12 (2011).
[58] *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1 (2007).
[59] Dori K. Bailey, *A Defense of the Doctrine of Preemption: Revealing the Fallacy That Federal Preemption Contributed to the Financial Crisis*, 16 U. PA. J. CONST. L. 1041, 1073 (2014).

Merrill has taken the position that the preemptive actions in both *Watters* and *Cuomo* were decided by way of court review that already amounted to nothing more than the less deferential *Skidmore* deference.[60] Nonetheless, the Supreme Court did not discard the *Chevron* analysis entirely but instead stated "the presence of some uncertainty does not expand Chevron deference to cover virtually any interpretation of the NBA."[61] In so stating, the court seemed to indicate that in situations when federalism concerns are more prevalent, the Court would be more critical of whether the OCC's interpretation of the NBA is indeed reasonable.[62]

Accordingly, we see that the Dodd-Frank Act imposed some significant procedural limitations on the OCC's power to preempt state law on behalf of national banks. It did not however abolish that ability entirely. This article will next consider the case of *Madden v. Midland*, in which the Second Circuit circumscribed the effect of usury preemption in a way that both limits the effectiveness of the OCC's preemption powers with respect to banks and suggests that the idea of an OCC limited purpose charter for fintech firms is more important now that ever.

In *Madden v. Midland*, the Second Circuit held that a non-bank assignee of debt originated by a Delaware national bank was not entitled to protection from state usury claims under the NBA. The plaintiff, a resident of New York, opened a credit card with Bank of America ("BoA"), which was located in Delaware, a state with no usury ceiling on bank-made loans. After the plaintiff defaulted, BoA sold the debt to a non-bank assignee in the secondary market. When the non-bank defendant attempted to collect the debt (that included 27% interest)

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[60] Ramyn Atri, *Cuomo v. Clearinghouse: The Latest Chapter In the OCC's Pursuit of Chevron Deference*, 14 N.C. BANKING INST. 467, 493 (2010)
[61] Ramyn Atri, *Cuomo v. Clearinghouse: The Latest Chapter In the OCC's Pursuit of Chevron Deference*, 14 N.C. BANKING INST. 467, 493 (2010)
[62] Ramyn Atri, *Cuomo v. Clearinghouse: The Latest Chapter In the OCC's Pursuit of Chevron Deference*, 14 N.C. BANKING INST. 467, 493 (2010)

the plaintiff filed a putative class action against the non-bank defendant alleging that because New York usury law caps annual interest at 25% the non-bank debt collector's attempt to collect the debt violated the Fair Debt Collection Practices Act ("FDCPA").[63]

Although the NBA preempts the application of state usury laws to any loan made by a national bank, the Second Circuit held that preemption is not available after the sale of a debt to a non-bank purchaser.[64] While the court made clear that preemption may be appropriate when a national bank's agents or subsidiaries exercise its power under the NBA, the court held that preemption would not be appropriate in the instant case because the non-bank purchaser was acting solely on its own behalf in collecting the debt. The court further found that application of state usury laws to a non-bank purchaser "would not significantly interfere with any national bank's ability to exercise its powers under the NBA."

Madden however overlooked that fact that poisoning the secondary loan market through inhibiting preemption of state usury laws would also have an indirect, but similarly substantial, economic impact on the national bank originating a loan intended for subsequent resale in the secondary market.[65] Smith observes that the *Madden* holding comes at a time when banks are already being discouraged from participation in the secondary market for debt, particularly distressed debt, by the wave of capital requirements being instituted in the wake of the Dodd-Frank Act.[66] Smith identifies a direct result of the *Madden* holding increasing transaction costs in that Lending Club has altered its operating practices to now require that all banks selling loans

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[63] A Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CH. L. REV. 101 (2016).
[64] *Madden v. Midland Funding*
[65] Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CH. L. REV. 101, 123 (2016).
[66] Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CH. L. REV. 101, 138 (2016).

on its platform maintain an interest in the loans traded on their platform.[67] This effect will result in increased costs, and diminish the amount of credit available intended to be traded in the secondary market.

Madden stands in marked contrast to prior case law. The Supreme Court first addressed preemption in the context of interest rates in the landmark case *Marquette National Bank of Minneapolis v. First Omaha Service Corp* in 1978.[68] In *Marquette*, the Supreme Court found that the NBA permitted the OCC to allow a bank to export its permitted interest rate to out-of-state customers.[69] In doing so, the Court took notice of the advantages of a national market, noting that it would permit banks to geographically diversify their risks with out of state customers and provide financial services to populations that might otherwise be underserved.[70] The Court recognized that the ability to export consumer financial protection law was what made that national market possible. Moreover, a Seventh Circuit opinion by Judge Posner held that once a loan is deemed non-usurious, subsequent sale of the loan to another holder for purposes of collection does not change the character of the loan such that it becomes usurious.[71]

The Dodd-Frank Act left this prior case law unaffected as a provision in the Dodd-Frank Act noted that national preemption of state usury laws for national banks was unaffected by the Act.[72] It is clear though that *Madden* departed from the deferential approach to preemption displayed in *Marquette*.

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[67]Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CH. L. REV. 101, 150 (2016).
[68] *Marquette Nat. Bank of Minneapolis v. First Omaha Service Corp.,* 439 U.S. 299 (S. Ct. 1978).
[69] *Marquette Nat. Bank of Minneapolis v. First Omaha Service Corp.,* 439 U.S. 299 (S. Ct. 1978).
[70] *Marquette Nat. Bank of Minneapolis v. First Omaha Service Corp.,* 439 U.S. 299 (S. Ct. 1978); In 1980 the Federal Deposit Insurance Act was amended to give state-chartered banks the same exportation rights.
[71] *Olvera v. Blitt & Gaines, P.C.*, 431 F.3d 285 (7th Cir. 2005).
[72] Michael Hamburger, *The Dodd-Frank Act and Federal Pre-emption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 15 (2011).

The conflict with prior precedent is even stronger in regards to *Pacific Capital Bank v. Connecticut*, which the Second Circuit decided in 2008. In *Pacific Capital Bank*, the Court found that an agency relationship between a bank and an outside party could establish the basis for preemption benefits to the outside third party, on the basis that the agency relationship had a direct economic impact on the bank itself and therefore state laws inhibiting the bank's agent were preempted due to their effect on the incidental powers of the bank itself.[73]

By contrast, in *SPGGC v. Blumenthal* the Second Circuit determined that national bank preemption did not apply to protect an unaffiliated third party, but noted in dicta that it was possible preemption could in the future be used to the benefit of unaffiliated bank third parties.[74] The fact pattern in *Madden* would seem to be exactly what the Court had in mind as a possible appropriate use of preemption on behalf of third parties doing business with a bank, but the Second Circuit did not take the opportunity to act in accordance with the prior prediction.

In *NationsBank v. VALIC*, the Supreme Court granted the OCC deference in a fairly expansive definition of the incidental banking powers it defended through use of preemptive authority, but warned in dicta that "exercise of the [preemptive powers afforded to the regulatory agency in their] discretion…must be kept within reasonable bounds" and the Court warned in the future it would look skeptically upon "ventures distant from dealing in financial investment instruments."[75]

The Supreme Court requested a briefing from the Solicitor General on whether to take up cert in *Madden v. Midland*. The Solicitor General made the unprecedented move of providing a brief that elaborated on how the case was incorrectly decided, but then actually recommended

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[73] *Pacific Capital Bank, N.A. v. Connecticut*, 542 F.3d 341 (2nd Cir. 2008).
[74] *SPGGC, LLC v. Blumenthal*, 505 F.3d 183 (2nd Cir. 2007).
[75] *NationsBank of North Carolina, N.A. v. Variable Life Ins. Co.*, 513 U.S. 251 (1995).

against granting cert, a recommendation that the Supreme Court followed. It is clear that *Madden v. Midland* was a marked departure from prior precedent with respect to preemption under the NBA, one that only enhances the need for a new group of firms allowed by the OCC to participate in the secondary market free of state usury laws per a bank charter, but not subject to the regulatory barriers that discourage traditional banks from participation in the secondary loan market. In one way, *Madden* actually paves the way for the OCC's new limited purpose charter. Preemption would undoubtedly be a key component of a limited purpose non-bank charter and the primary motivator to apply for the charter.

