FEDERALISM AND FINTECH FIRMS: A REVIEW OF PRO-FINTECH INNOVATIONS AND A SUGGESTED FEDERALISM BASED REFORM TO FACILITATE FINTECH INNOVATION

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Abstract

This Article examines the Office of the Comptroller of the Currency's (OCC) proposal to grant special purpose national bank charters to rapidly emerging financial technology (fintech) companies. The Article contemplates the particular dynamics of the OCC's proposal in light of court decisions such as Madden v. Midland Funding, LLC and CashCall that have called certain aspects of the fintech-bank partnership model (bank partnership model) historically favored by fintech companies into question. This Article reviews how the dual banking system has functioned historically and uses this analysis to predict how the OCC's proposal would be expected to operate. After detailing potential issues posed by the OCC's federal solution, the Article puts forth a more effective alternative to the OCC's proposal in the form of a competitive state fintech chartering system modeled on the competitive state chartering system for corporations. The Article also briefly considers whether the OCC could establish a hybrid approach in which national bank charters might incorporate elements of state competition. The Article concludes with a consideration of complications that will continue to inhibit the promise of a fintech charter under a competitive federalism inspired system of state fintech chartering competition.

Table of Contents

I. *Introduction* 315
II. *What Is Fintech?* 317
A. Marketplace Lending 319
1. *The Current Regulatory Landscape for Marketplace Lending* 320

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B. Money Transmission 323

1. The Current Regulatory Landscape for Money Transmission 324

C. Digital Currency 326

1. The Current Regulatory Landscape for Digital Currency...327

III. Differences in Fintech and the Traditional Banking Model.....328

IV. Current Barriers to Fintech Innovation..................................329

A. The Reality of the Dual Banking System and the Role of Federal Preemption in Banking Law 329

1. Did Our Dual Banking System Live Up to Its Promise of Competition and Innovation?.................................330

2. Why Preemption in Banking and Financial Services Promotes Markets and (Counter-intuitively) Federalism..333

B. Preemption Under the NBA Takes Punches under Madden and the Dodd-Frank Act, But Isn't Knocked Out Yet.......338

C. The FDIC's Proposed Guidance for Third-Party Lending 346

D. Bank Partnerships and "True Lender" Issues 348

V. The OCC's New Special Purpose National Bank Charter for Fintech Firms..350

A. Why are Fintech Companies Seeking a "Non-Bank" Special Purpose National Bank Charter? 352

B. Shortcoming of the OCC's Special Purpose National Bank Charter 355

1. Receivership...355

2. Non-Balance Sheet Lenders...356

VI. Considering an Alternative State Chartering System for Non-Bank Fintech Companies 357

A. The Virtues of Competitive Federalism, and Why it Did Not Naturally Evolve in Banking 358

B. How Competitive Federalism Would Operate Effectively for Fintech Companies 361

C. Can a New Competitive Federalism System for Fintech Companies Endure?..365

D. Can the OCC Facilitate Competitive Federalism Under Its Own Authority? 367

VII. Remaining Challenges to Renewed Federalism Under a New Fintech Charter...372

A. The Ever-Present CFPB..372

1. Supervision and Enforcement 372

2. Structure and Accountability 376

3. Project Catalyst and No-Action Letters 377
B. Heightened BSA Scrutiny by the Federal Banking Regulators 379
C. Bank Examiner Privilege 381
D. The Spector of Overreach by the FDIC and OCC in a State-Law Chartering Regime 381
VIII. Conclusion 383

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 continue through a tapestry of legal reforms that occur at regular ten-thirty-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 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.[1] 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 the new nascent fintech companies will fit into the existing regulatory regime.

Fintech companies, which are in some ways like banks, but in some ways not, promise to completely reshape the industry.[2] Some

[1] *See* Carl Felsenfeld & Genci Bilali, *Is There a Dual Banking System?* 2 J. BUS ENTREPRENEURSHIP & L. 30, 31 (2008) ("There is a fierce controversy being waged today about the status of the historic dual banking system in American law. National banks (banks chartered by the national government) derive their powers from federal law. States, on the other hand, assert that they should be able to control certain aspects of national bank operations …").

[2] Cheng-Yun Tsang, *From Industry Sandbox to Supervisory Control Box: Rethinking the Role of Regulators in the Era of Fintech*, 2019 U. III. J.L TECH. & POL'Y 355, 356 (2019) ("The rise of financial technology (fintech) has transformed the modern financial markets and poses unprecedented challenges to regulators.").

fintech innovations are futuristic in the science fiction sense and are changing the world of finance. However, many of these nontraditional providers of financial services do not fit squarely into the current regulatory scheme that was written with traditional bank products and services in mind.[3] 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-era 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.[4] The pace of change promised by the future of fintech is much faster.[5]

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, but 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 under-banked.[6] They also feel compelled to bring an otherwise state-regulated system into federal control.[7] Those in the fintech industry see in the promise of a new federal charter a reprieve from a multitude of fifty different, and

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[3] *Id.*

[4] Aaron C.F. Salerno, *Regulating the Fintech Revolution: How Regulators can Adapt to Twenty-First Century Financial Technology*, 75 N.Y.U. ANN. SURV. AM. L. 365, 381 (2020) ("Even at the turn of the twenty-first century, regulation as applied specifically to online banking was still in its infancy.").

[5] *Id.* at 372 ("The proliferation of open information and lower technology costs have catalyzed this new era of FinTech's history by lowering barriers to entry.).

[6] *Id.* at 372–73 ("Demographic shifts toward younger generations that embrace technology and the growing use of smartphones for financial services now allow FinTech firms to reach a market of millions of consumers instantly").

[7] *Id.* at 380 ("This state-by-state approach to regulation may not have been a major impediment to financial services in an earlier time of our nation's history, but in the era of the FinTech Revolution such fragmented regulatory structure impedes the introduction of new financial service models.").

potentially contrary, state licensing and examination regimes.[8] 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.[9]

Adding to this calculus, a case decided by the Second Circuit in *Madden v. Midland Funding, LLC* 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.[10] 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 expand the range of participants on this secondary market.

This Article will consider the potential paths forward in establishing an efficient regulatory regime for fintech companies. This Article argues that the best approach is 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 federal fintech charter regime. Lastly, this Article 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?

According to the Department of Commerce, the fintech industry is comprised of "companies whose line of business combines

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[8] *Id.* at 379 ("("States have traditionally played a leading role in regulating lending, including interest and feed limitations … For example, nationally-chartered banks and federally-insured state-chartered banks are able to lend nationwide, while FinTech firms must be licensed in every state in which they do business.").

[9] *Id.* at 380 ("This risks depriving the U.S. market of financial innovation benefits, such as improved access to financial services and greater market liquidity.").

[10] Kirby M. Smith, *Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales*, 83 U. CH. L. REV. 1631, 1665 (2016); Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).

software and technology to deliver financial services."[11] These non-bank companies have recently emerged at an accelerated pace, largely due to advances in technology and evolving consumer preferences.[12] Investment in the industry has grown exponentially, evidenced by the fact that investment grew from $1.8 billion in 2010 to $19 billion in 2015 alone.[13] However, the rapid growth in non-bank fintech companies has caused the traditional banking industry to face increased challenges.[14] Jamie Dimon, Chief Executive Officer of JPMorgan, noted these challenges when he stated, "Silicon Valley is coming. There are hundreds of startups with a lot of brains and money working on various alternatives to traditional banking."[15]

Although fintech companies engage in traditional banking functions such as lending, payments, wealth management, and settlements, these companies diverge from the traditional banking model by leveraging new technologies such as cloud computing, artificial intelligence, and big data analytics to provide products and services through alternative platforms and delivery channels.[16] As a

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[11] *2016 Top Markets Report: Financial Technology*, U.S. DEP'T OF COMMERCE & INT'L TRADE ADMIN 3 (Aug. 2016), https://legacy.trade.gov/topmarkets/pdf/Financial_Technology_Top_Markets_Report.pdf [https://perma.cc/PY5T-KL9E].

[12] *See Recommendations and Decisions for Implementing a Responsible Innovation Framework,* OFFICE OF THE COMPTROLLER OF THE CURRENCY 2 (Oct. 2016), https://www.occ.gov/topics/supervision-and-examination/responsible-innovation/comments/recommendations-decisions-for-implementing-a-responsible-innovation-framework.pdf [https://perma.cc/EWS6-M95F] [hereinafter OCC, *White Paper*] ("Technological advances, together with evolving consumer preferences, are reshaping the financial services industry at an accelerated pace.").

[13] *Digital Disruption: How FinTech is Forcing Banking to a Tipping Point,* CITI 7 (Mar. 30, 2016), https://ir.citi.com/SEBhgbdvxes95HWZMmFbjGiU%2FydQ9kbvEbHIruHR%2Fle%2F2Wza4cRvOQUNX8GBWVsV [https://perma.cc/2U7Z-FY35] ("Investments in financial technology have growth exponentially in the past decade—rising from $1.8 billion in 2010 to $19 billion in 2015 …").

[14] *Id.* (finding that new fintech companies have the innovation edge that is leading to increased challenges for traditional banking).

[15] *Id.* at 7.

[16] OCC*, White Paper*, *supra* note 13, at 2 ("[F]intechs engage in the traditional banking functions of consumer lending, payments, wealth management, and settlements. Fintechs also are leveraging new technologies and processes, such as cloud computing, application programming interfaces, distributed ledgers, artificial intelligence, and big data analytics.").

result, fintech companies 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 lend to small businesses and consumers."[17] By using internet-based platforms to link an applicant seeking a loan with party (or parties) willing to fund it, marketplace lenders can 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.[18] 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.[19] Moreover, by utilizing alternative credit models, marketplace lenders are able to identify underserved or undervalued segments of the market.[20]

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[17] *Public Input on Expanding Access to Credit Through Online Marketplace Lending*, Office of the Undersecretary for Domestic Finance, Department of the Treasury, 80 Fed. Reg. 42866 (July 20, 2015) ("Online marketplace lending refers to the segment of the financial services industry that uses investment capital and data-driven online platforms to lend to small businesses and consumers.").

[18] *See* Bimal Patel, Jeremiah O. Norton & Jason Yan, *The Symbiosis of Banks and Marketplace Lending: Where Are We and Where Are We Headed?*, 133 BANKING L.J. 322, 326 (2016) (indicating that many different business models and accounting methods exist and many of them are non-balance sheet lenders).

[19] *Id.* (finding that non-balance sheet lenders who do not account for their loans traditionally effectively avoid exposure to credit risk).

[20] *Id.* ("Many marketplace lenders base their formation on leveraging alternative credit models to identify underserved or undervalued segments of borrowers or mispriced credit.").

1. *The Current Regulatory Landscape for Marketplace Lending*

At present, marketplace lenders have two choices when selecting their operating business model.[21] The Federal Deposit Insurance Corporation (FDIC) has defined these two options stating that marketplace lenders can either become: 1) a "direct marketplace lender"; or 2) become a "bank-affiliated marketplace company."[22] Marketplace lenders operating as direct marketplace lenders facilitate all elements of a loan transaction including "collecting borrower applications, assigning credit ratings, advertising the loan request, pairing borrowers with interested investors, originating the loan, and servicing any collateral loan payments."[23] The borrower's repayment obligation remains with the direct marketplace lender throughout the life of the loan.[24]

Generally, a direct marketplace lender must be licensed and registered in every state where it conducts business.[25] Because the states have different rules and regulations for licensing and registration, the process can be a burdensome, costly, and time-consuming ordeal.[26] In

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[21] *See Supervisory Insights*, FED. DEPOSIT INS. CORP. 12–13 (Winter 2015), https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/SI_Winter2015.pdf [hereinafter FDIC, *Supervisory Insights*] [https://perma.cc/MN3W-3D67] ("When a borrower's requested loan amount is fully pledged, the market-place lending company originates and funds the loan through one of two frameworks: the company lends funds directly (subsequently referred to as a 'direct marketplace lender') or 2) the company partners with a traditional bank to facilitate the loan transaction (subsequently referred to as a 'bank-affiliated marketplace company'.").

[22] *Id.*

[23] *Id.* at 13 ("Direct marketplace lenders facilitate all elements of the transaction, including collecting borrower applications, assigning credit ratings, advertising the loan request, pairing borrowers with interested investors, originating the loan, and servicing any collected loan payments.").

[24] *Id.* at 14 ("Consequently, the borrower's repayment obligation remains with the direct marketplace lender, the security notes issued to investors become the obligation of the direct marketplace lender, and the investors are unsecured creditors of the direct marketplace lender.").

