FEDERALISM ON THE FINTECH FRONTIER

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What Does “Fintech” Mean?

• A set of characteristics
  – Use of borderless platforms
  – Lower barriers to entry
  – Increased competition and disintermediation
Impact on Regulation?

• Jurisdiction issues
  – Assumptions of who should regulate under pressure

• Discrepancies in regulation between competitors
  – How you are regulated depends on your status, not your actions
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<th>REGULATORY BARRIER</th>
<th>NATIONAL BANK</th>
<th>INSURED STATE BANK</th>
<th>NONBANK FINANCIAL INSTITUTION</th>
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Source: https://www.mercatus.org/publications/modernizing-financial-technology-regulations-facilitate-national-market
The Problems Created

• Inefficiency
  – Cumbersome regulation raises costs and lowers access and competition

• Competitive Inequality
  – Some competitors have a regulatory advantage

• Political Inequality
  – Some states’ regulations distort national market, making some citizens more powerful than others
The Take Away

• Where Inefficiency, Competitive Inequality, or Political Inequality are significant – consider national-level preemptive regulation

• Where they are absent allow state-level regulation to control with minimal national intervention
Industries Examined

• “Marketplace” Lending
  – Non-bank online oriented lenders

• Money Transmission
  – Both fiat and virtual currency

• Corporate Securities
  – Private and unregistered securities sold online
MARKETPLACE LENDING
State Regulation of Interest

• State laws set limits on interest
  – Limits on rate
  – Limits on what counts as interest (e.g. fees, penalties)
• Different rates for different types of loans/providers
• Non-banks generally are subject to state-by-state regulation
Federal Regulation of Interest

• Federal laws allow banks to “export” the law of their home state
  – Federally chartered Banks – National Bank Act
  – State chartered Banks – Depository Institutions Deregulation Act of 1980

• Home state laws applies to both rate and definition
  – Marquette Nat. Bank v. First of Omaha Corp. and Smiley v. Citibank (South Dakota), N.A.

• Why does it matter
  – Consistency
  – Limits search costs
Issues Facing Marketplace Lending

• Need Bank Partnerships to Compete
  – Allows Marketplace Lender to use bank’s export

• Bank-Partnership model called into question
  – NBA Preemption/Valid When Made – *Madden v. Midland Funding*
    – *Colorado v. Avant/Marlette; Bethune v. Lending Club*

• Huge Search and Monitoring Costs
Figure 2. Summary Statistics: Growth in Loan Volume Post-Madden. The figure below presents the growth in loan volume for loans issued to borrowers in the Second Circuit relative to loans issued to borrowers outside the Second Circuit. The borrowers are broken down into buckets by FICO score, and the sample includes all loans issued during calendar year 2015 (i.e., the “before” period includes all loans issued in 2015 before Madden, and the “after” period includes all loans issued in 2015 after Madden). The figure shows that growth rates for loans issued to borrowers in the Second Circuit are roughly comparable to loan volume nationwide for high-quality borrowers, but that growth was dampened—or even nonexistent—for lower-quality borrowers.
MONEY TRANSMISSION

Send Payment

Make a Mass Payment
What is Money Transmission

• Defined broadly
• Use of correspondents, offices, wire, mails, ACH etc.
• Technology changing
  – Players
  – Methods
  – Underlying store of value
State Regulation of Money Transmission

• State laws are broad and ubiquitous
  – 49 states and DC have laws (Montana lone exception)
  – Expansive coverage but variations among states

• Heavy focus on consumer protection and systemic safety

• Banks frequently exempt
Federal Regulation of Money Transmission

• Traditionally focused on Law Enforcement and Systemic concerns
  – FinCEN requires registration of money transmitters
  – BSA/AML requirements
  – Federal crime to operate w/o state license (if required by state)
• Dodd-Frank potentially introduces consumer protection
  – e.g. CFPB actions against Dwolla and Intercept Corp.
• Congress has called for state harmonization
What is Virtual Currency

