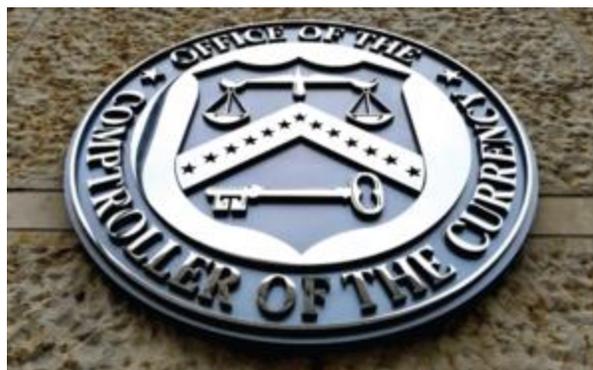


Inside The Legal Battle For The Future Of Fintech

By Philip Rosenstein

Law360 (June 3, 2019, 3:48 PM EDT) -- A simmering turf battle between New York state and the Office of the Comptroller of the Currency has left many fintech companies in a frustrating holding pattern as they wait for the courts to decide how they will ultimately be regulated.

The OCC said last July it was ready to begin accepting applications for a special purpose national bank charter for fintech companies, providing a simplified avenue to engage in banking activities on a national scale. The New York Department of Financial Services promptly challenged the federal agency in court, saying it was reaching beyond its congressional mandate by redefining the business of banking.



The OCC and New York's financial regulator are locked in a legal battle that will define how large swaths of the fintech industry will be regulated.

With the district court chapter of the fight coming to a close, attorneys say an appeal to the Second Circuit can be expected, extending the uncertainty for fintech companies. Other options exist, however, as fintech companies await a decision on the purview of federal and state banking regulators.

"The litigation challenging the OCC's authority to issue a special purpose fintech charter certainly has delayed the process for nondepository fintech firms to apply and receive approval from the OCC for special purpose national banks," Mike Nonaka, co-chair of the financial services group at Covington & Burling LLP, told Law360.

On May 2, Manhattan U.S. District Judge Victor Marrero allowed a challenge to the OCC's special purpose national bank charter for fintech companies to proceed, striking down the government's motion to dismiss. He said DFS' challenge to the fintech charter was "ripe for adjudication."

Judge Marrero's order immediately dampened the interest of potential applicants in the fintech charter, with the OCC itself saying it does not expect to receive applications anytime soon.

On May 30, the OCC said it was ready to move on following the May 2 order, telling the court that it would work with the New York DFS on drafting a proposed final judgment while reserving its right to appeal. This leaves fintech companies in an undesirable position that will have profound consequences on what their business models will look like moving forward. Those that were interested in the fintech charter are now forced to scan other options like a full service bank charter or an industrial loan charter. Allying with banks is also a viable option, but it raises other legal concerns.

The OCC v. 50 States

The New York suit has created a short-term conundrum for many fintech companies looking to expand on a national scale. They can adhere to each of the 50 states' licensing requirements for providing credit and engaging in money transmission, or move to the federal level and apply for a federal bank charter.

The legal battle simmering in downtown Manhattan is a 21st-century iteration of the tug-of-war inherent in our federal system, Alan Avery, a partner in Latham & Watkins LLP's corporate department and financial institutions group, told Law360. Central to the case is the OCC's interpretation of the "business of banking," which the DFS argues in this case reaches beyond the federal agency's purview provided to it by Congress.

This type of conflict between federal and state regulators "goes back to the beginning of time when it comes to our current system," Avery said.

The state agency had argued that the OCC is "impermissibly redefining the 'business of banking'" to exclude deposit-taking as a required minimum function. In denying the OCC's motion to dismiss, Judge Marrero agreed, saying that the "business of banking" under the National Bank Act "unambiguously requires receiving deposits as an aspect of the business."

The National Bank Act permits the OCC to charter firms that engage in the "business of banking."

That law "has been around since the Civil War," said Jeffrey Taft, a partner in Mayer Brown LLP's financial services regulatory and enforcement group and member of its consumer financial services practices. "What was the business of banking in 1865?" The state-by-state chartering paradigm made much more sense then, he said.

Over the years, however, the courts have made it clear the OCC has significant breadth to define the "business of banking." The U.S. Supreme Court found in 1995 in *NationsBank v. VALIC* that the OCC could define, within reason, what it means to be in the "business of banking," Nonaka said.

"The OCC's regulation ... providing for special purpose national bank charters would seem to fall squarely within the OCC's authority as described by the Supreme Court in the VALIC case," he said.

The agency faces a similar challenge to the fintech charter in a D.C. federal court from the Conference of State Bank Supervisors, a national organization of state banking regulators, which shares DFS' view of the OCC as having overstepped its authority.