[25] *Id.* at 13 ("A direct marketplace lender typically is required to be registered and licensed to lend in the respective state(s) in which it conducts business.").

[26] *See* Lalita Clozel, *OCC Weighs New Charter for Fintech Firms*, AM. BANKER (May 9, 2016), http://www.cbaofga.com/uploads/4/1/3/7/41371065/occ_weighs_new_charter_for_fintech_firms_american_banker.pdf ("The time, money and energy fintech companies

addition to the patchwork of licensing and registration requirements, direct marketplace lenders are subject to, and must contend with, each state's lending, usury, and consumer protection laws.[27]

Conversely, marketplace lenders can become bank-affiliated marketplace companies by partnering with either a state or national bank.[28] In this model, the bank-affiliated marketplace company "collects borrower applications, assigns the credit grade, and solicits investor interest."[29] However, the bank-affiliated marketplace company then refers the completed loan application package to the partner bank that will originate the loan.[30] Generally, two or three days after the partner bank originates the loan, the partner bank will sell the loan to the bank-affiliated marketplace company.[31] Upon the sale, the borrower's repayment obligation transfers to the bank-affiliated marketplace company.[32]

Although arguably the favored operating model for marketplace lenders, the bank partnership model has been criticized as a "rent-a-bank" scheme by its critics and state-level consumer protection advocates.[33] Critics of the model argue that marketplace lenders have

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expend on the licensing process often clips their wings in the early stages.").

[27] *Id.*

[28] Catherine Brennan, *Clash of the Titans: Federal Versus State Interest in Bank Partnerships*, A.B.A. (Mar. 15, 2019), https://www.americanbar.org/groups/business_law/publications/blt/2019/03/titans/ [https://perma.cc/34Q6-NMS8] ("Some marketplace lending companies operate through a cooperative arrangement with a partner bank.").

[29] FDIC, *Supervisory Insights*, *supra* note 22, at 14.

[30] *Id.* ("However, from that point the bank-affiliated marketplace company refers the completed loan application packages to the partner bank that makes the loan to the borrower.").

[31] *Id.* ("The partner bank typically holds the loan on its books for 2-3 days before selling it to the bank-affiliated marketplace company.").

[32] *Id. (*By the end of the sequence of transactions, the borrower's repayment obligation transfers to the bank-affiliated market-place company, and the security noteholder maintains an unsecured creditor status to the bank-affiliated marketplace company, which mirrors the outcome described under the direct funding framework.").

[33] *See* Nat'l Consumer L. Ctr. et al., Comments to the Comptroller of the Currency Office of the Comptroller of the Currency on "Exploring Special Purpose National Bank Charters for Fintech Companies" (Jan. 17, 2017) [hereinafter NCLC Comment Letter], https://www.occ.treas.gov/topics/responsible-innovation/comments/comment-nclc-et-al.pdf [https://perma.cc/W8CG-

historically used the bank partnership model as a means to evade state interest rate caps, licensing requirements, and consumer protection law.[34] 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.[35] Thus, 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 violating state usury law.[36] However, non-bank lenders, such as marketplace lenders, are unable to take advantage of the exportation doctrine and have consequentially used the bank partnership model as a means to evade state usury law restrictions.[37]

Certain aspects of the bank partnership model, such as whether non-banks can rely on the partner bank's exported interest rate, have been called into question by the *Madden v. Midland Funding, LLC* decision and the growing prominence of the "true lender" test.[38] Though

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D33D] (noting that federal bank regulators and the FDIC tried to shut down high-rate rent-a-bank lending that harmed consumers).

[34] *Id.* at 6–13 (finding that state law attempted to regulate the rent-a-bank structure as it allows lenders to bypass state interest rate caps, licensing requirements, as well as consumer protection laws).

[35] *See* Marquette Nat'l. Bank v. First Omaha Serv. Corp., 439 U.S. 299, 318 (1978) (holding that a national bank can "export" the interest rates of its home state to loans made to out-of-state borrowers, even if such interest rates would otherwise violate usury laws in the borrower's home state); *see also* 12 U.S.C. § 1831(a) (2018) (listing the permissible activities of insured state banks).

[36] Richie Bernardo, *Usury Laws by State, Interest Rate Caps, The Bible & More*, WALLETHUB (June 20, 2014), https://wallethub.com/edu/cc/usury-laws/25568 [https://perma.cc/B9W7-RZN4] (finding that states, like South Dakota and Delaware, in order to attract large banks and strengthen their local economics, repealed their usury laws, allowing banks to charge "unlimited" interest rates without violating state law).

[37] *See* John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INST. 17, 34–35 (2016) (recognizing that in order to avoid state-by-state interest and usury restrictions, or to avoid the state-by-state licensing requirements, nonbank lenders often partner with regulated banks).

[38] Madden v. Midland Funding, LLC, 786 F.3d 246 (2nd Cir. 2015) (holding that non-bank entities are not protected under the National Bank Act from state-law usury claims just because they are assignees of a national bank); Consumer Fin. Prot. Bureau v. CashCall, Inc., No. CV-15-7522-JFW-RAOX, 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016) (concluding that the court should look at the substance, and not the form of the transaction, to identify

the OCC and the FDIC attempted to fix the issues created by the Madden case, the nearly five year time frame during which this market was in limbo demonstrates the rigidity of the present system's design. These issues are further discussed in later sections.

Regardless of the operating model, marketplace lenders must also comply with various federal laws during all points of the marketplace lending transaction, including: the Bank Secrecy Act (BSA), the Truth in Lending Act (TILA), the Equal Credit Opportunity Act (ECOA), the 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).[39]

B. Money Transmission

A money transmitter can be broadly defined as an entity that provides the transfer of money or value from one person to another.[40] However, the definition of a "money transmitter" differs both state-by-state and at the federal level.[41] 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.[42]

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who is the true lender by deciding who had the predominant economic interest.).

[39] *See* Patel, Norton & Yan, *supra* note 19, at 327–28 (summarizing various federal and state statutes for which compliance obligations attach for marketplace lenders).

[40] Ellen T. Berge & Andrew E. Bigart, *Money Transmission in the Payment Facilitator Model*, VENABLE LLP (June 27, 2018), https://www.venable.com/insights/publications/2018/06/money-transmission-in-the-payment-facilitator-mode [https://perma.cc/Y274-5Q7E] (finding that money transmission is "generally defined to mean the receipt of funds for the purpose of transmitting them to another place or person").

[41] *Id.* (finding that the definition of "money transmission" may vary to some degree as it is regulated under both state and federal laws).

[42] *See* 18 U.S.C. § 1960 (2018) ("[T]he term 'illegal money transmitting business' means a money transmitting business which affects interstate or foreign commerce in any manner or degree and … is intentionally operated without an appropriate money transmitting license in a State where such operation is punishable as a misdemeanor or a felony under State law …").

1. The Current Regulatory Landscape for Money Transmission

Money transmitters are regulated at both the state and federal level, but for different reasons.[43]At the state level, money transmitter laws are centered on safety, soundness, and consumer protection concerns.[44] Ultimately, state regulation aims to prevent loss to the individual consumer.[45] Conversely, applicable federal law aims to prevent money laundering.[46] 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 very limited exceptions.[47] 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.[48] If an entity meets the definition of a "money transmitter" under state law, it must also register at the federal level with the Financial Crimes Enforcement Network (FinCEN), a federal bureau within the United States Department of the Treasury.[49]

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[43] Benjamin Lo, *Fatal Fragments: The Effect of Money Transmission Regulation on Payments Innovation*, 18 YALE J.L. & TECH. 111, 113 (2016).
[44] Lawrence Trautman, *Virtual Currencies; Bitcoin & What Now After Liberty Reserve, Silk Road, and Mt. Gox?,* 20 RICH. J.L. & TECH. 13, 23 (2014) ("Accordingly, state money transmitter laws are essentially 'safety and soundness' statutes designed to ensure that consumer funds are protected from loss.").
[45] *Id.*
[46] Lo, *supra* note 44, at 113–14 ("Financial regulators stand on one side, arguing that companies moving large sums of consumer money around need to be monitored for consumer protection and anti-money laundering reasons, even if they don't fit the traditional money transmitter model.").
[47] Trautman, *supra* note 45, at 24 ("A license is required in most states before a money transmitted may conduct business. Therefore, any entity operating as a money transmitter that fails to obtain the necessary state licensing or to register with FinCEN may become subject to criminal prosecution …").
[48] Eric Weisbrot, *How to Get a Money Transmitter License*, JW SURETY BONDS (Mar. 5, 2019), https://www.jwsuretybonds.com/blog/money-transmitter-license-step-by-step-guide [https://perma.cc/T88R-YFZ7] ("While these vary from state to state, common requirements include the following: a license application that includes the business address, a tax identification number … application and licensing fees … a form of security, most often a surety bond …").
[49] *Id.* ("Above and beyond the various state requirements to get a money transmitter license, any business operating as an MSB also has federal laws

Under FinCEN regulations, a "money transmitter" is defined as a person that provides money transmission services.[50] 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 location or person by any means."[51] Whether an entity's activities come within the definition of a money transmitter is a matter of facts and circumstances.[52] The BSA and its implementing regulations require that money service businesses (MSBs) register with FinCEN as well as implement an effective AML compliance program.[53] As FinCEN has made clear that money transmitters are a category of MSBs, money transmitters must also comply with the BSA and AML requirements.[54] BSA requirements include, but are not limited to: filing Currency Transaction Reports (CTRs), filing Suspicious Activity Reports (SARs), and performing customer due diligence and retaining records.[55] 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.[56]

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to understand and comply with. This includes registration with the Financial Crimes Enforcement Network, FinCEN.").

[50] 31 C.F.R. § 1010.100.

[51] *Id.*

[52] *Id.* ("Facts and circumstances; Limitations … Whether a person is a money transmitter as described in this section is a matter of facts and circumstances.").

[53] 31 U.S.C. § 5330(a)(1) (2018) ("Any person who owns or controls a money transmitting business shall register the business (whether or not the business is licensed as a money transmitting business in any State) with the Secretary of the Treasury not later than the end of the 180-day period beginning on the later of … the date of enactment of the Money Laundering Suppression Act of 1994 [enacted Sept. 23, 1994] … or … the date on which the business is established.").

[54] Weisbrot, *supra* note 49.

[55] *BSA Requirements for MSBs*, FINCEN, https://www.fincen.gov/bsa-requirements-msbs [https://perma.cc/B6P8-QGBB].

[56] Patel, Norton & Yan, *supra* note 19, at 5.

C. Digital Currency

Digital currency has grown in popularity as an alternative to traditional currencies[57] 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."[58] Unlike government backed fiat money, digital currency is not controlled or backed by a central bank or government.[59] Digital currency enjoys several benefits over that of traditional currencies including lower transaction fees, faster transfer of funds, and anonymity of the user.[60]

Although there are currently 250 active digital currencies, Bitcoin, introduced in 2009, is by far the most common and comprises approximately 82% of the virtual currency market.[61] Between May 2013 and April 2016 the number of daily transactions related to Bitcoin 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.[62]

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[57] *See* Treasury Inspector Gen. for Tax Admin., *As the Use of Virtual Currencies in Taxable Transactions Become More Common, Additional Actions are Needed to Ensure Taxpayer Compliance,* U.S. DEP'T OF TREASURY 1 (Sept. 2016), https://www.treasury.gov/tigta/auditreports/2016reports/201630083fr.pdf [hereafter Treasury Inspector General, *Virtual Currencies*].

[58] Coinflip, Inc. d/b/a Derividan, and Francisco Riordan, CFTC No. 15-29 (Sept. 17, 2015).

[59] Meghan E. Griffiths, *Virtual Currency Businesses: An Analysis of the Evolving Regulatory Landscape*, 16 TEX. TECH. ADMIN. L.J. 303, 306 (2015) ("The North American Securities Administrators Association describes virtual currency as "an electronic medium of exchange that, unlike real money, is not controlled or backed by a central government or central bank.").

[60] *Id.*

[61] Treasury Inspector General, *Virtual Currencies*, *supra* note 58, at 1.

[62] *Id.* ("Between May 2013 and April 2016, the number of bitcoins in circulation increased from approximately 11.2 million to more than 15.4 million, while the number of daily transactions related to bitcoins has grown from 58,795 to about 220,804").