• Store of value/Medium of exchange w/o legal tender status

• Includes Distributed Ledger Technologies

• Can be used as a substitute for fiat money or as a distributed database
  – May require transfer of valuable token to record data
State Regulation of Virtual Currency

• State taking a few different tacks
  – Ignore
  – Cover under existing rules
  – Modify rules
  – Create new VC specific rules
    • NY BitLicense
Federal Regulation of Virtual Currency
Issues Facing Money Transmission

• Inconsistency of rules
  – Banks vs. Non-banks
  – Fiat vs. Virtual Currencies
  – States v. Feds (and other States)
    • Some states more equal than others

• Overlapping regulations
  – Money transmission laws may cover DLT record keeping

• Huge search and monitoring costs
Securities

Online Securities Offerings

• Reg. A – sale of freely tradable securities to general public nationwide

• Rule 147 – safe-harbor from federal requirements for intrastate offerings

• Internet makes reaching people much easier (maybe too easy)
State Regulation of Securities

• Regulation originally state driven (Blue-Sky)
• Often included “merit-review”
• Scope has gradually contracted
• Retain power on fraud and consumer protection and certain types of offerings
Federal Regulation of Securities

• Began in 1930s
• Originally co-extensive with state regulation
• Focused on disclosure
• Increasing federal preemption
  – 1996 National Securities Market Improvement Act
  – Title IV of the JOBS Act (amendments to Reg. A)
  – Title III of the JOBS Act (crowdfunding)
**Regulation A**

- Provides exemption from full registration
- Originally no blue sky preemption
- Went from 116 offerings in 1997 to 19 in 2011
  - Companies switched to *inter alia* Reg. D offerings
- JOBS Act amended NSMIA to allow preemption if sold to qualified purchaser
- GAO report identified state regulation as a possible reason for Reg. A’s decline
  - States responded they were working on streamlining process
Regulation A+

- SEC ultimately created two tiers of Reg. A offering
  - Tier 1 – No preemption, $20m cap, No ongoing disclosure requirements to SEC
  - Tier 2 – Preemption, $50m cap, Ongoing disclosures to SEC, notice filing to states
- Two states sued and lost
Rule 147

• Meant to provide safe harbor for intrastate offerings

• Concerns that use of internet would preclude safe harbor

• SEC proposed new rule that included substantive requirements
  – $5m offering limit
  – Required investor limits to be set by state
Rule 147

• Pushback from states and market participants, as well as policy organizations
• Argued that states were capable of investor protection and that federal rules would make it harder for states to craft rules best suited to them
• SEC final rules dropped federal requirements
What can be done

• State coordination/reciprocity
  • *But* how likely or durable would that be?

• Nationalize regulation
  – OCC fintech charter
    • *But* is that too “one-size-fits-all”?

• Federal law encouraging competitive federalism
  – State-licensed/chartered entity export for at least some elements of law
    • *But* how likely is that to happen?

b The Depository Institutions Deregulation Act of 1980 (12 U.S.C. § 1831d(a) (2015)) (granting the same power to state-chartered, federally insured banks); 12 C.F.R. § 560.110(a)(1997) (allowing banks to use their home state’s definition of what constitutes interest nationwide); Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992) (“The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act in pari materia. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way.”). See also FDIC, General Counsel’s Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998).


d US Department of the Treasury, Opportunities and Challenges in Online Marketplace Lending, May 10, 2016, 6; Douglas, “New Wine into Old Bottles,” 34.

e Department of the Treasury, Opportunities and Challenges, 6; Douglas, “New Wine into Old Bottles,” 34.

f Department of the Treasury, Opportunities and Challenges, 5; Douglas, “New Wine into Old Bottles,” 32.


h Tu, “Regulating the New Cashless World,” 89; Bryan Cave LLP, “The Latest in Money Transmitter Licensing.”

i Tu, “Regulating the New Cashless World,” 86–89.