C. Bank Partnership and "True Lender" Issues

Recent court decisions call into doubt bank partnerships and those that "rent-a-bank" to avoid state licensing and usury laws. This case law suggests that courts will look more carefully at how lending partnerships are structured. On August 31, 2016 the Central District of California found that an online consumer-lending platform engaged in UDAAP violations when it sought to bypass state usury law caps by partnering with a tribal lender. [76]

In *CashCall*, consumers took out loans online or over the phone through Western Sky Financial ("WSF"), a tribal entity under the jurisdiction of Cheyenne River Sioux tribal law.[77]After the loans were originated, CashCall, a California based consumer-lending platform, purchased and serviced the loans. As CashCall did not originate any of the loans, CashCall had not secured a lending license in the majority of states in which it was operating. After the CFPB brought action against CashCall, CashCall claimed immunity from state usury law caps due its affiliation with the sovereign Native American tribe.

[76] *CFPB v. CashCall*, August 31, 2016.
[77] *CFPB v. CashCall*, August 31, 2016

The court ruled that CashCall was the "true lender" of high-interest rate consumer loans originated by Western Sky financial because "the entire monetary burden and risk of the loan program was placed on CashCall, such that CashCall, and not Western Sky had the predominate economic interest." The court adopted a "totality of the circumstances" test to determine which party in the transaction had the "predominate economic interest." Even though WSF was the nominal lender on the loans, CashCall had accepted all of the default, legal and regulatory risk by funding a reserve account to fund two days' worth of loans; agreeing to purchase all loans originated by WSF after a 3 day holding period before consumer payments were made; and agreeing to indemnity WSF for any liability incurred in connection with the loans. Because CashCall was the "true lender," a choice of law provision in the loan contracts that selected the Indian's tribe's laws was disregarded because the loan transactions bore no substantial relationship to the tribe. Instead, the state usury laws of the borrowers' home states was applied.[78] The court found that telling consumers they were obligated to pay illegal interest under state usury law constituted a violation of UDAAP.

This decision can implicate partnerships where marketplace lenders rely on bank partners to make loans that are subsequently purchased by the non-bank partner. Due to this recent trend, non-bank partners may lose the benefits of the interest rate exportation after the bank sells the loan. Also worth noting is that the CFPB essentially federalized a state usury law claim by turning it into a UDAAP violation.

After the enactment of the Dodd-Frank Act using a charter for the primary purpose of gaining preemption advantageous (rent-a-bank schemes) has fallen out of favor.

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[78] *CFPB v. CashCall*, August 31, 2016

D. The FDIC's Proposed Guidance for Third-Party Lending

On July 29, 2016, the FDIC issued proposed examination guidance ("Proposed Guidance") on third-party lending arrangements thereby supplementing the FDIC's 2008 release, *Guidance for Managing Third-Party Risk*. The proposed guidance outlines the risks and expectations concerning third-party lending and emphasizes that "institutions that engage in new or significant lending activities through third parties will generally receive increased regulatory attention."[79] The Proposed Guidance also makes clear that the FDIC "will evaluate lending activities conducted through third-party relationships as though the activities were performed by the institution itself".[80] Although the FDIC does not oppose banks using third-party vendors, the Proposed Guidance echoes the FDIC's prior stance of holding banks accountable for the acts of their third-party vendors.

The proposed guidance targets three types of third-party relationships: (1) banks originating loans for third parties; (2) banks originating loans through third-party lenders or jointly with third party lenders; and (3) banks originating loans using third-party platforms (e.g. fintech developed platforms).[81] Should the Proposed Guidance become final, the Proposed Guidance would apply to all FDIC-supervised institutions that engage in third-party lending programs.

The development of the Proposed Guidance comes after the Office of Inspector General ("OIG") issued a critical report entitled *Report of Inquiry into the FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel* in

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[79] FDIC, *Proposed Examination Proposed Guidance of Third-Party Lending*, (July 29, 2016) available at https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf, last accessed Sept. 5, 2016.
[80] FDIC, *Proposed Examination Proposed Guidance of Third-Party Lending*, (July 29, 2016) (available at: https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf).
[81] FDIC, *Proposed Examination Proposed Guidance of Third-Party Lending*, (July 29, 2016) (available at: https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf).

February 2016.[82] The report detailed the FDIC's efforts to cause three supervised banks to exit the refund anticipation loan ("RAL") business. Although the FDIC contended that its actions were justified by safety and soundness concerns, the OIG found an "absence of significant examination-based evidence of harm caused by RAL programs" and noted "the basis for [the FDIC's decision to cause the banks to exit RALs] was not fully transparent because the FDIC chose not to issue formal guidance on RALs." The report also noted the use of "moral suasion" by FDIC examiners in an attempt to influence banks' risk management practices. In response to the OIG's report, the FDIC stated it had "begun developing guidance to address the risks associated with banks making loans through third parties as well as risk management practices that would be expected of banks engaging in these activities to mitigate risk."

Unlike the OCC and the Federal Reserve ("FRB"), the FDIC's primary role is to insure bank deposits. Thus, the FDIC has incentives to resist banking innovations if the deposit insurance fund ("DIF") is solvent.[83]

V. The Prospect of a New OCC Limited Purpose Non-Bank Charter for Fintech Firms

Comptroller of the Currency Thomas J. Curry and various officials at the OCC have indicated that they are presently considering an initiative to provide a limited purpose, or "nonbank" charter for a growing group of "fintech" firms that offer new and innovative technologies in financial services. These firms have some, but not all, of the attributes typically characteristic of banking services. They do not however accept demand deposits, and so would not be covered by deposit insurance, and so have been colloquially described as "nonbanks."

[82] http://www.ballardspahr.com/alertspublications/legalalerts/2016-03-23-fdic-developing-guidance-on-risks-for-banks-lending-through-third-parties.aspx

[83] See Carnell, Macey, Miller, The Law of Financial Institutions, Aspen (5th ed.).

A federal charter for these new firms would permit them the same preemption advantages that nationally chartered commercial banks receive. A small set of hybrid financial institutions currently are granted limited purpose charters by the OCC, namely uninsured trusts and credit card banks, but the OCC's proposal would vastly expand the number of limited charter non-banks.

This article will carefully consider the design of this new system, and the benefits and costs of a uniform national charter for nonbanks will be considered. The examination in this section will help provide an understanding for the alternative proposal considered in the section that follows to provide for a state-based, competitive system in which state chartered fintech firms are required to comply only with the state banking laws of their chartering state. The fact that fintech nonbank chartering is at such a nascent stage offers an opportunity to design a system free of the pathologies that have held the dual banking system back.

A. Why are Fintech Firms Seeking a "Non-Bank" Limited Purpose Charter?

The OCC has previously offered limited purpose charters to both trust companies without deposit insurance, and to credit card banks, which provided those entities with some of the preemptive benefits of a federal charter.[84] The non-bank sector players seeking a limited purpose, or non-bank charter, resemble Take Circle Internet Financial Ltd, which describes itself as a digital payments company and which acts as a platform on which bitcoin and other digital currencies can be traded.[85] This digital platform has requested a limited purpose charter from the OCC to allow it to obtain the benefit of preemption of state laws, including the requirement to

[84] http://bankingjournal.aba.com/2016/06/occ-examining-possibility-of-limited-purpose-fintech-charter/.
[85] http://www.wsj.com/articles/fintech-startup-craves-more-regulation-1465517775

register as a "money center" in 50 state jurisdictions and be subject to registration costs in each state and possible compliance examination by 50 state jurisdictions.