1. *The Current Regulatory Landscape for Digital Currency*

Although the regulatory landscape is evolving and somewhat uncertain, digital currency business may be deemed to be money transmitters and thus subject to applicable requirements and obligations as MSBs.[63] Recent developments show that some states have issued guidance and regulations affecting digital currency businesses.[64]

At the federal level, FinCEN has issued several administrative rulings detailing the requirements and obligations for digital currency, using the related phrase of "virtual currency" businesses.[65] In March 2013, FinCEN issued guidance stating virtual currency would not constitute "currency" under the BSA's implementing regulations.[66] 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 regulation as MSBs.[67] FinCEN defined three different actors in the virtual currency market: (1) users, who obtain virtual currency to purchase goods or services;

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[63] See Griffiths, *supra* note 60, at 308–11 ("An important question that any virtual currency business should ask is whether its operations subject the company to federal and state registration requirements as a money transmitter … [FinCEN] has issued several administrative rulings regarding money transmitter registration requirements and related obligations for virtual currency businesses … Forty-seven states and the District of Columbia have money transmitter licensing requirements, and some have issued memoranda or, in the case of New York, proposed regulations regarding licensing requirements for virtual currency businesses.").

[64] *See* Emily Schmall & Jill Craig, *States Differ on Need for Bitcoin Oversight*, WASH. TIMES (Apr. 1, 2015), www.washingtontimes.com/news/2014/nov/27/states-differ-on-need-for-bitcoin-oversight/?page=all.

[65] Griffiths, *supra* note 60, at 309.

[66] *Application of FinCen's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies* (Mar. 18, 2013), https://www.fincen.gov/resources/statutes-regulations/guidance/application-fincens-regulations-persons-administering [https://perma.cc/K6G6-9GFX] ("Virtual currency does not meet the criteria to be considered 'currency' under the BSA, because it is not legal tender").

[67] *See id.*; *see also* 31 C.F.R. § 1010.100(m) (defining "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").

(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.[68] 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.[69]

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.[70] Professors Henry Butler and Jonathan 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."[71] 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.[72] When they do work with existing banks, however, they can potentially be subject to regulation by the banking regulators

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[68] *Id.* (Persons "creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies … are referred to … as 'users,' 'administrators', and 'exchangers' … A user is a person that obtains virtual currency to purchase goods or services. An exchanger is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency. An administrator is a person engaged as a business in issuing … a virtual currency, and who has the authority to redeem … such a virtual currency.).

[69] *Id.*

[70] *See* Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 711 (1988).

[71] *Id.*

[72] Sergio Schmuckler & Juan Jose Cortina Llorente, *The Fintech Revolution: The End of Banks as We Know Them?*, WORLD BANK BLOGS (May 7, 2018), https://blogs.worldbank.org/allaboutfinance/fintech-revolution-end-banks-we-know-them [https://perma.cc/E3XC-SFSY] ("Banks also seem to be shifting toward viewing fintech companies as partners and enablers rather than disruptors and competitors.").

as third-party service providers under the Bank Service Company Act (BSCA).[73] Decisions such as the *Madden v. Midland Funding, LLC* and *CFPB v. CashCall*, however, brought the viability of these partnerships into question for a significant period of time until subsequent guidance from the OCC and FDIC was adopted in 2020 to reduce a portion of that uncertainty.[74]

IV. Current Barriers 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.[75] The promise of the dual banking system was that it would promote competition and innovation

[73] Even 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. Andrew E. Bigart, *Fintech Guide to Bank Partnerships: A Practical and Legal Roadmap*, VENABLE LLP (Mar. 1, 2021), https://www.venable.com/insights/publications/2021/03/fintech-guide-to-bank-partnerships [https://perma.cc/6RFE-8R4V] ("Specifically, the BSCA provides banking regulators with authority to examine and regulate third-party vendors that provide services to banks.").

[74] Pratin Vallabhaneni, *FDIC and OCC Attempt to Settle Uncertainty Created by Second Circuit's Madden Decision*, WHITE & CASE (Dec. 5, 2019), https://www.whitecase.com/publications/article/fdic-and-occ-attempt-settle-uncertainty-created-second-circuits-madden [https://perma.cc/HPR3-LJFQ] ("The Madden decision also increased legal and business risks for marketplace lending and bank-non-bank lending partnerships, adding to the uncertainty faced by such partnerships from the "true lender" questions discussed below"); *CFPB v. CashCall: Another Concern for Partner Lending Models?*, MCGLINCHEY (Sept. 12, 2016), https://www.mcglinchey.com/insights/cfpb-v-cashcall-another-concern-for-partner-lending-models/ [https://perma.cc/2XHT-9MQJ] ("The CashCall decision calls into question the inherent legitimacy of arrangements similar to bank partnership programs, while the Second Circuit's decision in Madden to disregard the "valid when made" doctrine becomes a factor only if the named lender actually is the true lender.").

[75] JAY B. SYKES, CONG. RESEARCH. SERV., R45081, BANKING LAW: AN OVERVIEW OF FEDERAL PREEMPTION IN THE DUAL BANKING SYSTEM 4 (2018).

in regulatory approaches to banking.[76] 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.[77]

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."[78] 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.[79]

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?*

Since 1863, the United States has had a dual banking system in which state and federal governments compete to charter and regulate commercial banks.[80] Accordingly, when obtaining a bank charter, a bank can choose to obtain either a national charter from the OCC or a state charter from the state's primary banking regulator.[81] If a bank chooses to obtain a national charter, the bank will be subject to primary

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[76] *Id.* at 7.

[77] *Id.* at 7–8.

[78] *See* Tiffany v. National Bank of Missouri, 85 U.S. 409, 412 (1873) ("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.").

[79] SYKES, *supra* note 77, at 5.

[80] *Id.* at 4.

[81] Christine E. Blair & Rose M. Kushmeider, *Challenges to the Dual Banking System: The Funding of Bank Supervision*, 18 FDIC BANKING REV. 1, 2.

supervision by the OCC.[82] However, if a bank obtains a state charter, the bank will be subject to joint supervision between the state's primary banking regulator and at least one primary federal regulator.[83] The primary federal regulator for state-chartered banks that join the Federal Reserve System is the Board of Governors of the Federal Reserve System.[84] Conversely, state-chartered banks that do not join the Federal Reserve System will have the FDIC as their primary federal regulator.[85]

The dual banking system decidedly leans in favor of federal power due to the fact that virtually all depository institutions are federally insured and consequentially subject to at least one federal primary regulator.[86] State and federal regulators coordinate their supervision of state-chartered institutions and typically conduct either alternative or joint supervisory examinations.[87] In addition, state and federal regulators coordinate on other matters such as policy through the Federal Financial Institutions Examination Council and the Conference of State Bank Supervisors.[88]

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.[89] 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.[90] However, Butler and Macey show that the dual banking system never

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[82] *Id.* at 1.
[83] *Id.*
[84] *Id.*
[85] *See* MARK JICKLING & EDWARD V. MURPHY, CONG. RESEARCH SERV., R44918, WHO REGULATES WHOM? AN OVERVIEW OF U.S. FINANCIAL SUPERVISION 12 (2010).
[86] *Id.*
[87] OFF. OF AUDITS AND EVALUATIONS, OFF. OF THE INSPECTOR GEN., FED. DEPOSIT INS. CORP., REPORT NO. AUD-12-011, THE FDIC'S EXAMINATION PROCESS FOR SMALL COMMUNITY BANKS (2012), at 2, http://www.fdicoig.gov/reports12/12-011AUD.pdf [hereinafter FDIC OIG, *Exam Process*].
[88] *Id.* at 2–3.
[89] Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 39 (2006).
[90] Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 12 (1977).

obtained the necessary preconditions to make regulatory competition effective.[91]

Unlike a general corporate charter, obtaining a bank charter is not a matter of right and there is no guarantee the charter will ultimately be approved.[92] 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.[93] For example, 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.[94]

Similarly, unlike state competition for general corporate charters, there is no competition amongst the state banking regulators for bank charters due to the fact that banks must obtain a charter in the jurisdiction in which they do business.[95] Consequentially, a bank wishing to change regulators is effectively left with only one option for charter conversion if they want to continue to operate in the same jurisdiction, namely to convert from a state charter to a federal charter or vice versa. [96] Charter competition is thus inhibited by the lack of free entry and exit by the regulated parties.[97]

The necessary preconditions to competitive state federalism are not present in the current dual banking system.[98] A lack of free entry and exit by chartered institutions inhibits effective charter competition.[99]

Consequentially, in order for a non-bank charter system to be competitive, federal law must preempt application of state law to out-of-state charters.[100] It must also facilitate the free conversion of charters

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[91] Butler & Macy *supra* note 72, at 684–89 (describing how the preconditions for making regulatory competition effective were held back by the chartering process and difficulty of converting charters.)
[92] *Id.* at 685.
[93] *Id.*
[94] *Id.*
[95] *Id.* at 686.
[96] *Id.* at 686–87.
[97] *See id.* at 686 (observing that "[r]egulated firms must be able to switch easily from one regulator to another in order to obtain the benefits of competition among regulators.").
[98] *See id.* at 693–94.
[99] *See id.* at 688.
[100] Smith, *supra* note 11, at 1681–82 (observing that if state usury laws were not preempted under the NBA, it would create uncertainty and lead to a reduction in credit available).

between states by affording chartered institutions a right to leave one jurisdiction.[101] 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.[102]

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.[103] 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.[104] 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.[105]

Another reason preemption became so essential was that a lack of an internal affairs doctrine in banking law to give the chartering institution 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.[106] The multitude of competing state regulations hindered development of national markets in bank services without the presence of strong preemption.[107]

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[101] Scott, *supra* note 92, at 12.
[102] *See id.* at 10.
[103] Smith, *supra* note 11, at 1637.
[104] *See id.* at 1633 ("Congress passed the NBA at the height of the Civil War in 1864 to create a stable national currency and banking system during and after the Civil War.").
[105] *See* Veazie Bank v. Fenno, 75 U.S. 533, 539 (1869).
[106] *See* Smith *supra* note 11, at 1633 (analyzing that the National Banking Act's preemption doctrine was designed to establish a stable national market for currency and provide a significant shield against intrusion by state regulations and consumer protection laws.).
[107] *Id.* at 1640–41.

Advocates of federalism tend to be suspicious of legal doctrines, laws, or regulations which preempt state law. Professors Larry Ribstein and Erin 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."[108] They admit that "in order to facilitate interstate trade [in the law market], the federal government can always preempt these states' refusal to enforce choice-of-law clauses."[109] Professor Michael Greve puts a finer point on the matter, arguing, "The last line of defense, and the central battlefield along federalism's frontier, is federal preemption. In that theatre, the Rehnquist Court's state's rights defenders have handed the false federalist a deadly weapon."[110]

In the banking law context, preemption was essential to establish a national banking system.[111] 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.[112]

Critics of preemption have urged, in addition to traditional arguments about federalism, that preemption, particularly in the financial services context, has various economic costs.[113] 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

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[108] *See* Larry E. Ribstein & Erin Ann O'Hara, *Corporations and The Market for Law*, 2008 U. ILL. L. REV. 661, 666 (2008).

[109] *Id.* at 667.

[110] *See* Michael S. Greve, *Federalism's Frontier*, 7 TEX. REV. L. & POL. 93, 111 (2002).

[111] SYKES, *supra* note 77, at 2.

[112] Ellen Traupman Berge & Andrew E. Bigart, *Challenges in Expanding Financial Services to the U.S. Market*, VENABLE LLP (Feb. 27, 2020), https://www.venable.com/insights/publications/2020/02/challenges-in-expanding-financial-services-to-the [https://perma.cc/A9EG-Q8NT] (discussing bank partner lending models and how preemption of state lending may apply to a fintech company).

[113] *See, e.g.*, Joseph R. Mason, Robert Kulick, & Hal J. Singer, *The Economic Impact of Eliminating Preemption of State Consumer Protection Laws*, 12 U. PA. J. BUS. L. 781, 790 (2010).

preemption by the OCC helped to contribute to the financial crisis of 2008.[114]

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.[115] Instead, it found that smaller national banks, which lacked the economies of scale enjoyed by larger banks in compliance costs, experienced the greatest benefits from preemptive actions, which relieved them of compliance with 50 different state regulatory regimes.[116]

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.[117] They also argue that it led to a rise in predatory lending practices and precluded state attorney generals from enforcing their states' consumer protection laws. [118] 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.[119]

Professor 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.[120] What he fails to appreciate

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[114] *See id*. at 789–90 (considering the compliance costs ending preemption will have on smaller banks).
[115] *Id.* at 788–89.
[116] *Id.*
[117] *See id*. at 790.
[118] *Id.*[119] 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).
[119] 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).
[120] Arthur E. Wilmarth Jr., Cuomo v. Clearinghouse*: The Supreme Court Responds to the Subprime Financial Crisis And Delivers A Major Victory for the Dual Banking System and Consumer Protection*, *in* THE PANIC OF 2008: CAUSES, CONSEQUENCES, AND IMPLICATIONS FOR REFORM 21 (Edward Elgar Publishing, 2010) (describing how the OCC only issued one enforcement order for a violation of state law, and that was only after the investigation received public attention.).

is that banking enforcement is subject to a high degree of nonpublic informal action by regulators and informal settlement by regulated banks.[121] 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.[122]

In making that argument, Wilmarth ignores a wealth of literature that demonstrates hybrid loans such as these have helped both borrowers and lenders to efficiently manage financial risk.[123] 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.[124]

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[121] *See* 12 U.S.C. § 1818(u) (2018) (noting that 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)).

