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The Path Forward in FinTech and Nonbank Financial Services

U.S. Treasury Report Recommends Congressional and Regulatory Support of Technological Innovation for FinTech and Nonbank Financial Services Industries

The Department of the Treasury (“Treasury”) released a sweeping report on July 31, 2018 entitled “Nonbank Financials, Fintech, and Innovation” (the “Report”), recommending updates to regulations to embrace current technology and consumer practices, unification and harmonization of regulations to promote innovation, changes to regulations for certain financial service industry activities, and alteration of the regulatory environment to foster innovation.¹ Much of the Report deals with the complexities caused by the dual federal-state system of financial regulation. While the Report itself does not adopt new laws or regulations, the official positions taken in the Report may very well create the momentum needed for such changes in the years to come.

The Report is the fourth in a series of reports issued by Treasury in response to President Donald Trump’s February 3, 2018 Executive Order 13772, “Core Principles for Regulating the United States Financial System.”¹ Generally, the Report reflects Treasury’s recommendations that regulatory frameworks should be supportive of technological advances and innovation, data sharing and experimentation to address the needs of financial markets and the FinTech and nonbank financial service industries.

This alert summarizes ten of the Report’s most notable recommendations.



1. UPDATING TELEPHONE CONSUMER PROTECTION ACT & FAIR DEBT COLLECTION PRACTICES ACT

In the Report, Treasury notes that the existing rules governing how companies may communicate through automated phone calls and messages under the Telephone Consumer Protection Act (“TCPA”) and the Fair Debt Collection Practices Act (“FDCPA”) hinder financial services firms from using current methods of digital communication to communicate with customers and expose debt collection firms to litigation risk. The Report recommends various reforms to both the TCPA and FDCPA to reflect consumers’ increased use of digital communication, including a recommendation that the Federal Communications Commission provide guidance on methods that consumers can use to revoke their consent to unwanted contact and a recommendation that the Consumer Financial Protection Bureau promulgate regulations “to codify that reasonable digital communications, especially when they reflect a consumer’s preferred method, are appropriate for use in debt collection.”²

2. PROTECTING CONSUMER FINANCIAL ACCOUNT AND TRANSACTION DATA

The Report observes that the largest publicly-traded U.S. companies rely heavily on data aggregation for telecommunications, logistics, marketing, social media, and other aspects of their businesses.³ The Report loosely defines data aggregation as “any process in which information from one or more sources is compiled and standardized into a summary form.”⁴ Treasury recommends several practices to improve the benefits of data aggregation for consumers, including improving access to such data and disclosures to consumers regarding such data collection, encouraging more secure methods of accessing financial data, and standardizing data elements.⁵ Treasury also notes that Section 1033 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires certain actors to make financial account and transaction data available to consumers, could be expanded to require data aggregators to make such information available to consumers as well.

3. ESTABLISHING A NATIONAL DATA BREACH NOTIFICATION LAW

Treasury observes that while several states have enacted data breach notification laws and codified mechanisms for resolving associated disputes, there is no federal law governing notification of data breaches. Bills aiming to establish a national standard have been introduced in both U.S. legislative chambers this term, although both remain in committee.⁶ Treasury recommends that Congress “enact a federal data security and breach notification law to protect consumer financial data and notify consumers of a breach in a timely manner.”⁷ Treasury lists the following principles to be included in such a law:

- protect consumer financial data;
- ensure technology-neutral and scalable standards based on the size of an entity and type of activity in which the entity engages;
- recognize existing federal data security requirements for financial institutions; and
- establish uniform national standards that preempt state laws.

Given Treasury’s support, it is possible that the pending bills to establish a national standard may receive heightened attention in Congress.