Fintech firms currently face a multitude of issues including uncertainty caused by recent decisions such as *Madden* and *CashCall* as the viability of bank partnerships, duplicative state licensing and regulation, and regulatory overlap between state ad federal regulators. One commentator responding to the OCC's release describes the problem currently facing fintech companies by noting:

> "the presence of overlapping, multi-state regulation…. Each state has a unique definition of money transmission, a unique and highly comprehensive licensing application, and each a unique set of rules that licensees must follow to remain compliant. This panoply of requirements necessitates herculean compliance costs for fintech startups that engage in activities found to be money transmission…. this may be the majority of innovative fintech companies. The state of the art in financial network architecture often makes it impossible for a firm to innovate without engaging, itself, in activities classified as money transmission."[86]

The principal benefits of a limited purpose federal charter for fintech firms would be to preempt duplicative state licensing regimes, eliminate the possibility of 50 differing examinations on top of potential federal examinations, and also help to facilitate access to the existing banking and payment system to ensure that banks are not motivated to exclude fintech firms from the banking system as a result of some future renewal of an

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[86] https://coincenter.org/wp-content/uploads/2016/06/CC-OCCInnovationCommentLetter.pdf

"Operation Chokepoint" push by federal regulators to deny the industry access to the banking system or for competitive reasons.

The federal government exerts significant control over the payment system.[87] The Monetary Control Act of 1980 requires the FRB to offer payment system services to all "depository institutions." regardless of whether the institution is member of the Federal Reserve.[88] The FRB provides four payment services to depository institutions: (1) centralized check collection system; (2) Automated Clearing House ("ACH"); (3) Fedwire; and (4) coin and currency services.

As one example of the type of regulatory innovation presently discouraged by federal regulators in the fintech space, a leading fintech innovator cites the use of open source software development methods to generate payment processing systems and the security systems that protect them. He argues that the Swift payment system, operated by the Federal Reserve, instead operates on a private system that is more prone to hacking as demonstrated by recent instances.[89] The banking regulators exhibit a preference for a payment system that does not utilize open source methods.

Many of the more recent fintech firms have only expressed interest in a limited purpose charter which merely affords them the option to engage in the check payment function of banks, which would grant them access to the Federal Reserve's Swift system, as well as the alternative clearing house ("ACH") system which competes with the Fed but which the Federal Reserve regulates. These firms argue this would allow them to

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[87] Julie Andersen Hill, *Banks, Marijuana, and Federalism* (2015).
[88] *Underbanked: Cooperative Banking as a Potential Solution to the Marijuana-Banking Problem* (March 2016).
[89] https://coincenter.org/wp-content/uploads/2016/06/CC-OCCInnovationCommentLetter.pdf

more easily develop ready conversion between dollar-based payments and bitcoin and other virtual currency based payments by customers.[90]

A recent publication by the OCC articulates the agency's interest in innovation in the financial services sector by non-bank entities. The release cites that in 2015, "the number of fintech companies in the United States and the United Kingdom increased to more than 4,000, and investment in fintech companies since 2010 has surpassed $24 billion worldwide.[91] Some of those entities work with existing banks in the provision of new forms of financial services either through partnership models or through working as third party service providers.[92]

The OCC release specifically cites the possibility of collaboration between banks and non-banks, citing mutual comparative advantages between the two industries that facilitate collaboration.[93] The OCC does not acknowledge the risk that non-banks may be compelled to partner with banks because of the advantages that national banks obtain as a result of the federal safety net or of the power of the OCC's regulatory license as a barrier to entry by non-bank challengers.

The OCC stands at formidable crossroads, as it considers a limited purpose charter for this new form of financial services provider that does not obtain access to federal deposit insurance. The risk is that the OCC will apply a regulatory regime to this limited purpose

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[90] https://coincenter.org/wp-content/uploads/2016/06/CC-OCCInnovationCommentLetter.pdf
[91] See Office of the Comptroller of the Currency, Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective, available at http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf, at p. 3/
[92] See Office of the Comptroller of the Currency, Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective, available at http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf.
[93] See Office of the Comptroller of the Currency, Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective, available at http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf, at p. 4.

chartered entity which employs tools with which the agency is familiar in the banking space, but which are not well tailored to this new and innovative non-banking space.

Under an alternative federal regime which instead would set up each of the fifty states as sovereign chartering authorities, and allow each fintech charter to "passport" to the other fifty states, new fintech firms could realize all of the benefits proposed for an OCC charter, but additionally realize the benefits of a more competitive regulatory system that allowed regulatory innovation to better keep pace with the payment system and financing innovations being developed in the industry.

B. The Shortcomings of the OCC's Proposed Non-bank Charter

1. Receivership

On September 13, 2016 the OCC proposed a new rule addressing how the OCC would handle receivership for national banks not insured by federal deposit insurance including trust banks and limited purpose charters. [94] The OCC used decades of legislative developments to assert its position that it has the power to take a national non-federally insured institution into receivership. Although the proposal would currently only apply to 52 trust banks, the Comptroller stated that the plan "is relevant to any potential future fintech charter that could or may be issued by the OCC." The OCC has not however put an uninsured entity into receivership since the Great Depression.

It is the OCC's position that the FDIC lost the power to take over noninsured banks after the savings and loan crisis with the passage of the Financial Institutions Reform, Recovery and Enforcement Act in 1989. However, unlike the FDIC who relies on the deposit insurance fund

[94] https://www.federalregister.gov/documents/2016/09/13/2016-21846/receiverships-for-uninsured-national-banks

and the Treasury Department in emergencies, it is unclear where the OCC would obtain the funding to wind down these institutions.

OCC grabbed fintech resolution in the rule. However, the OCC wants no part of foreign bank resolution because of cross border complications.

1. Non-Balance Sheet Lenders

Although the OCC's limited purpose non-bank charter solves the "true lender" problems detailed in *CashCall*, the OCC's charter does not solve the problem in *Madden* that most fintech firms are non-balance sheet lenders.

2. Statutory Authority

On November 14, 2016 the Conference of State Bank Supervisors ("CSBS") responded to the OCC's notice of proposed rulemaking entitled *Receivership for Uninsured National Banks*. The CSBS opposed the idea of OCC issued limited purpose non-bank charter citing a lack of statutory authority, a history of preempting state consumer protection laws and potential market distortion.[95]

VI. Considering An Alternative State Chartering System for Non-Bank Fintech Firms

There are a number of other methods available to facilitate an alternative, "non-bank" lender chartering model, that one could consider, depending upon whether it must be achieved only by existing regulatory authority at the OCC, or whether it could be developed through new legislation. The different models of a new chartering system will be explored below based on their viability and will be compared against an ideal, competitive law market.

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[95] https://www.csbs.org/regulatory/policy/Documents/2016/CSBS%20Comment%20Letter%20on%20OCC%20Receiverships%20for%20Uninsured%20National%20Banks%20NPRM.pdf

First, a federal statute could be adopted which sets up state chartering competition by establishing that states shall charter and regulate non-bank lenders, but state regulation of out-of-state chartered entities shall be preempted in favor of regulation by the chartering state. This will be described as competitive preemption. Second, the OCC could charter under a dual system, which would require new legislation. Such a system would mirror many of the drawbacks described by Butler and Macey however.

Third, the OCC could establish a charter for non-banks, but incorporate laws of a particular state (such as the headquartering state) in regulating the entity but otherwise pre-empt state laws, including consumer protection laws, by non-hq states. This may be possible in part without new legislation, depending on how the Dodd-Frank Act's new limitations on OCC preemption powers are interpreted. This option would not permit the full range of benefits afforded by a fully competitive state chartering system, but it would accomplish some of them. It would also utilize a similar approach in grafting state law into federal banking law that is already used in bank corporate governance and in the regulation of bank interest rates.

Fourth, the OCC could provide a non-bank charter, but only for those firms acting as agents for national banks in providing secondary markets for financial products created by chartered banks. This particular model would not be available through the OCC's authority alone, given the limits on OCC powers to pre-empt on behalf of any institution other than a chartered commercial bank. It may however be an option that could be implemented via new legislation.

A. The Virtues of Competitive Federalism, and Why it Did Not Naturally Evolve in Banking

The best analogy for a well functioning, competitive state chartering system being considered in this subsection is state corporate law. State corporation law is competitive, in that states create corporations and the law that governs the relationship between the corporation and its shareholders. States other than the state of incorporation generally recognize this relationship through a mutual recognition regime in which the law of the state of incorporation (or chartering state) governs, even when the shareholder resides in another state.