[122] Wilmarth, *supra* note 122, at 21 ("Between 1999 and 2006, more than thirty states enacted laws to combat predatory lending. recent study found that state anti-predatory laws reduced the number of mortgages with unsound or abusive features such as prepayment penalties, balloon payments, and no- and low documentation terms. In addition, state officials vigorously used their enforcement powers to prosecute financial service providers for a wide range of unlawful practices.").

[123] *See generally*, Todd Zywicki, *The Consumer Financial Protection Bureau*: *Savior or Menace*?, 81 GEO. WASH. L. REV. 856 (2013) (finding generally that both borrowers and lenders are exposed to large amounts of financial risk, and varied loan structures may help them find more favorable structures).

[124] *See* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV 1, 81–83 (2008) ("By permitting the states to compete for business by offering less and less consumer protection, the regulation scheme starts to unravel. Moreover, federal regulations that preempt state consumer protection without substituting other protection schemes create large holes in the regulatory fabric that encourage lenders to use a national charter to evade local protection. The combination not only leaves consumers with little protection, it also creates structures in which the most aggressive lenders can pursue their tactics with impunity."); 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, 309 (1995) (remarking that consumers are frequently deceived and focused on short-term versus long-term outlooks in such circumstances); *see also* Smith, *supra* note 11, at 1643 ("Advocates claim the average consumer does not have enough knowledge to fully understand the implications of most loans,

Critics of preemption in financial services also miss the principal benefit it offers.[125] Preemption is also vitally important to ensure that national markets in securitized loans can function.[126] 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.[127]

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.[128] 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.[129]

especially the most pernicious lending practices such as payday lending and instant tax refunds. Further, advocates argue that extremely high interest rates can lead to a cycle of borrowing that unsophisticated consumers cannot understand when they initially take out a loan and cannot escape once they do.").

[125] Mason et al., *supra* note 115, at 804 ("Critics of preemption have focused on the straw-man issue of the subprime mortgage crisis while ignoring the empirical evidence that preemption has increased economic efficiency and consumer welfare.").

[126] *See id*. at 797 ("For example, preemption has helped ensure the efficient functioning of the national market for securitized mortgages.").

[127] *Id.* ("Moreover, disparate state laws in areas concerning what defines a 'finance charge' or what constitutes an 'acceptable' interest rate further undermine the ability to securitize the cash flows from mortgage loans.").

[128] *Id.* at 782–83 ("Each of these actions facilitated increased price competition and increased availability of financial services for local consumers, despite efforts by entrenched local political interests to avoid increased competition … preemption increases the availability of credit while reducing its price … Preemption also removes obstacles to the creation of national credit markets … preemption creates a uniform regulatory climate for banks operating across state lines, allowing them to operate more efficiently. A review of the economic literature on state regulation of banks reveals that reducing barriers to bank services across state lines increases economic efficiency and social welfare.").

[129] *Id.*

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

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 as well as from limitations contained in the Dodd-Frank Act.[130]

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 Article.[131] It will show the limits that OCC preemption could provide to a new class of non-bank limited purpose fintech companies. 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 companies will actually be to them.

New restrictions in the Dodd-Frank Act will also have important implications for the alternative advanced later in this Article that a competitive, 50-state charter system for limited purpose fintech companies, with mutual recognition among the states achieved via federal preemption, would be superior to a unified federal OCC charter system. This Article 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 the Dodd-Frank Act 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.[132] It must make preemption decisions with respect to

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[130] *See* Madden v. Midland Funding LLC, 786 F.3d 246, 255 (2d Cir. 2015).

[131] *See id.*

[132] SYKES, *supra* note 77, at 18 ("Section 1044 [of Dodd-Frank] contains a provision articulating a general standard to govern the preemption of "state

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.[133]

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.[134] The OCC, however, does not have the power to preempt state consumer financial protection laws for bank subsidiaries however.[135] Bailey 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.[136]

The CFPB is also granted preemptive powers under the Dodd-Frank Act, but it can only preempt state consumer protection laws if they are inconsistent with federal law.[137] The Dodd-Frank Act specifically states that any state law that provides greater protection

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consumer financial laws," and additional provisions addressing a number of discrete preemption issues.").

[133] Michael Hamburger, *The Dodd-Frank Act and Federal Preemption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 14 (2011) ("A reviewing court must evaluate: (1) Whether the determination is valid (based on the OCC's thoroughness in considering the issue); (2) Whether the OCC's reasoning is valid; (3) Whether the determination is consistent with other valid determinations; and (4) Any other factors that the court finds to be relevant and persuasive.").

[134] *Id.* at 10 ("Entities covered under the CFP Act remain subject to state laws unless the laws are "inconsistent" with the Act's provisions.").

[135] *Id.* ("Subsidiaries and affiliates of these banks and thrifts, however, are made subject to state law despite potentially contrary provisions of the 'National Bank Act and Home Owners' Loan Act.").

[136] Bailey, *supra* note 121, at 1085 ("Undoubtedly, national banks will respond to this change by merging their operating subsidiaries into the parent bank rather than incurring the burdensome cost of complying with the diverse laws of the fifty states.").

[137] Hamburger, *supra* note 135, at 2 ("Several provisions of the CFP Act modify the extent to which federal consumer financial laws preempt state consumer financial laws. First, state laws are generally preempted only if they are inconsistent with federal law.").

than federal law is not inconsistent with the Dodd-Frank Act and accordingly cannot be preempted.[138]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 guise of consumer protection. The OCC can only preempt consumer financial protection laws to the extent it is doing so for a bank.[139] 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 *Barnett Bank of Marion County, N.A. v. Nelson*, [140] which is essentially a conflict preemption standard.[141] State consumer protection laws, which interfere with a national bank's exercise of powers granted by the National Bank Act, can be preempted.[142] The Dodd-Frank Act, however, vitiated the Supreme Court's holding in *Watters v. Wachovia Bank, N.A.*, which had previously found that the OCC could extend preemption to operating subsidiaries of national banks.[143] In its reasoning, the *Watters* Court found that the determination of preemption focuses "on the exercise of a national bank's powers, not on its corporate structure."[144]

Professor Dori Bailey argues that the new preemption standard created by the Dodd-Frank Act amounts to the less deferential *Skidmore* review of agency decision-making.[145] In *Baptista*, decided after the Dodd-Frank Act, the Eleventh Circuit didn't allude to

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[138] *Id.* at 3 ("A state law is not inconsistent, however, if it provides greater protection to consumers than the 'protection provided under [the Act].'").
[139] *Id.* at 5 ("In addition to codifying a separate preemption standard for national banks, the Act vests authority to make preemption determinations in a different regulator: the OCC.").
[140] 517 U.S. 25, 33 (1996).
[141] Hamburger, *supra* note 135, at 3.
[142] *Id.*
[143] 550 U.S. 1, 4 (2007) ("A national bank may engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the bank itself; that power cannot be significantly impeded by state law.").
[144] *Id.* at 18.
[145] Bailey, *supra* note 121, at 1073 ("In the Dodd-Frank Act, Congress adopted *Skidmore* deference as the new standard of review of a decision by the Comptroller to preempt a state law … Congress apparently has decided to accord the Comptroller the lower level of deference under *Skidmore*.").

Skidmore when granting deference to OCC preemption.[146] 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.[147]

Professor Thomas 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.[148] Nonetheless, the Supreme Court did not discard the *Chevron* analysis entirely but instead stated that "the presence of some uncertainty does not expand Chevron deference to cover virtually any interpretation of the NBA."[149] 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.[150]

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 *Madden v. Midland Funding, LLC* case, 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 companies is more important now that ever.[151]

In *Madden v. Midland Funding, LLC*, 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

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[146] Baptista v. JPMorgan Chase Bank, N.A., 640 F.3d 1194, 1198 (11th Cir. 2011).
[147] *Id.* at 1997. ("State consumer financial laws are preempted, only if … in accordance with the legal standard for preemption in *Barnett* … the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers.").
[148] Ramyn Atri, Cuomo v. Clearinghouse*: The Latest Chapter In the OCC's Pursuit of Chevron Deference*, 14 N.C. BANKING INST. 467, 493 (2010) (citing Thomas W. Merrill, Cuomo v. Clearing House*: Why We Are Still in the Dark about Agency Preemption*, LOMBARD STREET, Aug. 17, 2009, at 22).
[149] *Id.*
[150] *Id.*
[151] Madden v. Midland Funding, LLC, 786 F.3d 246, 246 (2d Cir. 2015).

NBA.[152] 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.[153] After the plaintiff defaulted, BoA sold the debt to a non-bank assignee in the secondary market.[154] When the non-bank defendant attempted to collect the debt (that included 27% interest) 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).[155]

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.[156] 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.[157] 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."[158]

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.[159] 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

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[152] *Id.*
[153] *Id.* at 247.
[154] *Id.* at 248.
[155] *Id.*
[156] *Id.* at 246.
[157] *Id.* at 251.
[158] *Id.* at 249.
[159] Smith, *supra* note 11, at 1668 ("This has implications for the price of the loan that a bank in the Second Circuit (under Madden) is attempting to sell. Other banks will not be able to purchase the debt at its intrinsic value because of this regulation, so debt purchasers may be the only natural buyers left.").

the wake of the Dodd-Frank Act.[160] 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 on its platform maintain an interest in the loans traded on their platform.[161] This effect will result in increased costs and diminish the amount of credit available that is intended to be traded in the secondary market.[162]

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.[163] 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.[164] 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.[165] The Court recognized that the ability to export consumer financial protection law was what made that national market possible.[166] Moreover, a Seventh Circuit opinion by Judge Richard 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.[167]

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[160] *Id.* at 1665 ("The price other banks will pay for defaulted loans (like those at issue in Madden) with high capital requirements, and thus high equity requirements, is limited by the capital requirements—a lower price will increase the expected return and may make the purchase attractive despite the large capital requirements.").

[161] *Id.* at 1680.

[162] *See id.* ("Lending Club's change concretizes the results suggested by the transaction cost analysis of the question of preemption continuing to apply after a sale—banks will find ways around it and consumers will be harmed.").

[163] Marquette Nat'l. Bank v. First Omaha Serv. Corp.,439 U.S. 299, 299 (1978).

[164] *Id*.

[165] *Id*. In 1980 the Federal Deposit Insurance Act was amended to give state-chartered banks the same exportation rights. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 & 15 U.S.C.).

[166] *Id.*

[167] Olvera v. Blitt & Gaines, P.C., 431 F.3d 285, 285 (7th Cir. 2005).

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.[168] It is clear though that *Madden* departed from the deferential approach to preemption displayed in *Marquette*.[169]

The conflict with prior precedent is even stronger in regards to *Pacific Capital Bank v. Connecticut*, which the Second Circuit decided in 2008.[170] 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.[171]

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.[172] 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 that preemption could be used in the future to the benefit of unaffiliated bank third parties.[173]

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 that, in the future, it would look skeptically upon "ventures distant from dealing in financial investment instruments."[174]

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[168] Hamburger, *supra* note 135, at 15.
[169] *See* Marquette Nat'l. Bank v. First Omaha Serv. Corp, 439 U.S. 299, 299 (1978).
[170] Pac. Cap. Bank, N.A. v. Connecticut, 542 F.3d 341, 341 (2d Cir. 2008).
[171] *Id.*
[172] *Id.* at 183.
[173] SPGGC, LLC v. Blumenthal, 505 F.3d 183 (2d Cir. 2007).
[174] NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 259 n.2 (1995).