4. HARMONIZING STATE MONEY-TRANSMITTER LICENSING AND SUPERVISION

Treasury’s report also encourages harmonization of state-based regulations for money transmitters, which are nonbank firms that transfer or receive funds on behalf of individuals. As an increasing number of consumers use nonbank firms for services like remittances, online payments, and digital wallet and bill payment services, the myriad state-based regulations pose operational challenges to money transmitters.⁸



Treasury recommends the creation of a model state law to foster consistency, expanding the scope of the Nationwide Multistate Licensing System, streamlining examinations through multi-state cooperation, and potentially, creating a “passporting” system that would provide licensing reciprocity between states. The Treasury Report also recommends that Congress take direct action to promote uniformity of state regulation in this area if states are unable to do so within three years.

5. ENDORSING OCC SPECIAL PURPOSE NATIONAL BANK CHARTER FOR FINTECH FIRMS

The Report expressly endorses the Office of the Comptroller of the Currency’s (“OCC”) proposal from December 2016 to offer special purpose national bank charters for FinTech companies. Such charters would allow for preemption of certain state laws, while triggering minimum supervisory expectations that typically apply to a national bank.

On the same day that Treasury published its report, the OCC issued a press release announcing that it would officially begin accepting applications for these new charters.⁹ See King & Spalding’s separate Client Alert, available [here](#) that discusses this development in greater detail.

6. REQUESTING CONGRESS TO CODIFY THE “VALID WHEN MADE” AND “TRUE LENDER” DOCTRINES

Treasury uses portions of the Report to advocate for Congressional intervention on two legal doctrines that impact the businesses of entities that contract with financial institutions, such as loan servicers, debt collectors, and marketplace lenders.

The “valid when made” doctrine generally provides that an extension of credit that was valid when made does not become invalid simply because it is transferred to another party. This doctrine provides comfort, for example, if a firm purchases or services a high-interest loan that would be invalid under usury laws in its own state but that was valid in the state where the originating lender was located. Treasury’s report recommends that Congress codify this doctrine to clear up any ambiguity created by the 2015 federal circuit court decision in *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2nd Cir. 2015).¹⁰

Similarly, recent court decisions have muddied the distinction between the originating bank and its nonbank partners, such as marketplace lenders, for purposes of determining which is the “true lender.” Since a non-bank that is found to be the true lender potentially becomes subject to interest-rate, licensing and other state requirements, Treasury recommends that Congress codify the principle that “the existence of a service or economic relationship between a bank and a third party (including financial technology companies) does not affect the role of the bank as the true lender of loans it makes.”¹¹

7. PROVIDING IRS INCOME VERIFICATION THROUGH API

For mortgage and other consumer lenders, Internal Revenue Service (“IRS”) tax transcripts have become a key part of analyzing the creditworthiness of potential borrowers. The current process of obtaining such tax transcripts from the IRS can take two to three days or longer and requires the use of third-party vendors. Treasury’s report notes that application programming interfaces (“APIs”) could increase the speed and reliability of the IRS in providing such tax transcripts, which could, in turn, enable lenders to consider tax data more effectively during the underwriting process. The IRS has been constrained by other mission-critical budget priorities from implementing APIs to address these issues. In light of that funding tension, Treasury recommends that Congress fund general IRS modernization, including with respect to tax transcript services.¹²

8. FACILITATING ALTERNATIVE, NON-FICO CREDIT EVALUATION MODELS

Treasury observes that the advent of machine learning and other methods of analyzing large volumes of data has led some firms to explore alternative models to FICO scores to evaluate creditworthiness. Such alternative models use non-



traditional data elements, such as rental history or utility bills, social media, browsing history, behavioral data, shopping patterns, and data about the potential borrower's friends and associates.¹³ The use of such alternative models expands consumer access to credit by enabling lenders to improve credit decisions and extend credit to borrowers that may not have qualified under traditional models. Treasury encourages regulators to support the inclusion of alternative credit data in reporting to credit bureaus and to provide regulatory support to experimentation with non-traditional data inputs for credit analysis.