This makes one state responsible for the relationship between an organization and the individuals who choose to associate with the organization via share ownership. A comparable regime in bank chartering, or more precisely in limited purpose "non-bank" chartering, would allow the chartering state's law governing the relationship between the bank and its customers to govern even for transactions taking place in other states.

A mutual recognition regime is essential for states to compete as sources of law. In the corporate context, the concept is termed the "internal affairs doctrine." Ribstein and O'Hara describe how the internal affairs doctrine developed because in the very earliest days of American corporate law, corporations were created by individual acts of state legislatures, and states recognized corporations as entities beholden to the state of incorporation.[96] This institutional history was an important pre-cursor of the internal affairs doctrine.

By contrast, in banking law no such history of mutual recognition of state interest in chartering banks developed. Quite the opposite in fact, as states were openly hostile to out of state banks establishing branches across state lines (or even across county lines) for much of the history of American banking law. Thus the political and economic history of corporate law allowed for a competitive state based chartering system to organically develop, but in banking law it did not.

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[96] See Larry E. Ribstein and Erin Ann O'Hara, *Corporations and The Market for Law*, 2008 U. ILL. L. REV. 661, 663 (2008).

The federalism literature emphasizes the importance of exit by individual counterparties, and by firms, as a means to internalize the value of state regimes. Firms must be able to re-charter in new jurisdictions freely, and individuals must be able to exit the relationship with the chartered firm.[97] The ability to exit was not available for most of the nation's banking history, due in part to restrictions on interstate banking and in part to a physical need on the part of customers to bank with a firm nearby.

In the non-bank lending context, such a system would involve federal pre-emption of state regulation of non-banks chartered out-of-state, but not of state regulation by the chartering state of firms it chartered. Ribstein and O'Hara also describe technological mobility as a vital underpinning of a robust law market for organizational charters.[98] Part of the appeal of non-bank lenders and financial intermediaries is that customers can rapidly access them, and that customers can quickly and easily move between different service providers.

Technological innovation in the way consumers interact with their lenders and a repeal of interstate branching restrictions have made exit a more effective means by which consumers can police the quality of their banking service, but the inability of banks to re-charter in other jurisdictions has inhibited a competitive market for bank charters. In light of this technological change, federal competitive preemption could afford a vibrant market for non-bank charters if the right conditions are created in which it could thrive.

Ribstein and O'Hara describe the factors that lead contracting parties to select the laws that govern their relationships with an organizational counterparty as principally to ensure that the laws are well tailored to the unique needs of the specific business relationship, that the law

[97] Larry E. Ribstein and Bruce Kobayashi, *The Economics of Federalism*, Illinois Working Paper No. LE06-001 (2006), at p. 4.
[98] See Larry E. Ribstein and Erin Ann O'Hara, *Corporations and The Market for Law*, 2008 U. ILL. L. REV. 661, 675 (2008).

governing their relations can be readily anticipated, and to help standardize contractual relationships with multiple counterparties to one single firm.[99]

In the chartering of banks, the problems the lead parties to value a competitive law market are greatly enhanced by the fact that multiple constituencies are party to the bargain. Whereas corporate chartering is principally viewed by the drafters of governing law as merely as a contract between shareholders and the corporation, in bank chartering the bank charter is viewed as part of the regulatory process overseeing the bank's relationship with its customers as well as its shareholders. As non-banks develop new and innovative means of interacting with customers, the heterogeneous needs of those entities will grow in ways best served by a competitive state system rather than a uniform federal system.

Critics of competitive chartering at the state level argue that it creates a "race to the bottom" in which states compete for the most lax regime. And yet market forces constrain such a race to the bottom if i) states derive franchise fees from the process of chartering, and find those fees meaningful, and ii) there is free entry and exit by firms and by the firm's contractual counterparties, such that firms will lose customers or shareholders as a result of poor performance of contractual obligations and firms will migrate to the state which signals value to customers.[100]

In the context of state chartered and publicly traded corporations, the principal signaling mechanism for quality of the regulatory regime of the state will be the market price of publicly traded stock in the firm. Any differential in the quality of a regime from the perspective of the

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[99] See Larry E. Ribstein and Erin Ann O'Hara, *Corporations and The Market for Law*, 2008 U. ILL. L. REV. 661, 675 (2008).
[100] See Larry E. Ribstein, *Dabit, Preemption, and Choice of Law*, 2006 CATO SUP. CT. REV. 141, 167 (2006).

investor will be manifested in the market value of a company's stock.[101] In the context of consumer finance, both the market value of financial instruments and the value of the regulated firms to their owners (whether the non-bank lenders or publicly traded or privately held) will internalize the impact of the state-chartering regime.

Some critics of the state-chartering model for corporations urge that one jurisdiction, Delaware, has obtained a market advantage through lock-in effects of its law. Critics also urge that any premium value in that state's corporate code is dissipated through rent seeking by the lawyers that draft the code and control its development.[102] Assuming arguendo those arguments are valid, it is less clear they would be problematic in the context of a newly created competitive state chartering regime, one in which all states begin in a similar situation, rather than one like the corporate law regime which developed over a hundred year time frame and might suffer from various path dependencies.

B. How Competitive Federalism Would Operate Effectively for Fintech Firms

It may seem at first glance that competitive federalism based in a state-chartering regime would be inconsistent with the uniformity requirements of a national market. Quite the opposite, if uniformity in certain regulatory regimes is required the demand/supply equilibrium in the market for fintech chartering law will settle on a regime that facilities the uniform requirements of the market. The competitive process that develops any aspects that eventually become uniform will be one more sensitive to market needs. In addition, to the extent that aspects of

[101] Larry E. Ribstein and Bruce Kobayashi, *The Economics of Federalism*, Illinois Working Paper No. LE06-001 (2006) at 12, citing Winter.
[102] Larry E. Ribstein and Bruce Kobayashi, *The Economics of Federalism*, Illinois Working Paper No. LE06-001 (2006) at 12, citing Macey.

payment technology or the terms of financial instruments do not require uniformity, then those aspects will continue to develop in heterogeneous competition.

The literature on corporate federalism suggests that via state competition, states will efficiently provide goods, such as legal chartering regimes, whenever there is free flow between states of both resources and citizens, whenever jurisdictions can design their own laws flexibly in response to market forces unconstrained by federal limitations, and whenever the number of jurisdictions competing against each other is large enough to ensure robust competition.[103] An additional requirement for state chartering competition to be efficient is that it be free of spillover effects on other jurisdictions.

In the non-banking context, spillovers are not likely to be a problem. Regulation of the relationship between customers and non-bank lenders, with respect to out-of state customers, would not be deemed a spillover in this context. Those customers have recourse to exit from the relationship as a response to suboptimal performance, and the bonding dynamics for individual state regimes will internalize the impact of the state's regulatory regime.

In the financial services context, the traditional spillover effect usually described is systemic risk. It is unlikely that small non-bank lenders will be of sufficient size or complexity to pose any sort of systemic risk in the near future, no matter how systemic risk is defined.

An additional potential spillover present in the traditional banking context will not apply in the non-bank context. Federal Reserve member banks, and indeed now all banks, serve a role as the conduits of monetary policy, as a result of their participation in the Federal Reserve's fractional reserve banking system by way of their reserve requirements with the Federal Reserve.

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[103] Larry E. Ribstein and Bruce Kobayashi, *The Economics of Federalism*, Illinois Working Paper No. LE06-001 (2006) at 3.

Because banks are conduits of monetary policy, federal regulators have taken a particular interest in the uniform application of certain safety and soundness requirements such as capital funding rules. Non-bank lenders however would not serve a similar "special" role in the monetary policy transmission mechanism, and would for that purpose be no more unique than any other financial intermediary. Thus potential spillover discussions that may apply in a proposal to create a competitive chartering system for traditional commercial banks will not apply in the non-bank, limited charter context.