The Supreme Court requested a briefing from the Solicitor General on whether to take up cert in *Madden*.[175] The Solicitor General made the unprecedented move of providing a brief that elaborated on how the case was incorrectly decided while ultimately recommending that the Supreme Court deny the cert. The Supreme Court followed that recommendation.[176] It is clear that *Madden* was a marked departure from prior precedent with respect to preemption under the NBA. *Madden* only enhances the need for the OCC to allow a new group of firms 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.[177] In one way, *Madden* actually paves the way for the OCC's new limited purpose charter.[178] Preemption would undoubtedly be a key component of a limited purpose non-bank charter and the primary motivator to apply for the charter.[179]

The OCC engaged in a number of rulemakings during the Trump Administration to address the holding in *Madden*, including the "valid when made" rule and the "true lender" rule.[180] The "valid when made" rule clarified that interest that is permissible on a loan shall not be impacted by the sale of that loan.[181] The FDIC similarly amended its rules to provide that whether interest on a loan is permitted is a determination made at the time the loan is made.[182] Both rules make clear that the validity of the loan will not be impacted by the transfer

[175] Midland Funding, LLC v. Madden, SCOTUSBLOG (Mar. 21, 2016), https://www.scotusblog.com/case-files/cases/midland-funding-llc-v-madden [https://perma.cc/RMC9-XLZU].
[176] Brief for the United States as Amicus Curiae, Midland Funding, LLC v. Madden, 136 S. Ct. 2505 (2016) (No. 15-610).
[177] Lisa Ledbetter et al., *OCC Victory Not a Clear Win for Fintech Charters*, JD SUPRA (June 24, 2021), https://www.jdsupra.com/legalnews/occ-victory-not-a-clear-win-for-fintech-9652997 [https://perma.cc/LSJ4-2SAQ] ("The OCC's decision to issue fintech charters was in response to the fact that the Madden decision limited the ability of nonbank debt purchasers to benefit from the NBA's preemption of state usury law, which is key to the business models adopted by many fintech companies that are not themselves nationally chartered banks and which oftentimes partner with banks to originate loans, which are immediately sold to the fintech company.").
[178] *Id.*
[179] *Id.*
[180] *See* 12 C.F.R. § 7.4001 (2020); *see also* 12 C.F.R. § 160.110 (2020).
[181] 12 C.F.R. § 7.4001 (2020).
[182] 12 C.F.R. § 331.4(e) (2020).

of the loan to a third party.[183] The OCC went a step further in adopting the "true lender" rule.[184] This rule facilitated bank partnerships with non-bank lenders, particularly fintech firms or loan platforms.[185]

The OCC's true lender rule was subsequently repealed by Congress using the Congressional Review Act.[186] Even before this happened, state attorneys general sued the OCC arguing that the OCC lacked the authority to adopt this rule.[187] There was some speculation that the OCC would also repeal the valid when made doctrine, but, in 2021, the Acting Comptroller announced that he did not intend to repeal that doctrine.[188]

The uncertainty around these developments, and the impermanence of regulatory efforts to mitigate uncertainty in the wake of *Madden v. Midland*, further bolster the argument in this Article that a comprehensive solution grounded in federalism for non-bank chartered fintech firms is essential to foster innovation and competition in this sector.

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

In July 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*.[189] The proposed guidance outlines the risks and

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[183] 12 C.F.R. § 7.4001 (2020); 12 C.F.R. § 311.4(e) (2020).
[184] Ledbetter et al., *supra* note 179.
[185] *Id.*
[186] *See The OCC's True Lender Rule Has Been Repealed*, DAVIS POLK (July1, 2021), https://www.davispolk.com/insights/client-update/occs-true-lender-rule-has-been-repealed [https://perma.cc/33VL-CXK3] ("President Biden has signed a joint resolution of disapproval passed by the House and the Senate with majority votes under the Congressional Review Act to repeal the so-called true lender rule that the Office of the Comptroller of the Currency (OCC) finalized in October 2020.").
[187] *Id.*
[188] Brendan Pedersen, *OCC Not Reviewing Trump-Era 'Valid When Made' Rule, Hsu Says*, AM. BANKER, (June 2, 2021), https://www.americanbanker.com/news/occ-not-reviewing-trump-era-valid-when-made-rule-hsu-says.
[189] FED. DEPOSIT INS. CORP., EXAMINATION GUIDANCE FOR THIRD-PARTY LENDING 1 (2016), https://www.fdic.gov/ne

expectations concerning third-party lending and emphasizes that "institutions that engage in new or significant lending activities through third parties will generally receive increased supervisory attention."[190] 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."[191] 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.[192]

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).[193] Should the Proposed Guidance become final, the Proposed Guidance would apply to all FDIC supervised institutions that engage in third-party lending programs.[194]

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 February 2016.[195] The report detailed the FDIC's efforts to cause three supervised banks to exit the refund anticipation loan

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ws/news/financial/2016/fil16050a.pdf [https://perma.cc/Q8FA-FGPC] [hereinafter FDIC, *Third-Party Lending*].

[190] *Id.*

[191] *Id.*

[192] *Id.* at 12 ("The institution is ultimately responsible for ensuring all aspects of third-party lending activities are in compliance with consumer protection and fair lending requirements to the same extent as if the activities were handled within the institution itself.").

[193] *Id.*at 2 ("Third-party lending arrangements may include the following: Insured institutions originating loans for third parties … Insured institutions originating loans through third-party lenders or jointly with third-party lenders … Insured institutions originating loans using platforms developed by third parties.").

[194] *Id.* at 1 ("The Third-Party Guidance applies to any of an institution's third-party arrangements, including lending.").

[195] OFF. OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., REPORT OF INQUIRY INTO THE FDIC'S SUPERVISORY APPROACH TO REFUND ANTICIPATION LOANS AND THE INVOLVEMENT OF FDIC LEADERSHIP AND PERSONNEL (2016).

(RAL) business.[196] 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."[197] The report also noted the use of "moral suasion" by FDIC examiners in an attempt to influence banks' risk management practices.[198] In response to the OIG's report, the FDIC stated that 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."[199]

The examination pressure explored in the prior paragraph may be a result of the FDIC's unique funding structure. Unlike the OCC and the Federal Reserve, 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 [200] Unlike the OCC whose funded based on chartering fees, the FDIC is funded through the DIF.[201]

D. Bank Partnerships 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. Recently decided case law suggests that courts will look more carefully at how lending partnerships are structured. In August 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.[202]

In *CashCall*, consumers took out loans online or over the phone through Western Sky Financial (WSF), a tribal entity under the

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[196] *Id.* ("Ultimately, the FDIC caused all three of its supervised institutions that then continued to facilitate RALs to exit the business in 2011 and 2012.").
[197] *Id.*
[198] *Id.*
[199] *Id.*
[200] *See* RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 81 (5th ed. 2013).
[201] *Id.* at 62.
[202] *See generally* Consumer Fin. Prot. Bureau v. CashCall, Inc., No. CV-15-7522-JFW-RAOX, 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016).

jurisdiction of Cheyenne River Sioux tribal law.[203]After the loans were originated, CashCall, a California-based consumer-lending platform, purchased and serviced the loans.[204] 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.[205] After the CFPB brought action against CashCall, CashCall claimed immunity from state usury law caps due its affiliation with the sovereign Native American tribe.[206]

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."[207] The court adopted a "totality of the circumstances" test to determine which party in the transaction had the "predominate economic interest."[208] 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.[209] 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.[210] Instead, the state usury laws of the borrowers' home states were applied.[211] The court found that telling

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[203] *Id.* at *3.
[204] *Id.* at *1.
[205] *Id.*
[206] *Id.* at *4 ("Defendants claim … loan agreements are not void because the laws of the CRST apply in accordance with the choice-of-law provision in those loan agreements.").
[207] *Id.* at *6.
[208] *Id.*
[209] *Id.*
[210] *Id.* ("The Court concludes that the CRST has no substantial relationship to the parties or the transactions and that there is no other reasonable basis for the parties' choice of CRST law.").
[211] *Id*. at *9 ("Accordingly, the Court concludes that, absent an effective choice-of-law provision, the law of the borrowers' home states applies to the loan agreements.").

consumers they were obligated to pay illegal interest under state usury law constituted a violation of UDAAP.[212]

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. It is 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.[213] As mentioned previously, the regulatory pendulum swung in the other direction with regulatory guidance that softened the impact of true lender restrictions during the Trump Administration, but that was swiftly repealed by Congress in 2021 using the Congressional Review Act.[214]

V. *The OCC's New Special Purpose National Bank Charter for Fintech Firms*

The OCC first addressed issues surrounding fintech companies when it launched an initiative to identify and understand trends and innovations in the financial services industry in late 2015.[215] In December 2016, Comptroller of the Currency Thomas J. Curry announced that the OCC would move forward with an initiative to

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[212] *Id.* at *12 ("The Court concludes that Defendants' conduct, i.e., servicing and collecting on Western Sky loans where payments were not due and owing, satisfies the requisite elements of a UDAAP violation under the CFPA.").

[213] *See,* e.g., Mindy Harris, *Fans and Foes of OCC True Lender Rule Spar at Senate Committee "Rent-a-Bank" Hearing*, BALLARD SPAHR, LLP (May 3, 2021), https://www.consumerfinancemonitor.com/2021/05/03/fans-and-foes-of-occ-true-lender-rule-spar-at-senate-committee-rent-a-bank-hearing/ [https://perma.cc/S6ZW-UD8P].

[214] *The OCC's True Lender Rule Has Been Repealed*, *supra* note 188.

[215] *Three Financial Regulators Issue Repots on Product and Service* Innovations, MAYER BROWN (Nov. 18, 2016), https://www.mayerbrown.com/files/Publication/2ae91e0e-098a-45c7-8377-c8b9706edba9/Presentation/PublicationAttachment/2e909cd0-5a38-4596-8b11-f3a836d6d226/161118-UPDATE-FSRE.pdf [https://perma.cc/Q28N-QFEA].

provide special purpose national charters to fintech companies that offer bank products and services.[216]

These firms have some, but not all, of the attributes typically characteristic of banking services.[217] They do not, however, accept demand deposits, and so would not be covered by deposit insurance, and so have been colloquially described as "nonbanks."[218]

A federal charter for these new firms would permit them the same preemption advantages that nationally chartered commercial banks receive.[219] 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.[220]

This Article will carefully consider the design of this new system, and the benefits and costs of a uniform national charter for

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[216] *See* Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency, Remarks Regarding Special Purpose National Bank Charters for Fintech Companies Before Georgetown University Law Center (Dec 2, 2016), http://online.wsj.com/public/resources/documents/CurrySpeech1202.pdf ("[T]he OCC *will* move forward with chartering financial technology companies that offer bank products and services and meet our high standards of chartering requirements.").

[217] *Banks See Challenges from Fintech Disruption*, RES. FOR EIGHTH DIST. BANKS (Apr. 29, 2021), https://www.supervisionoutreach.org/posts/banks-see-challenges-from-fintech-disruption [https://perma.cc/L6PW-X2KL]. ("Most fintech firms are not—and do not aim to be—full-service financial institutions. They do not meet the definition of a bank—an institution that takes demand deposits and makes loans.").

[218] *Id.* ("They typically market their narrow range of products to specific market segments, such as students, small-business owners and freelancers. Some seek to serve the under- and unbanked who may not want or need a bank to meet some objectives, such as savings, person-to-person payments and small-dollar loans. These firms frequently partner with traditional financial institutions using a variety of models that benefit both providers.").

[219] *The Fintech War Between the States and the OCC is Redefining What it Means to be a Bank in the United States*, SEWARD & KISSELL LLP (Oct. 15, 2020), https://www.sewkis.com/publications/the-fintech-war-between-the-states-and-the-occ-is-redefining-what-it-means-to-be-a-bank-in-the-united-states/ [https://perma.cc/Y6GH-NPUK].

[220] Monica C. Mincert, *OCC Examining Possibility of Limited-Purpose Fintech Charter*, ABA BANKING J. (June 14, 2016), http://bankingjournal.aba.com/2016/06/occ-examining-possibility-of-limited-purpose-fintech-charter/ [https://perma.cc/3A48-Y5N2].

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 companies 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, and indeed may over the long-term prove to make the traditional banking system obsolete.