In the meantime, the conference has taken it upon itself to harmonize the disparate state licensing and oversight regimes to lower the burden on fintech companies. The organization announced a multistate compact as part of its "Vision 2020" initiatives, whereby states can sign on to standardize their money transmitter license applications.

Until there is a resolution in the New York case, fintech companies are out in the cold waiting for a decision in the courts that is likely to take some time.

Why the Fintech Charter?

Given the uncertainty around the fintech charter, why not just gear up for a full-service national bank charter?

Some larger, more established fintech companies have done so. Varo Bank NA, for example, has forgone the fintech charter in favor of a full national bank charter and received preliminary conditional approval in August. A handful of others have also opted for the full-service national bank approach.

Attorneys say a company applying for a fintech charter would face many of the same hurdles as one applying for a full-service national bank charter, but uncertainty continues to reign given the lack of evidence of how a fintech charter application would play out.

"We haven't yet seen the process play through a full application, so we don't know yet how they will apply the standards, but on paper, they are very similar," Avery said.

There are two important reasons a fintech charter may be particularly attractive, he said.

First, companies in pursuit of a full-service charter would face increased scrutiny and regulatory oversight from the Federal Deposit Insurance Corp., adding burdens on burgeoning companies that might not have the means to address compliance concerns.

Second, a company obtaining a full-service charter would be considered a "bank" for the purposes of the Bank Holding Company Act, subjecting the owners to significant regulatory requirements, including supervision and regulation by the Federal Reserve.

"The big difference here isn't necessarily at the bank level; it's at [the level] of those who own the bank," said Taft.

"Some fintech companies could not be bank holding companies because their activities may be impermissible," he said. "Others may not want to be because they don't want to be subject to consolidated supervision and regulation by the Fed."

Still other fintech companies would be unwilling to go the full-service route because of their investor structure, Taft said. Some investors would likely be deemed bank holding companies, and no venture capital firm or hedge fund would permit that to happen.

Should a commercial company such as a social media company or retailer want to lend or provide payment services on a national scale, obtaining a fintech charter would be a good approach, as there is no way that

type of company would be permissible given its retail business under the Bank Holding Company Act, Avery said.

That might include companies like Amazon or Facebook, which have been actively seeking new ways to harness fintech.

Without a federal charter, companies engaging in such financial activities would be required to adhere to specific regulations in all states they want to do business in, forcing them to develop and pay for immensely complex compliance programs.

With the fintech charter on hold, fintech companies are forced to contemplate other avenues for growth.

Where Do Fintech Companies Go Now?

"Anyone who goes first" in applying for the OCC fintech charter will be buying into a lawsuit, Catherine Brennan, a partner in Hudson Cook LLP's fintech and alternative business finance practices, had told Law360 in May. "And no one wants to do that."

More assurances are needed before a fintech company would go full steam ahead to obtain a fintech charter, she said. Those assurances are likely to come at some point, but fintech companies will need to find a different approach in the meantime.

Avery doesn't think the New York case will create a sense of "finality" and seriously constrain interest in obtaining a fintech charter in the long term, but the current state of the charter leaves many companies looking at other options, or just moving on with what they know.

How fintech companies that were ready to begin the chartering process with the OCC are likely to respond really depends on where they are in their life cycle, Avery said. If a company is already involved in bank partnerships, or under a licensing regime that they feel comfortable with, it is unlikely to change course.

A company's business model could solidify during this period of limbo such that once the fintech charter becomes viable again, it just won't be worth it, Avery said.

"It is highly likely that nondepository fintech firms will eventually find a more stable place in the regulated financial services sector at the federal level," Nonaka said. "Whether that happens through a specialized national bank charter is, at present, an issue for the courts to decide."

The other option could be for fintech companies to pivot to applying for an industrial loan charter. ILCs allow nonfinancial firms to set up their own banks that are regulated by state banking supervisors and the FDIC, but not by other national regulators such as the Federal Reserve.

Fintech companies see them as a way to get a bank charter in order to lend directly without allying with a traditional bank or dealing with restrictions stemming from the Bank Holding Company Act. They also bring the ability to obtain FDIC deposit insurance and engage in nonbank commercial activities.

Established fintech companies Square and SoFi have both indicated their interest in going the route of the ILC.

Nonaka also highlighted the potential for Congress to move in and allow nondepository companies to live within the existing regulated environment.

That said, the chance of any fintech company braving the choppy waters of the OCC's fintech charter any time soon seems slim, leaving many of them to navigate the 50-state labyrinth of financial services regulations, take the leap into a full-service national bank charter or switch gears to apply for an ILC.

And, Avery said, "Some companies may have already judged [the fintech charter] is not viable for them, regardless of the litigation risk."

--Additional reporting by Jon Hill. Editing by Brian Baresch and Jill Coffey.