Butler and Macey argued against a pure state chartering system for banks as long as those institutions receive deposit insurance, particularly deposit insurance that is not accompanied by a well-calibrated risk premium, urging that the presence of that subsidy would result in moral hazard that would encourage a state race to laxity.[104] It is also the case that states would have little incentive to protect the Deposit Insurance Fund as they examine insured banks. This is because the states with the most risky oversight regimes would still see their depositors enjoy insurance protection, with no premium metered to the level of risk in that state's system.

It is unclear that federal regulators could implement a risk-adjusted deposit insurance system that adjusted premiums based on the quality of state regulation, without thereby risking the federal domination of state regulatory competition that Butler and Macey find so detrimental to state competition. In any event, that problem would not inhibit a competitive state race in the context of non-banks that do not take on-demand deposits and therefore do not receive deposit insurance.

In the event consumers of non-bank financial services wish to obtain insurance for counterparty risk, they option of private insurance would be available. Even to those who argue

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[104] Jonathan R. Macey and Henry N. Butler, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 680 (1988).

that run-prone liabilities generate negative externalities that justify government insurance, it is important to note that the traditional banking sector isn't going away any time soon.

It is unlikely the non-bank sector will replace the banking sector such that the former may become the target of the systemic risk regulatory apparatus contained in the Dodd-Frank Act. Indeed, having two systems providing similar services, one without deposit insurance and the moral hazard distortions that it causes, can add a healthy diversification of regulatory approaches to the existing system.

Preemption at the federal level, in a manner that facilitates competition at the state level, is key to establishing a competitive federalism system. Wilmarth argues from the other direction that the presence of federal preemption in the dual banking system, and aggressive use of the power by the OCC will ensure that large banks will all become national, and small local banks will merely use state charters.[105] If that is true, he fails to appreciate that the cause is the lack of a functioning passport system to allow state charter banking laws to export across jurisdictions.

The lack of an internal affairs doctrine is what killed the dual banking system, not federal preemption. Setting up a system for fintech firms premised on chartering competition can help to ensure a competitive state based system can survive, and indeed can even survive against a competing federal chartering system for banks operating in the same competitive space.

C. Can a New Competitive Federalism System for Fintech Firms Endure?

Macey has shown that a state based regulatory regime can survive once it reaches a critical mass, if interest groups that are affected by the state regime are sufficiently motivated to defend it and if federal legislators can derive economic rents from maintaining the federalism

[105] Arthur E. Wilmarth, *The OCC's Preemption Rules Exceed The Agency's Authority And Present A Serious Threat To the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 230-231 (2004).

based system.[106] This suggests an alternative state based regime for non-bank lenders could survive if it lasted for a sufficient period of time to reach that critical mass before a political window for massive financial services reform opened up again like that created by the financial crisis of 2008 to threaten the regime.

Weingast provides the seminal literature exploring the conditions under which a federalism solution will endure and survive, what he terms "market preserving federalism."[107] He notes that if the federal limits that promote state based regulation are to survive as constraints on the federal government, "political officials must have an incentive to abide by them."[108] One pre-requisite is that states are not allowed to erect barriers to a national market.[109] We have already seen that historically barriers to entry against out-of-state banks characterized the banking industry. This further bolsters the case that some form of competitive preemption will be necessary to establish a system of state chartering competition for non-banks.

A second pre-requisite he describes is that states must have budget constraints, in other words they cannot be able to use monetary policy as a tool to subsidize credit for the firms that they charter.[110] This would otherwise distort their competitive interest in providing optimal rules as their method of competition in favor of using the subsidy. In this context, access to the Federal Reserve's lending would distort the competitive forces of the state market in a different

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[106] See Jonathan R. Macey, Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public Choice Explanation of Federalism, 76 Va. L. Rev. 265, 275-282 (1990).
[107] See Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, JOURNAL OF LAW, ECONOMICS & ORGANIZATION, Vol. 11, No.1 (1995) at p.2.
[108] See Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, JOURNAL OF LAW, ECONOMICS & ORGANIZATION, Vol. 11, No.1 (1995) at 2.
[109] See Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, JOURNAL OF LAW, ECONOMICS & ORGANIZATION, Vol. 11, No.1 (1995) at 4.
[110] See Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, JOURNAL OF LAW, ECONOMICS & ORGANIZATION, Vol. 11, No.1 (1995) at 4.

way, in that it would subsidize individual firms and distort the market impact of the individual state's oversight regime.

Access to Federal Reserve lending would be detrimental to a state based non-bank chartering regime for an additional reason grounded in the political economy of both regulator protection of their safety net and in public reaction to bailouts. In this context one vital component to ensure constraints on the federal government are to survive will be to ensure that non-banks do not obtain access to the federal safety net, whether in the form of emergency liquidity provided by the Federal Reserve or through congressional appropriation. Otherwise the incentives of federal regulators will shift to uniform national regulation to protect the federal safety net, and the incentives of political officials will be motivated toward uniform federal regulation as a result of populist backlash against the federal bailout.

The fact that non-bank lenders would not obtain access to Federal Reserve funding would give their traditional bank competitors a competitive leg-up, in that their traditional bank competitors' borrowing costs will be partly subsidized as a result of their access to the safety net. However that subsidy, which distorts the agency cost reducing effect of market forces, may also contribute to internal firm complacency that itself makes larger banks slower to adapt to technological innovations developed by smaller non-bank competitors.

This proposed alternative will only work if there is no DIF or safety net that can be abused by state regulators. Geoffrey Miller found that while not as commonly recognized, the state regulators are subject to moral hazard stemming from the DIF.[111] Unlike FDIC examiners, state supervisors have an incentive to allow state banks to engage in risky activities because the

[111] Geoffrey P. Miller, *The Future of The Dual Banking System* (1987).

state will reap the benefits of those activities.[112] Benefits can take the form of additional credit or investment.[113] However, any loss will be born by the DIF and thus the FDIC.[114]

D. Can the OCC Facilitate Competitive Federalism Under Its Own Authority?

In the event legislation creating the sort of full competitive state chartering system I propose in this article is not ultimately possible, it may be that the OCC would have power to inject some measure of state competition into a non-bank charter. Metzger observes that the range of pre-emption afforded to Congress by the Supreme Court's interpretation of the Commerce Clause is largely unconstrained, while pre-emption by regulators is a matter of statutory interpretation and further involves determinations of whether Chevron deference will apply.[115] In this context the Dodd-Frank Act provides a further hurdle to any action taken by the OCC intended to encourage competitive federalism in the form of explicit limitations on the ability of the OCC to pre-empt state consumer protection laws.

The Dodd-Frank Act limited the ability of the OCC to pre-empt state consumer protection laws, and also placed process constraints on how the OCC could utilize its preemptive powers.[116] Whether the OCC is able to create the sort of competitive state system for non-bank charters would depend on how this limit on state pre-emption is defined. If the OCC preempts consumer protection laws of all states except a single state, it will still leave power in state hands, albeit only a single state's hands.

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112 Geoffrey P. Miller, *The Future of The Dual Banking System* (1987).
113 Geoffrey P. Miller, *The Future of The Dual Banking System* (1987).
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115 Gillian E. Metzger, *Administrative Law As The New Federalism*, 57 DUKE L. J. 2023, 2048 (2008).
116 Christine Daleiden, *Financial Reform for Consumers: An Overview of the Dodd-Frank Act and the Consumer Protection Bureau*, 15-APR HAW. B. J. 4, 9 (2011).

If pre-empting foreign states, but preserving the regulatory power of one state, doesn't count as pre-emption covered by the Dodd-Frank Act then the OCC might be able to create a partially competitive, state based system. It would not be a charter competition system, because the OCC would be providing the charter rather than the states. It could, for example, provide that the consumer protection laws of only the state in which the non-bank is headquartered will govern, much as laws administered by the OCC presently provide for bank corporate governance and for usury preemption.