A. Why are Fintech Companies Seeking a "Non-Bank" Special Purpose National Bank 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.[221]

Fintech firms currently face a multitude of issues including uncertainty caused by recent decisions such as *Madden* and *CashCall* as to the viability of bank partnerships, duplicative state licensing and regulation, and regulatory overlap between state and federal regulators.[222] 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

[221] *Id.*

[222] *Examining Opportunities and Challenges in the Financial Technology ('FINTECH') Marketplace*: *Hearing Before the Subcomm. On Financial Institutions and Consumer Credit*, 115th Cong. 52 (2018) (statement of Brian Knight, Director, Program of Financial Regulation and Senior Research Fellow) ("First, many non-bank fintech firms are subject to burdensome State-by-State regulation in areas where banks offering comparable products enjoy broad uniformity thanks to Federal law. Second, even if firm partner with banks, recent litigation and regulatory actions have called into question the legitimacy of those partnerships. This risks reducing access to those most in need of new options.").

> 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.[223]

The principal benefits of a limited purpose federal charter for fintech firms would be to preempt duplicative state licensing regimes and eliminate the possibility of 50 differing examinations on top of potential federal examinations.[224] A limited purpose federal charter would 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. This future pressure may occur as a result of some future renewal of an "Operation Chokepoint" push by federal regulators to deny the industry access to the banking system or for competitive reasons.[225]

Many of the more recent fintech firms have only expressed interest in a special 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.[226] These firms argue that this would allow them to more easily develop ready conversion between dollar-based payments and bitcoin and other virtual currency-based payments by customers.[227]

A recent publication by the OCC articulates the agency's interest in innovation in the financial services sector by non-bank entities.[228] The release cites that, "[i]n 2015, the number of fintech

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[223] Peter Van Valkenburgh & Jerry Brito, *Comments to the Office of the Comptroller of the Currency on Supporting Responsible Innovation*, COIN CENTER (2016), https://www.coincenter.org/comments-to-the-office-of-the-comptroller-of-the-currency-on-supporting-responsible-innovation/ [https://perma.cc/KU82-8V9R].

[224] *Id.*

[225] *Id.*

[226] *Id.* (describing how the OCC could craft a risk-mitigating charter that only allows these firms to engage in certain bank activities).

[227] *Id.* (describing that the previously described risk-mitigating charger would allow fintech firms access to ACH or Fedwire as a means of facilitating the exchange of dollars and virtual currencies).

[228] OFF. OF THE COMPTROLLER OF CURRENCY, SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE 2-3

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."[229] 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.[230]

The OCC release specifically cites the possibility of collaboration between banks and nonbanks, citing mutual comparative advantages between the two industries that facilitate collaboration.[231] The OCC does not acknowledge the risk that nonbanks 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.[232]

The OCC stands at a crossroad, 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, 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.[233]

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.[234]

(Mar. 2016), https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-responsible-innovation-banking-system-occ-perspective.pdf [https://perma.cc/ZGR2-ZYFG] [[hereinafter OCC, Supporting Reasonable Innovation].

[229] *Id*. at 3.

[230] *Id.* at 4.

[231] *Id.*

[232] *But see id.* at 4–6 (describing the benefits of collaboration between banks and non-banks without acknowledging a risk of compelled partnership).

[233] *See id.* at 6 (describing that the OCC may provide flexibility while also causing some inconsistencies and inefficiencies).

[234] *See id.* at 5–10 (describing the benefits resulting from a potential OCC charter).

B. Shortcoming of the OCC's Special Purpose National Bank Charter

1. Receivership

In September 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 special purpose charters.[235] 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.[236] 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."[237][The OCC has not, however, put an uninsured entity into receivership since the Great Depression.[238]

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.[239] However while the FDIC can use the deposit insurance fund and the Treasury Department in emergencies to facilitate wind downs, the OCC does not have a clear source of funding to wind down these institutions.[240]

It is worth noting that the proposed rule would not apply to uninsured federal branches or foreign banks under the International Banking Act of 1978.[241] This exemption reveals the continuing difficulties faced by the federal regulators as they try to optimize an international resolution framework that complies with the bankruptcy law of various jurisdictions.

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[235] Receivership for Uninsured National Banks, 81 Fed. Reg. 177, 62,835 (Sept. 13, 2016) (to be codified at 12 C.F.R. pt. 51).
[236] Lalita Clozel, *OCC Takes Big Step Toward Creation of FinTech Charter*, AM. BANKER (Sept. 13, 2016, 1:25 PM), https://www.americanbanker.com/news/occ-takes-big-step-toward-creation-of-fintech-charter.
[237] *Id.*
[238] *Id.*
[239] *Id.*
[240] *Id.*
[241] *See* Receivership for Uninsured National Banks, *supra* note 237.

2. *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. Thus, *Madden* subsequent assignee issues would still exist under the OCC's proposed federal solution. [242]

This discussion about the pros and cons of the OCC's new fintech charter is academic at this point, as the proposal is under siege from a litigation challenge and is apparently not supported by the current administration. While the OCC's fintech charter showed some promise in encouraging fintech development, even that reform was long stalled. The Conference of State Bank Supervisors sued the OCC alleging that the OCC lacked the regulatory authority to issue the non-bank charter.[243] The OCC under the Trump administration defended the fintech charter, but OCC under the new administration signaled that it did not support the fintech charter.[244] That litigation is currently stayed pending an agreement from the OCC to pause its chartering regime.[245]

Given the pendency of the litigation, and the OCC's current posture which appears to be a half-hearted defense of the new chartering regime, the fintech charter certainly isn't likely to transform financial services in the short-term and remains an unattractive prospect for firms who may otherwise seek to obtain the charter given the high likelihood it will not endure.[246]

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[242] *See* Bimal Patel, *State Regulation of Financial Technology: Emerging Payment Systems and Marketplace Lending*, O'MELVENY & MYERS (Oct. 19, 2016), https://www.omm.com/omm_distribution/fin_tech/State_Regulation_of_FinTech.pdf [https://perma.cc/FDB2-JS4M].

[243] Lisa Ledbetter, Mahesh Parlikad, Lanier Saperstein, Joseph Sconyers, Jayant Tambe, *OCC Victory Not a Clear Win for Fintech Charters*, JD SUPRA (June 24, 2021), https://www.jdsupra.com/legalnews/occ-victory-not-a-clear-win-for-fintech-9652997/ [https://perma.cc/CP7E-M3AS].

[244] *See* Brendan Pedersen, *OCC, States Declare Cease-Fire in Fintech Charter Case. Will it Hold?*, AM. BANKER (June 18, 2021), https://www.americanbanker.com/news/occ-states-declare-ceasefire-in-fintech-charter-case-will-it-hold.

[245] *Id.*

[246] *Id.*

VI. Considering an Alternative State Chartering System for Non-Bank Fintech Companies

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.

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.[247] This will be described as competitive preemption. Second, the OCC could charter under a dual system, which would require new legislation.[248] However, such a system would mirror many of the drawbacks described by Butler and Macey.[249]

Third, the OCC could establish a charter for non-banks that incorporates laws of a particular state (such as the headquartering state) in regulating the entity, while otherwise enabling non-headquarter states in preempting state laws, including consumer protection laws. 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.[250] 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.[251] This particular model would not be available through the OCC's authority alone, given the limits on OCC powers to preempt on

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[247] *See* SYKES, *supra* note 77, at 4.
[248] *Id.*
[249] *See* Butler & Macey, *supra* note 72, at 685.
[250] *See* SYKES, *supra* note 77, at 18–19.
[251] *Id.* at 24.

behalf of any institution other than a chartered commercial bank.[252] 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 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.[253] 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.[254]

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.[255] This institutional history was an important pre-cursor of the internal affairs doctrine.[256]

In banking law, by contrast, no such history of mutual recognition of state interest in chartering banks developed.[257] 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)

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[252] *Id.* at 19.
[253] Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 252 (1977).
[254] *Id.*
[255] *See* Ribstein & O'Hara, *supra* note 110, at 662–63.
[256] *Id.* at 662.
[257] *Id.* at 685.

for much of the history of American banking law.[258] 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.[259]

The federalism literature emphasizes the importance of exit by individual counterparties, and by firms, as a means to internalize the value of state regimes.[260] Firms must be able to re-charter in new jurisdictions freely, and individuals must be able to exit the relationship with the chartered firm.[261] 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.[262]

In the non-bank lending context, such a system would involve federal preemption of state regulation of non-banks chartered out-of-state, but not of state regulation by the chartering state of firms it chartered.[263] Ribstein and O'Hara also describe technological mobility as a vital underpinning of a robust law market for organizational charters.[264] 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.[265]

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.[266] In light of this technological change, federal competitive

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[258] *Id.* at 675.
[259] *See id.*
[260] *Id.*
[261] Larry E. Ribstein & Bruce Kobayashi, *The Economics of Federalism* 4 (Ill.. Law & Econ. Working Paper Series, Working Paper No. LE06-001, 2006) ("By letting a voter supplement his 'voice' with an option to 'exit' the jurisdiction, exit rights under federalism can powerfully check state governments' powers to tax and regulate").
[262] *Id.*
[263] *Id.* at 9.
[264] *See* Ribstein & O'Hara, *supra* note 110, at 675.
[265] *Id.*
[266] *Id.*

preemption could afford a vibrant market for non-bank charters if the right conditions are created in which it could thrive.[267]

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 governing their relations can be readily anticipated, and to help standardize contractual relationships with multiple counterparties to one single firm.[268]

In the chartering of banks, the problems that lead parties to value a competitive law market are greatly enhanced by the fact that multiple constituencies are party to the bargain.[269] 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.[270] 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.[271] 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.[272]

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[267] *See id.*

[268] *See id.* ("Firms have precisely the same reasons to choose the law governing the relations among the parties to the firm as all contracting parties have to choose governing law: to ensure that their disputes will be resolved according to the law that best fits their relationship, to enable the parties to know what law will apply at the time of contracting, and to allow the firm to deal on the same basis with multiple parties").

[269] *Id.*

[270] *Id.*

[271] *Id.* at 662.

[272] *See* Larry E. Ribstein, Dabit*, Preemption, and Choice of Law*, 2005 CATO SUP. CT. REV. 141, 167 (2005–2006).

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.[273] Any differential in the quality of a regime from the perspective of the investor will be manifested in the market value of a company's stock.[274] 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.[275]

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.[276] 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.[277] Assuming arguendo that 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 Companies

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.[278] 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.[279] The

[273] *Id.* at 143.
[274] *See* Ribstein & Kobayashi, *supra* note 263, at 12.
[275] *Id.* at 12–19.
[276] *See id.* at 12.
[277] *See id.* ("Macey & Miller (1987) argue that Delaware wins the race by offering laws superior to those in other jurisdictions, but that much of the advantage is dissipated in rents to lawyers who influence the lawmaking process").
[278] *Id.*
[279] *Id.*

competitive process that develops any aspects that eventually become uniform will be one more sensitive to market needs.[280] In addition, to the extent that aspects of 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.[281] An additional requirement for state chartering competition to be efficient is that it be free of spillover effects on other jurisdictions.[282]

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.[283]

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.[284]

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[280] *Id.*

[281] *See id.* at 3 ("These papers examine how the provision of public services and taxing power should be divided between the central and state governments—that is, federalism's vertical structure. The central government should use fiscal policy to correct spillovers and other distortions that result from uncoordinated state policymaking").

[282] *Id.*

[283] *Id.*

[284] *See generally* FED. RESERVE SYS., THE FED EXPLAINED: WHAT THE CENTRAL BANK DOES (11th ed. 2021).

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 federal deposit insurance, particularly deposit insurance that is not accompanied by a well-calibrated risk premium, urging that the presence of the subsidy causes the state banking regulators to face a moral hazard problem and encourages a state race to laxity.[285] Because state banking regulators may receive political credit for any local benefits associated with liberalized banking laws, the state regulators may be incentivized to authorize unsound banking practices that encourage excessive risk taking in order to increase potential profits.[286] Any losses incurred as a result of this excessive risk taking are borne by the DIF.[287]

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.[288] In any event, that problem

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[285] Butler & Macey, *supra* note 72, at 680 ("In other words, fixed premium federal deposit insurance allows state banking regulators to impose costs on banks in other jurisdictions by permitting local banks to engage in excess risk taking. This argument supports the preemption of states from bank regulation. Thus, we not only fail to find any evidence of the regulatory competition that the supporters of the dual banking system envision, we find that- such competition would harm the economy if it did exist under the current regulatory infrastructure in banking.").
[286] *Id.* at 712 ("Local depositors, whom state regulations are supposed to protect, suffer no consequences but the state regulators can be expected to take political credit for the local benefits associated with liberalized banking laws even where such liberalization increases the probability of bank failure.").
[287] *Id.*
[288] *Id.* at 713 ("This approach would require several radical alterations in current banking structure, including the imposition of risk-adjusted deposit

would not inhibit a competitive state race in the context of nonbanks that do not take on-demand deposits and therefore do not receive deposit insurance.[289]

In the event consumers of non-bank financial services wish to obtain insurance for counterparty risk, the option of private insurance would be available.[290] Even to those who argue 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.[291]

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.[292] 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

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insurance and the repeal of the McFadden Act's interstate and intrastate branching restrictions.").