9. ENABLING THE POLICY ENVIRONMENT: ESTABLISHING A REGULATORY SANDBOX

Treasury argues that the current financial regulatory regime, in particular, with its numerous agencies with overlapping responsibilities, hinders financial innovation. The Report cites many rules that Treasury sees as ripe for change, as well as areas where technological advances have created ambiguities in existing laws or left them entirely outdated. Treasury recommends that federal and state regulators enact regulations to promote innovation through a “regulatory sandbox” that provides a regulatory safe haven “to permit meaningful experimentation for innovative products, services, and processes.”¹⁴

Treasury commits to working with federal and state regulators to design a sandbox “in a timely manner,” and adds that Congress should consider legislation if regulators prove unable to develop a framework based on the following principles:

- Promote the adoption and growth of innovation and technological transformation in financial services;
- Provide equal access to companies in various stages of the business lifecycle (e.g., startups and incumbents);
- Delineate clear and public processes and procedures, including a process by which firms enter and exit;
- Provide targeted relief across multiple regulatory frameworks;
- Achieve international regulatory cooperation or appropriate deference where applicable;
- Maintain financial integrity, consumer protection, and investor protection commensurate with the scope of the project; and
- Increase the timeliness of regulatory feedback offered throughout the product or service development lifecycle.¹⁵

Treasury does not identify a particular agency or set of agencies that should lead such an effort, though the creation of any federal sandbox would likely involve input from multiple agencies with regulatory jurisdiction over FinTech and other nonbank financial services firms. Interestingly, there is little mention of any role that Treasury's Office of Financial Research could play.

10. INDIRECTLY ADDRESSING BLOCKCHAIN AND DISTRIBUTED LEDGER ISSUES

The Report only briefly alludes to blockchain and distributed ledger technology. Given the comprehensive scope of the Report and the rising prominence of cryptocurrencies in the financial world during the past few years, the scant attention paid to blockchain technology is notable. Indeed, Treasury directly acknowledges giving blockchain and distributed ledger technology only “limited treatment” in the Report.¹⁶

However, the Report does allude to additional focus and scrutiny to come: “These technologies, as well as digital assets, are being explored separately in an interagency effort led by a working group of the Financial Stability Oversight Council (“FSOC”). The working group is a convening mechanism to promote coordination among regulators as these technologies evolve.”¹⁷ In addition to any forthcoming guidance from FSOC member agencies, several recommendations in the Treasury Report should nevertheless draw interest from the blockchain community. In particular, the recommendations relating to state money transmitter laws and implementation of a regulatory sandbox approach have direct applications to blockchain start-up firms. Notably, the Report describes cryptography and distributed technologies



as “poised to impact innovation in financial services” — a clear sign that the sector will draw increased attention from Treasury in the years to come.

CONCLUSION / TAKEAWAYS

With Treasury’s positions on these issues now officially on the record, financial technology companies will be eager to see the implementation of many of the Report’s recommendations. With the exception of the OCC’s contemporary announcement regarding special purpose national bank charters, we do not expect the Report’s other recommendations to be implemented any time soon, particularly those requiring legislative action. However, the Report may nevertheless encourage regulators and Congress to consider such changes in a speedier manner and provide them with reassurance of executive branch support for changes to the existing regulatory scheme.

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¹ <https://www.gpo.gov/fdsys/pkg/DCPD-201700094/pdf/DCPD-201700094.pdf>

² Report at 21.

³ “These companies are Apple, Amazon, Alphabet [Google], Microsoft, and Facebook, based on Treasury analysis of Bloomberg data.” Treasury report at 23, FN 43.

⁴ Report at 23.

⁵ Report at 29–39.

⁶ Personal Data Notification and Protection Act of 2017, H.R.3806, 115th Cong.; Data Security and Breach Notification Act, S.2179, 115th Cong..

⁷ Report at 41.

⁸ Report at 65.

⁹ *OCC Begins Accepting National Bank Charter Applications From Financial Technology Companies*, Office of the Comptroller of the Currency, July 31, 2018, <https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html>.

¹⁰ Report at 92–93.

¹¹ Report at 93–94.

¹² Report at 132–34.

¹³ Report at 134.

¹⁴ Report at 167.

¹⁵ Report at 168–169.

¹⁶ Report at 6.

¹⁷ Report at 6.