The banking regulators already graft elements of state law into the rules governing bank chartering and corporate organization, in that nationally chartered banks are permitted to utilize the corporate law of Delaware or the state in which the bank is headquartered (or the Model Business Act) to govern the relationship between the chartered bank and its shareholders. A bank charter creates a bank in the same way that corporate organizational documents create a corporation, and yet national banking law does not contain a body of corporate law to provide precedent for adjudicating disputes between shareholders and companies. It therefore grafts state corporate law into the federal law governing the bank.[117]

12 U.S.C § 85 is essentially the type of federal choice of law rule that Ribstein and O'Hara identify as facilitating competitive federalism, in that it permits nationally chartered banks to be governed by the usury laws of the state where they are principally located regardless of the state in which a loan customer is located. This limited experiment in grafting state law into federal banking law suggests it may be one possible avenue to consider in the OCC's design of a limited purpose, non-bank charter for Fintech firms.

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[117] See Carnell, Macey, Miller, The Law of Financial Institutions, Aspen (5th ed.).

The OCC could instead provide a means to incorporate state law for non-bank lenders into national charter. It could, for example, provide that the laws of headquartering state should govern the non-bank charter, much in the same way that it permits the corporate laws of the headquartering state to govern the relationship between shareholders and the bank. It is likely however that the OCC would set minimum floor requirements, which Greve warns tend to restrict state competition and arise from rent-seeking activity by industry competitors who can operate more effectively at the federal level.[118] The OCC's release on innovation in the banking industry, which many suspected as a prelude to an ultimate fintech charter model, contained language urging that the OCC will only permit "responsible" innovation. The Comptroller has also noted that many industry incumbents are already urging the OCC to adopt an aggressive examination model inspired by traditional bank examinations in the event it begins to charter new fintech firms.

Greve describes a horizontal dimension to federalism which can result in state's abusing its authority over out-of-state entities in a politically motivated race to regulate, embodied by a number of poorly grounded actions brought by then New York Attorney General Elliot Spitzer.[119] The pre-emption regime provided by the Dodd-Frank Act, in which OCC pre-emption of state consumer protection laws is subject to limitations and in which pre-emption on behalf of non-bank affiliates or agents of banks is not possible, risks exacerbating this problem.

Thus it may be useful to consider whether a competitive preemption approach, which maintains for each entity the laws of one state at the expense of the other, would be deemed prohibited pre-emption by the Dodd-Frank Act, or whether the OCC could accomplish

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[118] See Michael S. Greve, *Business, The States, and Federalism's Political Economy*, 25 HARV. J. L. & PUB. POL'Y 895, 903 (2002).
[119] See Michael S. Greve, *Federalism's Frontier*, 7 TEX. REV. L. & POL. 93, 102 (2002).

competitive preemption without fear of Dodd-Frank's restrictions and instead accomplish it by rule protected with full Chevron deference.

To the extent that OCC chartered banks see opportunities to partner with non-banks in ways that do not directly threaten their business, the concern that federal regulators might be captured by industry and seek to use their authority to inhibit competition would be limited. One can expect however that major disruptive innovations by the non-banking sector that pose existential threats to existing lines of business for chartered national banks would see massive political pressure coming from national banks to discourage the OCC from permitting the new innovation. Such an approach would likely be described as an industry best practice or a minimum standard. Indeed, the OCC's recent release on innovation in the banking sector uses precisely that kind of language.

Greve also warns of the prospect that interest groups will align in favor of a uniform federal approach rather than a state-based system, particularly if it "rigs the playing field" in favor of their particular industry and prevents competitive threats.[120] In this context the greatest such danger might come from existing banks that fear competition from non-bank lenders, which suggests an approach in which the OCC provides charters to non-banks that compete with its chartered banks would be suboptimal.

As Butler and Macey point out, national regulators may utilize their powers in response to industry capture to inhibit competition. Mendelson and Merrill argue that federal regulatory agencies are motivated by empire building objectives to discourage regulatory competition from

[120] See Michael S. Greve, *Business, The States, and Federalism's Political Economy*, 25 HARV. J. L. & PUB. POL'Y 895, 902 (2002).

the states.[121] If that argument is true, it suggests that perhaps the OCC could be expected to take a different view of preemption designed to facilitate a state race than the pro-preemption approach it has taken with respect to past efforts. With respect to the use of preemptive authority however the OCC has tended to use that power to promote competition, particularly with respect to various state laws that sought to limit bank competition with insurance sales and annuities brokerage.[122] The OCC also notably used its preemptive powers to prevent ATM price controls in San Francisco that were limiting the supply of ATM services to customers.[123] This suggests that if the OCC were given the limited role of overseeing the preemptive power that makes a state based non-bank chartering system function; it may be trusted to use it in ways that promote competition given its history of using preemption powers responsibly.

From one perspective, the FDIC is a prime example of federal banking regulators enforcing a strong floor for state regulation. When state banks were granted parity with national banks and permitted under certain circumstances to utilize powers granted to national banks if permitted by their state, the FDIC was given authority to veto the exercise of those powers in the event it saw a threat to the deposit insurance fund.[124] It has used that power to limit the range of activities allowed for state banks.

On the other hand, the FDIC offered a proposal for public comment in 2005 that would have afforded state banks insured by the FDIC the same preemptive benefits that national banks

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[121]Arthur E. Wilmarth, *Cuomo v. Clearinghouse: The Supreme Court Responds to the Subprime Financial Crisis And Delivers A Major Victory for the Dual Banking System*, in The Panic of 2008: Causes, Consequences, and Implications for Reform (Edward Elgar Publishing, 2010), at 40.
[122] Joseph R. Mason, Robert Kulick and Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 793 (2010).
[123] Joseph R. Mason, Robert Kulick and Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 795-796 (2010).
[124]Arthur E. Wilmarth, *The OCC's Preemption Rules Exceed The Agency's Authority And Present A Serious Threat To the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, FN 142 (2004).

chartered by the OCC receive.[125] That would have allowed state banks to be governed for banking law purposes solely by their home states.[126] The proposal, if the FDIC had adopted it, may have substantially reinvigorated the dual banking system, at least partially, and alleviated some of the shortcomings identified by Butler and Macey.

It was unclear however whether the FDIC had the authority at the time to promulgate the rule. State chartered banks were granted parity with national banks, under the auspices of the FDIC, but only with respect to state usury laws.[127] In any event to the extent the FDIC attempted the same proposal again it would be subject to the same limits on preemption that Dodd-Frank placed on the OCC. More importantly, it suggests the federal regulators can vacillate between seeking to promote state competition and at times selectively seeking to inhibit it.

It is unclear whether the OCC would have the authority to advance a bit of federalism within a chartering system for fintech firms. It may be able to do so, depending on whether it aggressively interprets its remaining preemption authority under the Dodd-Frank Act. It also is unclear whether the agency would always seek to promote state competition or not. On the other hand, it would not be unprecedented for the OCC to incorporate elements of the law of a nationally chartered firm's home state into federal law. And in so doing it may be able to promote some of the benefits of state competition, even though such a regime would be suboptimal compared to a fully functioning state competitive system.

VII. Remaining Challenges to Renewed Federalism Under a New Fintech Charter

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[125] Elizabeth R. Schlitz, *Damming Watters: Channeling the Power of Federal Preemption of State Consumer Banking Laws*, 35 FL. ST. U. L. REV. 893, 940 (2008).
[126] Elizabeth R. Schlitz, *Damming Watters: Channeling the Power of Federal Preemption of State Consumer Banking Laws*, 35 FL. ST. U. L. REV. 893, 940 (2008).
[127] Arthur E. Wilmarth, *The OCC's Preemption Rules Exceed The Agency's Authority And Present A Serious Threat To the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 256 (2004).

A. The Ever Present CFPB

1. Supervision and Enforcement

Even if the OCC is able to preempt state laws however, the CFPB's broad jurisdiction looms as a specter over any competitive regulatory initiative that does not obtain a regulatory exemption via statutory reform. This is likely the principal threat to the notion that a new OCC non-bank charter, adopted solely through existing OCC authority, can encourage innovation without new statutory authorization and exemption from CFPB coverage.