[289] *Id.* at 714 ("This would lead to the development of a truly national market for banking laws which would exhibit all of the beneficial aspects of the current robust jurisdictional competition in the market for corporate charters.").

[290] *Id.* ("Although there is some controversy over the ability of private insurers to provide protection against the system-wide risk imposed by a depression, 145 private deposit insurers would clearly do a better job than federal regulators at structuring insurance contract.").

[291] *See* Arthur E. Wilmarth Jr., *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, 259 (2004).

[292] *Id.* at 230–31.

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.[293]

C. Can a New Competitive Federalism System for Fintech Companies 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-based system.[294] This suggests that 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 to threaten the regime like that created by the financial crisis of 2008.

Weingast provides the seminal literature exploring the conditions under which a federalism solution will endure and survive, what he terms "market preserving federalism."[295] 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."[296] One pre-requisite is that states are

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[293] *See id.* at 257 ("[F]ederal legislation since 1910 has established a dynamic interplay between competition and parity in the dual banking system. This dynamic allows significant room for diversity and rivalry between the national and state banking systems. At the same time, Congress has preserved an effective balance between the two systems. This interplay between competition and parity reflects a deliberate congressional purpose (i) to allow state laws to apply to national banks (either by express statutory mandate or by congressional silence) in many areas of the banking business and (ii) to prevent competitive factors from becoming 'so lopsided' in favor of one system that the other system is unable to make adjustments in order to reestablish a competitive equilibrium.").

[294] *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, 275–82 (1990).

[295] *See* Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J. L. ECON. & ORG. 1, 2 (1995).

[296] *Id.* at 2.

not allowed to erect barriers to a national market.[297] 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.[298] This would otherwise distort their competitive interest in providing optimal rules as their method of competition in favor of using the subsidy.[299] In this context, access to the Federal Reserve's lending would distort the competitive forces of the state market in a different way, in that it would subsidize individual firms and distort the market impact of the individual state's oversight regime.[300]

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.[301] In this context, one vital component to ensure that 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.[302]

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[297] *Id.* at 4 ("A federal system is market-preserving if it has three additional characteristics: … a common market is ensured, preventing the lower governments from using their regulatory authority to erect trade barriers").
[298] *Id*.
[299] *See id.*
[300] *See id.*
[301] *See* Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulations in the United States*, 31 REV. BANKING & FIN. L. 113, 194–95 (2011) ("Statutory definitions often become the frontline in political and economic battles, as the constant interplay of government action and industry reactions shapes the path of financial innovation.").
[302] *See* John Crawford, *The Moral Hazard Paradox of Financial Safety Nets*, 25 CORNELL J.L. & PUB. POL'Y 95, 98 (2015) ("The logic of eliminating free-standing guarantee authorities is that by tying regulators' hands, Congress yanks the safety net away and forces creditors to protect themselves.").

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. Professor Geoffrey Miller found that, while not as commonly recognized, the state regulators are subject to moral hazard stemming from the DIF.[303] Unlike FDIC examiners, state supervisors have an incentive to allow state banks to engage in risky activities because the state will reap the benefits of those activities.[304] Benefits can take the form of additional credit or investment.[305] However, any loss will be borne by the DIF and thus the FDIC.[306]

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

In the event that 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 preemption afforded to Congress by the Supreme Court's interpretation of the Commerce Clause is largely unconstrained, while preemption by regulators is a matter of statutory interpretation and further involves determinations of whether Chevron deference will apply.[307] In this context the Dodd-Frank Act provides a further hurdle to any action taken by the OCC intended to encourage

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[303] Geoffrey P. Miller, *The Future of The Dual Banking System*, 53 BROOKLYN L. REV. 1, 19 (1987).
[304] *Id.*
[305] *Id.*
[306] *Id.*
[307] Gillian E. Metzger, *Administrative Law as the New Federalism*, 57 DUKE L. J. 2023, 2048 (2008) ("An important initial point to note is the Court's unwillingness to curb congressional regulatory authority on constitutional federalism grounds.").

competitive federalism in the form of explicit limitations on the ability of the OCC to preempt state consumer protection laws.[308]

The Dodd-Frank Act limited the ability of the OCC to preempt state consumer protection laws, and also placed process constraints on how the OCC could utilize its preemptive powers.[309] 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 preemption 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.

If preempting 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.[310] 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.[311] It therefore grafts state corporate law into the federal law governing the bank.[312]

12 U.S.C § 85 is essentially the type of federal choice of law rule that Ribstein and O'Hara identify as facilitating competitive

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[308] *See id.*

[309] Christine Daleiden, *Financial Reform for Consumers: An Overview of the Dodd-Frank Act and the Consumer Protection Bureau*, 15 HAW. B. J. 4, 9 (2011) ("The Act provides that courts and the OCC must make preemption decisions on a case by case basis with respect to the laws of a particular state and cannot make sweeping preemption determinations").

[310] *See, e.g.*, 12 C.F.R. § 9.7 (2021).

[311] *See* CARNELL ET AL., *supra* note 202, at 71–72.

[312] *See id.*

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.[313] This limited experiment in grafting state law into federal banking law suggests that it may be one possible avenue to consider in the OCC's design of a limited purpose, non-bank charter for Fintech firms.

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.[314] 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.[315] 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.[316]

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.[317] The preemption regime provided by the Dodd-Frank Act, in which OCC preemption of state consumer protection laws is subject

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[313] *See* Ribstein & O'Hara, *supra* note 110, at 683–86.
[314] *See* Greve, *supra* note 112, at 93.
[315] OCC, *Supporting Responsible Innovation*, *supra* note 230, at 5.
[316] OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC SUMMARY OF COMMENTS AND EXPLANATORY STATEMENT: SPECIAL PURPOSE NATIONAL BANK CHARTERS FOR FINANCIAL TECHNOLOGY COMPANIES 13 (Mar. 2017), https://www.occ.gov/topics/supervision-and-examination/responsible-innovation/summary-explanatory-statement-fintech-charters.pdf [https://perma.cc/QLA7-HVED] ("Specifically, commenters noted the importance of having regular, rigorous examinations to ensure compliance with requirements regarding safety and soundness, Bank Secrecy Act/anti-money laundering (BSA/AML) provisions, financial inclusion, fair lending, and other applicable laws.").
[317] *See* Greve, *supra* note 112, at 102.

to limitations and in which preemption on behalf of non-bank affiliates or agents of banks is not possible, risks exacerbating this problem.[318]

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 preemption by the Dodd-Frank Act, or whether the OCC could accomplish 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 nonbanks 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.[319]

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.[320] 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 nonbanks that compete with its chartered banks would be suboptimal.[321]

As Butler and Macey point out, national regulators may utilize their powers in response to industry capture to inhibit competition.[322] Mendelson and Merrill argue that federal regulatory agencies are motivated by empire building objectives to discourage regulatory competition from the states.[323] If that argument is true, it suggests that

[318] *See* Daleiden, *supra* note 311, at 5–6.
[319] OCC, *Supporting Responsible Innovation*, *supra* note 230, at 8–9.
[320] Greve, *supra* note 316, at 902.
[321] *See id.*
[322] Butler & Macey, *supra* note 72, at 706.
[323] Wilmarth, *supra* note 122, at 40 ("Mendelson and Thomas Merrill contend that federal agencies are subject to additional institutional limitations

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.[324] 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.[325] 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.[326] 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.[327]

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.[328] It has used that power to limit the range of activities allowed for state banks.[329]

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 chartered by the OCC receive.[330] That would have allowed state banks to be governed for banking law purposes solely by their home states.[331] The proposal, if the FDIC had adopted it, may have substantially

(including a tendency toward 'empire building' and a bias against allowing regulatory 'competition' …").

[324] *See id.*

[325] Mason et al., *supra* note 115, at 793 ("[R]eview of the evidence indicates that preemption has been an important policy tool for opening up markets and increasing competition …").

[326] *Id.* at 795–96.

[327] *See id.*

[328] Wilmarth, *supra* note 293, at 261 n.142.

[329] *Id.*

[330] 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).

[331] *Id.*

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.[332] 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.[333] 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.[334] And, in doing so, 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

A. The Ever-Present CFPB

1. Supervision and Enforcement

Even if the OCC is able to preempt state laws, the CFPB's broad jurisdiction looms as a specter over any competitive regulatory initiative that does not obtain a regulatory exemption via statutory

[332] Wilmarth, *supra* note 293, at 256.

[333] *See* Hamburger, *supra* note 135, at 14 ("The import of these provisions is that the OCC (or a court) must make discrete preemption determinations for each state law that is to be preempted,").

[334] *See* Douglas Faucette, *OCC Proposes Widespread Codification to Corporate Governance Rules for National Banks and Federal Associations*, JD SUPRA (June 10, 2020), https://www.jdsupra.com/legalnews/occ-proposes-widespread-codification-to-38514/ [https://perma.cc/9LV5-9B9H].

reform.[335] 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.[336]

The Dodd-Frank Act grants the CFPB broad jurisdiction over "covered persons."[337] A "covered person" is defined as any entity that offers a "consumer financial product or service."[338] 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.[339] 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. Consequently, the CFPB enjoys supervisory authority over all insured depository institutions or insured credit unions that have more than $10 billion in assets and their affiliates.[340] The CFPB also 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 participant[s]" in certain consumer financial markets (to be defined by the CFPB 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 participant[s] of a market for other consumer financial products of services" as the CFPB defines through rulemaking.[341] Furthermore, the CFPB can regulate *any* entity that it has reasonable cause to believe is "engaging, or has engaged, in

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[335] 12 U.S.C. § 5481 (2018).
[336] *Id.*
[337] *Id.*
[338] *Id.*
[339] *Id.*
[340] *Id.*
[341] 12 U.S.C. § 5514(a)(1)(B) (2018).

conduct that poses risk to consumers with regard to the offering or provision of consumer financial products or services."[342]

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."[343] This provision grants the CFPB vast jurisdiction to prosecute UDAAP violations and gives the CFPB authority past 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.[344] 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.[345] The Consumer Financial Protection Act (CFPA) also granted UDAAP enforcement powers to state attorney generals and state regulators. [346]

The CFPB has relied on its favored UDAAP authority as its primary enforcement tool, alleging more violations of UDAAP than any other statute.[347] Although Section 1031 also grants the CFPB authority to promulgate rules and regulations aimed at preventing unfair, deceptive or abusive acts or practices[348], the CFPB has historically opted instead to regulate by enforcement.[349]

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[342] 12 U.S.C. § 5514(a)(1)(C) (2018).
[343] 12 U.S.C. § 5531(a) (2018).
[344] *Id.*
[345] 12 U.S.C. § 5565 (2018).
[346] 12 U.S.C. § 5531(a) (2018).
[347] Lisa Lambert & Patrick Rucker, *U.S. Consumer Finance Agency Expected to Punish Equifax -Lawyers*, REUTERS (Sept. 21, 2017), https://www.reuters.com/article/legal-us-equifax-cyber-consumers/u-s-consumer-finance-agency-expected-to-punish-equifax-lawyers-idUSKCN1BW316 [https://perma.cc/8H2B-E276].
[348] 12 U.S.C. § 5531(b) (2018) ("The Bureau may prescribe rules applicable to a covered person or service provider identifying as unlawful unfair, deceptive, or abusive acts or practices … Rules under this section may include requirements for the purpose of preventing such acts or practices.").
[349] 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

Consequentially, UDAAP has been defined primarily through enforcement actions.[350] While some FTC precedent exists for the terms "unfair" or "deceptive," the definition of those terms remains elastic and the CFPB has interpreted them expansively.[351] 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.[352]

Some 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. As one example, on March 2, 2016 the CFPB entered into a settlement agreement with an online payment platform, Dwolla Inc.[353] 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.[354] The CFPB determined that the standards were not "reasonable and appropriate measures to protect data obtained from consumers."[355] Worth noting is the fact that this enforcement action did not stem from any type of data breach.[356]

violations and make an immediate effort to correct any such improper practices." Richard Cordray, Director, Consumer Fin. Prot. Bureau, Prepared Remarks at the Consumer Bankers Association (Mar. 9, 2016), https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-consumer-bankers-association/ [https://perma.cc/MNQ4-6H9L].