The Dodd-Frank Act granted the CFPB broad jurisdiction over "covered persons." A "covered person" is defined as any entity that engages in offering a "consumer financial product or service." A "consumer financial product or service" is expansively defined and includes products and services "offered or provided for use by consumers primarily for personal, family, or household purposes" in addition to those products or services offered in connection with consumer financial products such as real estate settlement services, consumer reporting, loan servicing, and debt collection. Affiliates that act as service providers to "covered persons" are also classified as "covered persons" and thus are within the CFPB's jurisdiction.

The Dodd-Frank Act also gave the CFPB various supervisory authority over both bank and non-bank institutions. Consequentially, the CFPB enjoys supervisory authority over all insured depository institutions or insured credit unions that have more than $10 billion in assets as well as their affiliates.[128] In addition, the CFPB has supervisory authority over various non-bank entities including any covered person that: (1) originates, brokers or services loans secured by personal property and used "primarily for personal, family or household purposes;" (2) that are "larger participants" in certain consumer financial markets (to be defined by the CFPB

[128] 12 U.S.C. § 5515

through rulemaking); or (3) that the CFPB has reasonable cause to believe "pose risk to consumers" with respect to consumer financial products or services.

The CFPB has supervisory authority over certain non-bank entities of any size in the residential mortgage, private education lending, and payday lending markets. The CFPB also has jurisdiction to supervise nonbank entities that are "larger participants of a market for other consumer financial products of services" as the CFPB defines through rulemaking.[129] Furthermore, the CFPB can regulate *any* entity that it has reasonable cause to believe is "engaging, or has engaged, in conduct that poses risk to consumers with regard to the offering or provision of consumer financial products or services."

Section 1031 of the Dodd-Frank Act grants the CFPB sweeping authority to take actions "to prevent a covered person or service provider from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service."[130] This provision grants the CFPB vast jurisdiction to prosecute UDAAP violations and gives the CFPB authority pas the FTC's legacy unfair and deceptive authority by adding the novel term "abusive." The legal standards for abusive, unfair, and deceptive acts and practices are distinct. Thus, any given violation may encompass more than one term. Penalties for violating the UDAAP provision can be drastic and up to $1 million per day for knowing violations of the law. The Consumer Financial Protection Act ("CFPA") also granted UDAAP enforcement powers to state attorney generals and state regulators. [131]

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[129] 12 U.S.C. § 5514(a)(1)(C).
[130] 12 U.S.C. § 5531(a).
[131] 12 U.S.C. § 5552(a).

The CFPB has relied on its UDAAP authority as its primary enforcement tool, alleging more violations of UDAAP than any other statute. Although Section 1031 also grants the CFPB authority to promulgate rules and regulations aimed at preventing unfair, deceptive or abusive acts or practices[132], the CFPB has historically opted instead to regulate by enforcement.[133] Consequentially, UDAAP has been defined primarily through enforcement actions. While some prior FTC precedent exists for the terms "unfair" or "deceptive" the definition of those terms remains elastic and the CFPB has interpreted them expansively. In addition, there is no prior precedent for the novel term "abusive" and the statute provides little guidance on what constitutes an abusive act or practice.[134]

Recent enforcement actions by the CFPB indicate the CFPB's growing aggressive interest in regulating the fintech space and its continued view of its broad jurisdiction. On March 2, 2016 the CFPB entered into a settlement agreement with an online payment platform, Dwolla Inc. The CFPB alleged that Dwolla's representations to consumers, primarily that transactions were "safe" and "secure" and that its security practices exceeded industry standards, violated UDAAP. The CFPB determined that the standards were not "reasonable and appropriate measures to protect data obtained from consumers."[135] Worth noting is the fact that this enforcement action did not stem from any type of data breach.

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[132] 12 U.S.C. § 5531(b).

[133] It is "compliance malpractice" for companies "not to take careful bearings from the contents of these orders about how to comply with the law and treat consumers fairly." CFPB Chairman Richard Cordray, Prepared Remarks to the Consumer Bankers Association (March 9, 2016) --- Consent Orders are "intended as guides to all participants in the marketplace to avoid similar violations and make an immediate effort to correct any such improper practices."

[134] The statute defines abusive as "Something that materially interferes with the ability of a consumer to understand a term or condition of the product or service; or takes unreasonable advantage of: a lack of understanding on the part of the consumer about the risks, costs, or conditions of the product or service, the inability of the consumer to protect the interests of the consumer in selecting or suing the product or service; or the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

[135] Consent Order, *In re Dwolla, Inc.*, File No. 2016-CFPB-0007 (Mar. 2, 2016).

On June 6, 2016, the CFPB filed a complaint against Intercept Corp., a payment processor. Intercept transmits electronic funds transfers through the ACH for various clients, including payday lenders and debt collectors. The CFPB alleged that Intercept violated UDAAP by processing payments from consumer bank accounts on behalf of its clients while ignoring and failing to investigate red flags indicating potential fraud. The CFPB alleged that the high rate of returned payments indicated consumers may not have consented to payment withdrawals or may have been mislead about terms of payment. The CFPB asserted that Intercept had a duty to investigate, monitor and respond to signs of potential fraud.

In its June 6, 2016 complaint the CFPB alleged that "Intercept is a covered person under the CFPA because it provides payments or other financial data processing products or services to consumers by technological means, including through a payments system or network used for processing payments data."[136] Intercept contended that as a payment processor, it did not interact with consumers but only provided services to merchants who were not consumers. The case has yet to be decided, however, should the case be decided in favor of the CFPB the definition of "covered person" will be broadened extensively. Depending on the ruling, payment processors may end up having a duty to monitor the business practices of every person it processes payments for.

In September 2016, the CFPB and the California Department of Business Oversight ("DBO") announced separate enforcement against LendUp, an online lender. The CFPB alleged that LendUp deceptively marketed the benefits of its loan programs thereby violating UDAAP, as well as the FCRA and TILA.

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[136] *Intercept Corp. v. Consumer Financial Protection Bureau*, Case No. 3:16-cv-00118.

2. Structure and Accountability

The level of independence the CFPB enjoys from Presidential and Congressional oversight is unique to federal agencies, which has unique implications for the economic theory of regulation in this context. The CFPB may be subject to regulatory pathologies made worse by its political independence, such as bureaucratic empire building or regulatory biases.[137] It would however be insulated from industry attempts to pressure federal regulators to inhibit competition through regulatory barriers to entry. It may create such barriers on its own as a result of its regulatory pathologies, but they will not likely be a result of sustained effort by industry participants in the way Butler and Macey document in the banking industry.

The role of federalism has often been described as allowing the states to serve as "laboratories" in which they can experiment in regulatory methods.[138] The specter of another legal authority wiping out the value of that experiment however inhibits this value, as it has in the dual banking system. If another state, or if the federal government, can erode the value of potential future experiments, that can significantly dissuade states and entrepreneurs from making the upfront investments required to innovate. If for instance the CFPB may subsequently determine that a new innovative practice constitutes an "unfair, deceptive, or abusive acts or practices" it would destroy not only that innovation, but would dissuade upfront investments by innovators and states to develop other new innovations in financing. While the CFPB would always be able to bring consumer financial protection actions to block activities permitted by the home state, it is less likely than foreign states to do so as a result of anti-competitive industry capture concerns given its extraordinary independence from political oversight.

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[137] Todd Zywicki, *The Consumer Financial Protection Bureau*: Savior or Menace?
[138] Larry E. Ribstein and Bruce Kobayashi, *The Economics of Federalism*, Illinois Working Paper No. LE06-001 (2006), at 5.

An additional factor, which would limit creation of a fully federalized system, is that state attorneys general are authorized to enforce national consumer protection laws under the Dodd-Frank Act.[139] To the extent that a state's attorney general has discretion in how it brings actions, and what circumstances are determined to violate federal law, it may exercise that discretion in an anti-competitive manner designed to discourage firms chartered out-of-state from competing within the jurisdiction.