[350] *See id.*

[351] *See* Lambert & Rucker, *supra* note 349.

[352] 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. 12 U.S.C. § 5531(d)(1)-(2) (2018).

[353] Dwolla, Inc., CFPB No. 2016-CFPB-0007 (Mar. 2, 2016).

[354] *Id.*

[355] *Id.*

[356] *See id.*

2. *Structure and Accountability*

The CFPB's spending is not appropriated by Congress and the agency is instead self-funded. The level of independence the CFPB enjoys from 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.[357] It would however be insulated from industry attempts to pressure federal regulators to inhibit competition through regulatory barriers to entry.[358] 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.[359]

The role of federalism has often been described as allowing the states to serve as "laboratories" in which they can experiment in regulatory methods.[360] 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. 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.[361] To the extent

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[357] Todd Zywicki, *The Consumer Financial Protection Bureau*: *Savior or Menace?,* 81 GEO. WASH. L. REV. 856, 856 (2013).
[358] *See id.* at 885 ("With respect to the CFPB, the threat of capture seems to be less likely to come from the industry as a whole than from particular segments within it-namely, the biggest banks.").
[359] *See* Butler & Macey, *supra* note 72, at 680–81.
[360] Ribstein & Kobayashi, *supra* note 263, at 5.
[361] Hamburger, *supra* note 135, at 16–17.

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.[362] On February 18, 2016, the CFPB finalized a policy statement on no-action letters (NALs).[363] 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."[364] The policy statement allows fintech firms to apply for approval from the CFPB.[365]

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." [366] Moreover, the policy

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[362] Press Release, Consumer Fin. Prot. Bureau, CFPB Launches Project Catalyst to Spur Consumer-Friendly Innovation (Nov. 14, 2012), https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-launches-project-catalyst-to-spur-consumer-friendly-innovation/ [https://perma.cc/4CXD-B4A8] ("Through *Project Catalyst,* the CFPB will engage more closely with companies and entrepreneurs who are at the front lines of innovation. The Bureau has already conducted early outreach to the innovation community, and today is establishing a website dedicated to boosting access and communication between the Bureau and those in that community.").

[363] Policy on No-Action Letters; Information Collection, 81 Fed. Reg. 8686, 8686 (Feb. 22, 2016).

[364] Press Release, Consumer Fin. Prot. Bureau, CFPB Finalizes Policy to Facilitate Consumer-Friendly Innovation (Feb. 18, 2016), https://www.consumerfinance.gov/about-us/newsroom/cfpb-finalizes-policy-to-facilitate-consumer-friendly-innovation/ [https://perma.cc/4CXD-B4A8].

[365] *See* Policy on No-Action Letters; Information Collection, 81 Fed. Reg. at 8686 (stating that "[u]nder the Policy, Bureau staff would, in its discretion, issue no-action letters … to specific applicants in instances involving innovative financial products or services that promise substantial consumer benefit …").

[366] *Id.* at 8689, 8691.

statement explicitly states that the NALs are non-binding and the CFPB retains the authority to revoke or modify a NAL for any reason.[367] The NALs also provide no immunity against private litigation or enforcement actions by other federal and state regulators.[368] While obtaining a NAL may help a fintech firm gain assurance and negate some uncertainty, firms may be hesitant to apply for a NAL due to its 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 by applicants to structure supervisory or enforcement actions.[369]

In 2018, the CFPB created an Office of Innovation which was principally intended to facilitate a regulatory "sandbox" approach to regulating fintech firms and other startups.[370] The sandbox was intended to streamline regulatory approvals and to provide innovative approaches to finance to test out alternative means of disclosing financial information to customers free from regulatory uncertainty during a trial period.[371]

This was a belated move by the CFPB, as its policy regarding a disclosure "sandbox" was adopted in 2013, but during the ensuing 5 years the CFPB did not approve a single startup firm for the regulatory sandbox.[372] Given the politically charged nature of the CFPB, and the regular pendulum swings of agency priorities between Democrat and Republican Administrations, it is likely that the CFPB's Office of Innovation will take a similarly skeptical posture during the current administration. This regulatory innovation, while well intended, likely will not provide much lasting benefit to fintech innovators, and similarly

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[367] *Id.* at 8689, 8690.
[368] *See id.* at 8686–87 (stating that NALs would not bind "other actors who might challenge a NAL-recipient's product or services, such as other regulators or parties in litigation").
[369] *See id.* at 8688 (stating that companies applying for NALs should recognize that the CFPB "may consult with other governmental agencies that may have enforcement, supervisory or licensing authority over the applicant, or other interest in matters relating to a NAL …").
[370] *See CFPB Office of Innovation Proposes "Disclosure Sandbox" for Companies to Test New Ways to Inform Consumers*, CONSUMER FIN. PROT. BUREAU: BLOG (Sept. 13, 2018), https://www.consumerfinance.gov/about-us/blog/cfpb-office-innovation-proposes-disclosure-sandbox-companies-test-new-ways-inform-consumers/ [https://perma.cc/X538-R7UY].
[371] *Id.*
[372] *Id.*

calls for a more comprehensive solution like that suggested in this article.

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 authorities in the United States.[373] The BSA was enacted in response to concerns that bank accounts were being used to launder the proceeds of illegal activities.[374] 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.[375] 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.[376]

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.[377] Since 2014, the federal banking agencies (FBAs) have shown increased interest in compliance with the BSA as demonstrated by publicly available enforcement actions.[378] To

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[373] *Bank Secrecy Act (BSA) & Related Regulations*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, https://www.occ.treas.gov/topics/supervision-and-examination/bsa/bsa-related-regulations/index-bsa-and-related-regulations.html [https://perma.cc/G75Y-8FWQ].

[374] *Bank Secrecy Act / Anti-Money Laundering (BSA/AML)*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/resources/bankers/bank-secrecy-act/ [https://perma.cc/A7QD-ANYD].

[375] Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Residential Mortgage Lenders and Originators, 77 Fed. Reg. 8148, 8148 (Feb. 14, 2012) (codified at 31 C.F.R. pt. 1010, 1029).

[376] *Fact Sheet on MSB Registration Rule*, FIN. CRIMES ENF'T NETWORK, https://www.fincen.gov/fact-sheet-msb-registration-rule [https://perma.cc/RF7E-BGRC].

[377] Financial Crimes Enforcement Network; Customer Identification Programs, Anti-Money Laundering Programs, and Beneficial Ownership Requirements for Banks Lacking a Federal Functional Regulator, 85 Fed. Reg. 57129, 57129 (Sept. 15, 2020) (codified at 31 C.F.R. pt. 1010, 1020).

[378] *See FDIC and CBDO Assess Civil Money Penalties Against Banamex USA, Century City, CA,* REGXSA (July 27, 2015), http://amlabc.com/aml-

date, the FBAs have pursued enforcement actions against banks, nonbanks, and bank directors alike for various violations of the BSA.[379] In 2016, the OCC asserted that BSA/AML risks remain high and are on the rise.[380] Although the FBAs have historically enjoyed supervisory and examination authority over nonbanks providing services to 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 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.[381] 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.[382]

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category/aml-sanctions-fines/fdic-and-cdbo-assess-civil-money-penalties-against-banamex-usa-century-city-ca/ [https://perma.cc/4MVJ-A2QR]; Press Release, FinCEN, FinCEN Assesses $1 Million Penalty and Seeks to Bar Former MoneyGram Executive from Financial Industry, (Dec. 18, 2014), https://www.fincen.gov/sites/default/files/shared/20141218.pdf [https://perma.cc/YWW6-SF9C].

[379] OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BULL. 2016-31, RISK MANAGEMENT GUIDANCE ON FOREIGN CORRESPONDENT BANKING: RISK MANAGEMENT GUIDANCE ON PERIODIC RISK REEVALUATION OF FOREIGN CORRESPONDENT BANKING (Oct. 5, 2016).

[380] *Id.*

[381] Susan Hackett, *FinTech: Reinforcement for Banks' AML (Anti-Money Laundering) Efforts*, THOMPSON REUTERS, https://legal.thomsonreuters.com/en/insights/articles/fintech-reinforcement-for-banks-anti-money-laundering-efforts [https://perma.cc/FX4C-NFPL].

[382] Kenneth A. Blanco, Director, FinCEN, Prepared Remarks Delivered at the Consensus Blockchain Conference (May 13, 2020), https://www.fincen.gov/news/speeches/prepared-remarks-fincen-director-kenneth-blanco-delivered-consensus-blockchain [https://perma.cc/88GT-YN65] ("We expect each financial institution to have appropriate controls in place based on the products or services it offers, consistent with the obligation to maintain a risk-based AML program").

C. Bank Examiner Privilege

Banks are subject to frequent visits and examinations by the federal banking regulators.[383] As a result of these visits and examinations, federal banking regulators produce various reports detailing the agency's opinions and recommendations.[384] Various federal appellate courts have held that examination reports are protected by the bank examination privilege. The D.C. Circuit has noted that the privilege arose out of the practical necessity for candor between federal regulators and their regulated entities.[385] This privilege however is not absolute.[386] Thus, while agency opinions or recommendations are protected, the privilege does not protect "purely factual material." [387]The bank examination privilege belongs only to the federal banking regulators and cannot be asserted by third parties on behalf of the regulators. [388]

In an alternative state chartering regime, potential problems arise when bank examiners travel to other states.[389] In this situation, each state would have to recognize a form of "examiner privilege" with respect to out-of-state examiners.[390]

D. The Spector 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.[391] In the dual banking system, the issue has often manifested as

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[383] STEPHEN E. ARTHUR & ROBERT S. HUNTER, FEDERAL TRIAL HANDBOOK CIVIL § 55:27 (4th ed. 2010).
[384] *Id.*
[385] In re Subpoena Served Upon Comptroller of the Currency, 967 F.2d 630, 633 (D.C. Cir. 1992).
[386] *Id.*
[387] *Id.* at 634.
[388] Wultz v. Bank of China Ltd., 61 F. Supp. 3d 272, 282 (S.D.N.Y. 2013).
[389] Miller, *supra* note 305, at 2.
[390] *Id.*
[391] Butler & Macey, *supra* note 72, at 682 ("From an interest group perspective, then, it seems that Congress began chartering banks because it wanted to capture some of the advantages associated with being the monopoly provider of bank charters").

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.[392]

The problem of regulatory overreach may also manifest as a regulatory response to pressures from competing industries.[393] 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.[394] 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.[395] 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."[396]

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 that 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.[397]

An additional danger that federal regulation poses to the non-bank sector is the persistent risk that federal regulators will cut off

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[392] *Id.* at 693.

[393] *Id.*

[394] *Id.* ("We argue that federal banking regulators, possibly in response to concerns about competition from state regulators, have preempted every area of banking regulation where federal regulation is more effective than state regulation at aiding banks in achieving a regulatory environment that insulates them from competitive pressures.").

[395] *Id.* at 697.

[396] *Id.* at 699.

[397] Letter from Americans for Financial Reform Education Fund et al., to Jelena McWilliams, Chairman, FDIC (July 1, 2020) ("By making it easier for predominantly online non-bank lenders to obtain bank charters, while avoiding consolidated supervision of the Federal Reserve, the FDIC would pave the way for non-banks to benefit from federal preemption far more easily than they otherwise could.").

access by non-banks to the traditional banking system.[398] 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 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.[399] That incident generated substantial attention from Congressional oversight, and ultimately resulted in agency action to stop the excessive abusive of power at the regulator.[400] But it demonstrates that the 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.[401]

VIII. Conclusion

Fintech innovations promise to eventually reshape the financial services industry entirely. We are not able to presently fathom how fintech will upend the ways in which suppliers of financing and consumers of financing will interact in 100 years. We

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[398] *Id.*

[399] Michael J. Bresnickat, Executive Director, Financial Fraud Enforcement Task Force, Speech at the Exchequer Club of Washington, D.C. (Mar. 20, 2013), https://www.justice.gov/opa/speech/financial-fraud-enforcement-task-force-executive-director-michael-j-bresnick-exchequer [https://perma.cc/5VDJ-JVBE] ("The reason that we are focused on financial institutions and payment processors is because they are the so-called bottlenecks, or choke-points, in the fraud committed by so many merchants that victimize consumers and launder their illegal proceeds. For example, third-party payment processors are frequently the means by which fraudulent merchants are able to get paid. They provide the scammers with access to the national banking system and facilitate the movement of money from the victim of the fraud to the scam artist.").

[400] *Id.*

[401] *Id.*

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.