3. Project Catalyst and No-Action Letters

The CFPB launched Project Catalyst in 2012 to encourage consumer-friendly innovative financial products or services. On February 18, 2016 the CFPB finalized a policy statement on no-action letters (NALs).[140] In a press release accompanying the policy statement, Director Richard Cordray stated the policy statement "is designed to improve access to consumer financial products and services that promise substantial consumer benefits." The NAL allows fintech firms to apply for approval from the CFPB

However, the policy statement makes clear that the CFPB will provide NALs "rarely," as the CFPB estimates it will receive only "one to three actionable applications per year."[141] Moreover, the policy statement explicitly states that the NALs are non-binding and the CFPB retains the authority to revoke or modify a NAL for any reason. The NALs also provide no immunity against private litigation or enforcement actions by other federal and state

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[139] Michael Hamburger, *The Dodd-Frank Act and Federal Pre-emption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 16-17 (2011).
[140] Policy on No-Action Letters; Information Collection, 81 Fed. Reg. 8686 (Feb. 22, 2016) (https://www.gpo.gov/fdsys/pkg/FR-2016-02-22/pdf/2016-02390.pdf).
[141] Policy on No-Action Letters; Information Collection, 81 Fed. Reg. 8686 (Feb. 22, 2016) (https://www.gpo.gov/fdsys/pkg/FR-2016-02-22/pdf/2016-02390.pdf).

regulators.[142] While obtaining a NAL may help a fintech firm gain assurance and negate some uncertainty, firms may be hesitate to apply for a NAL due to it nonbinding nature and revocability at will. Further deterrence may be provided by the fact that the CFPB has the right to use information provided to it in applicants to structure supervisory or enforcement actions.

B. Heightened BSA Scrutiny by the Federal Banking Regulators

The BSA, as amended in 1970, and its implementing regulations, are currently the primary anti-money laundering authority in the United States. The BSA was enacted in response to concerns that bank accounts were being used to launder the proceeds of illegal activities. The BSA requires that "financial institutions" keep various records, report suspicious activity, and conduct due diligence as a means of helping the government uncover financial crimes. Entities that meet the definition of a "financial institution" must register with FinCEN, which administers the AML rules, and file various reports with the agency.

In addition, the federal banking agencies have all implemented regulations that require every federally insured depository institution to have a written compliance program that is reasonably designed to monitor compliance with the BSA. Since 2014, the federal banking agencies have shown increased interest in compliance with the BSA as demonstrated by publicly available enforcement actions.[143] To date, the FBAs have pursued enforcement actions against banks, nonbanks, and bank directors alike for various violations of the BSA. In 2016, the OCC asserted that BSA/AML risks remain high and are on the rise. Although the FBAs have historically enjoyed supervisory and examination authority over nonbanks providing services to

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142 Policy on No-Action Letters; Information Collection, 81 Fed. Reg. 8686 (Feb. 22, 2016) (https://www.gpo.gov/fdsys/pkg/FR-2016-02-22/pdf/2016-02390.pdf

143 See http://amlabc.com/aml-category/aml-sanctions-fines/fdic-and-cdbo-assess-civil-money-penalties-against-banamex-usa-century-city-ca/; https://www.fincen.gov/sites/default/files/shared/20141218.pdf

federally insured entities (such as MSBs) by way of the BSCA Service Company Act, case law under the BSA remains limited and the jurisdictional reach of the FBAs over third party service providers for violations of the BSA remain unclear.

The increasing use of innovative technologies makes it likely that the high level of regulatory scrutiny will continue into the future in this area. Although many products and services are already subject to AML regulation as MSBs (including money transmitters), some fintech products do not fit within the current regulatory framework notwithstanding the fact that they facilitate financial transactions. Entities that currently meet FinCEN's definition of a "financial institution" are responsible for implementing a robust BSA compliance program, and the FinCEN director has made it clear that the regulators expect innovating businesses to develop appropriate BSA compliance programs.

C. Examiner Privilege

Bank examination privilege ("BEP") is judge made confidentiality protection designed to protect communications between banks and their examiners. Financial institutions regulated by the OCC; [144] the FRB;[145] the FDIC; [146]and the CFPB[147] have documents in their possession that are covered by this privilege. Per federal regulations, this privilege belongs to the bank examiners and can only be waived by the examiner. The banks must prevent against disclose even from other federal government agencies.

The D.C. Circuit has noted the privilege arose out of the practical need for transparency between financial institutions and their regulators as "success of [regulatory supervision]

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[144] 12 C.F.R. § 4.36 et seq.
[145] 12 C.F.R. § 261.20 et seq.
[146] 12 C.F.R. § 309.1 et seq.
[147] 12 C.F.R. § 1070.40 et seq.

depends upon the quality of communication between the regulated banking firm and the bank regulatory agency."[148] This privilege also exists at the state level.

D. The Specter of Overreach by the FDIC and OCC in a state-law chartering Regime

The specter of a federal regulator abolishing the competitive advantages developed in a state system is always present in corporate federalism, as it is similarly present in the existing state corporate law system. In the dual banking system, the issue has often manifested as a uniform requirement for a floor on state bank requirements if a bank wants to join the Federal Reserve System or obtain FDIC deposit insurance.

The problem of regulatory overreach may also manifest as a regulatory response to pressures from competing industries. If, for example, the non-banking sector were set up to look like the dual system present in traditional banking, one might expect the OCC and FDIC to respond to pressures from other industries to adopt rules that limit the non-bank sector from posing a threat to the traditional banking sector in areas where they begin to fiercely compete. Butler and Macey describe a history of rules administered by the OCC, FDIC and Federal Reserve as demonstrating this problem of regulatory capture, including the administration of the Glass-Steagall Act.[149] They argue "the existence of any significant role for the federal government is incompatible with competition among federal and state regulators and among the states themselves."

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[148] *In re Subpoena Served Upon Comptroller of the Currency,* 967 F.2d 630, 633 (D.C. Cir. 1992).
[149] Jonathan R. Macey and Henry N. Butler, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 697 (1988).

This is part of the reason that a proposal considered by the FDIC (which it ultimately did not adopt for lack of authority) to afford preemptive advantages interstate banking compacts developed by regional groups of states, while possibly introducing some of the competitive advantages of a competitive federalism system, would ultimately not have allowed the dual banking system to reach the aspirations of its supporters to become a venue for innovation and competitive regulation.

An additional danger that federal regulation poses to the non-bank sector is the persistent risk that federal regulators will cut off access by non-banks to the traditional banking system. Many customers may want to maintain traditional banking services, particularly to take advantage of deposit insurance, and only prove willing to use non-bank services provided they can transfer funds from their commercial bank to the non-bank. But federal regulators have authority to widely define activities as violating "safety and soundness" requirements, and can therefore jawbone traditional banks into refusing to allow whole industrial sectors access to the banking system.

This was recently demonstrated by the "Operation Chokepoint" scandal in which the FDIC and Department of Justice discouraged banks from allowing the payday lending industry, gun dealers, and other firms access to the banking system on vague grounds that doing so would constitute a reputational risk to the banking institution. That incident generated substantial attention from Congressional oversight, and ultimately resulted in agency action to stop the excessive abusive of power at the regulator.[150] But it demonstrates that exercise of authority by traditional banking regulators can impact a new non-bank sector, even if that new sector is characterized solely by a state-based chartering regime.

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[150] http://www.americanbanker.com/gallery/timeline-operation-choke-point-1066360-1.html

VIII. Conclusion

Fintech innovations promise to eventually reshape the financial services industry entirely. We aren't able to presently fathom how fintech will upend the ways in which suppliers of financing and consumers of financing will interact in a 100 years. We can anticipate however that the regulatory markers laid down today will dramatically influence the path those financial innovations are permitted to take.

In the same way that financial innovations of the nascent internet era in the late 90s and early 2000s were held back by the path dependencies in modes of bank regulation that stretch all the way back to the NBA's passage in 1864, we can anticipate that choices made by the OCC, the Congress, and state regulators and legislatures will similarly either stand to empower or constrain innovations in the financial services industry as they ripple out in time, reaching beyond the lifespan of this author and of all other participants in this debate.

What we currently call "fintech" will ultimately one day be simply "financing." The best way to encourage innovation and competition in this nascent field will is designing a regulatory system that itself is encouraged to both compete, and innovate, in the way it approaches regulation of that financial system.