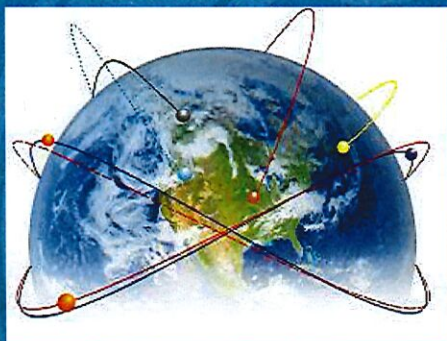


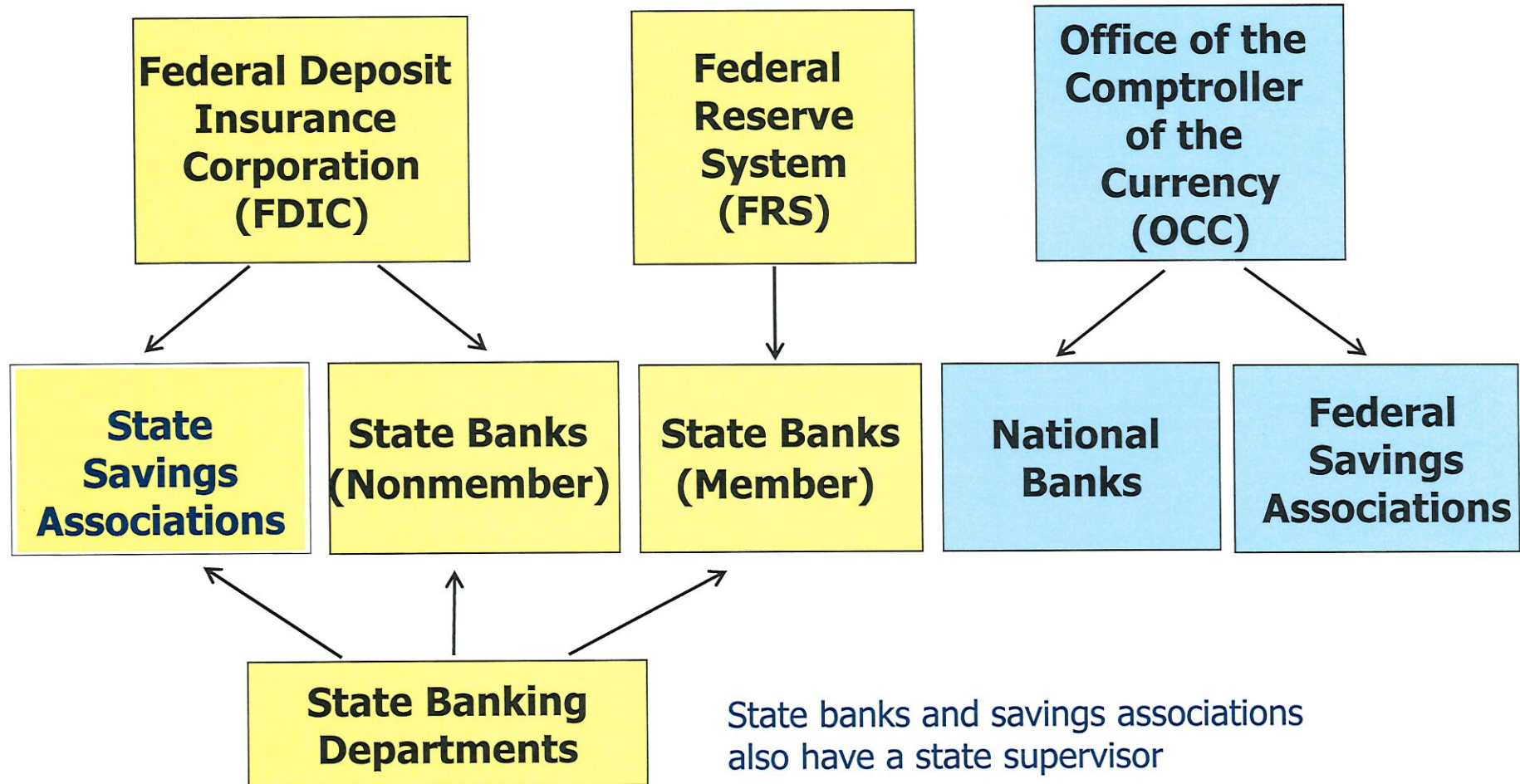
OCC Office of Innovation Regulatory Perspectives on Banking and Fintech October 2017



- Established in 1863 as a bureau of the Department of the Treasury.
- Headed by the Comptroller, who is appointed by the President with consent of the Senate, for a five year term.
- Regulates national banks, federal branches and agencies of foreign banks, and federal savings associations in the United States.
- Funded through assessments on the assets of national banks, federal branches and agencies of foreign banks, and federal savings associations.

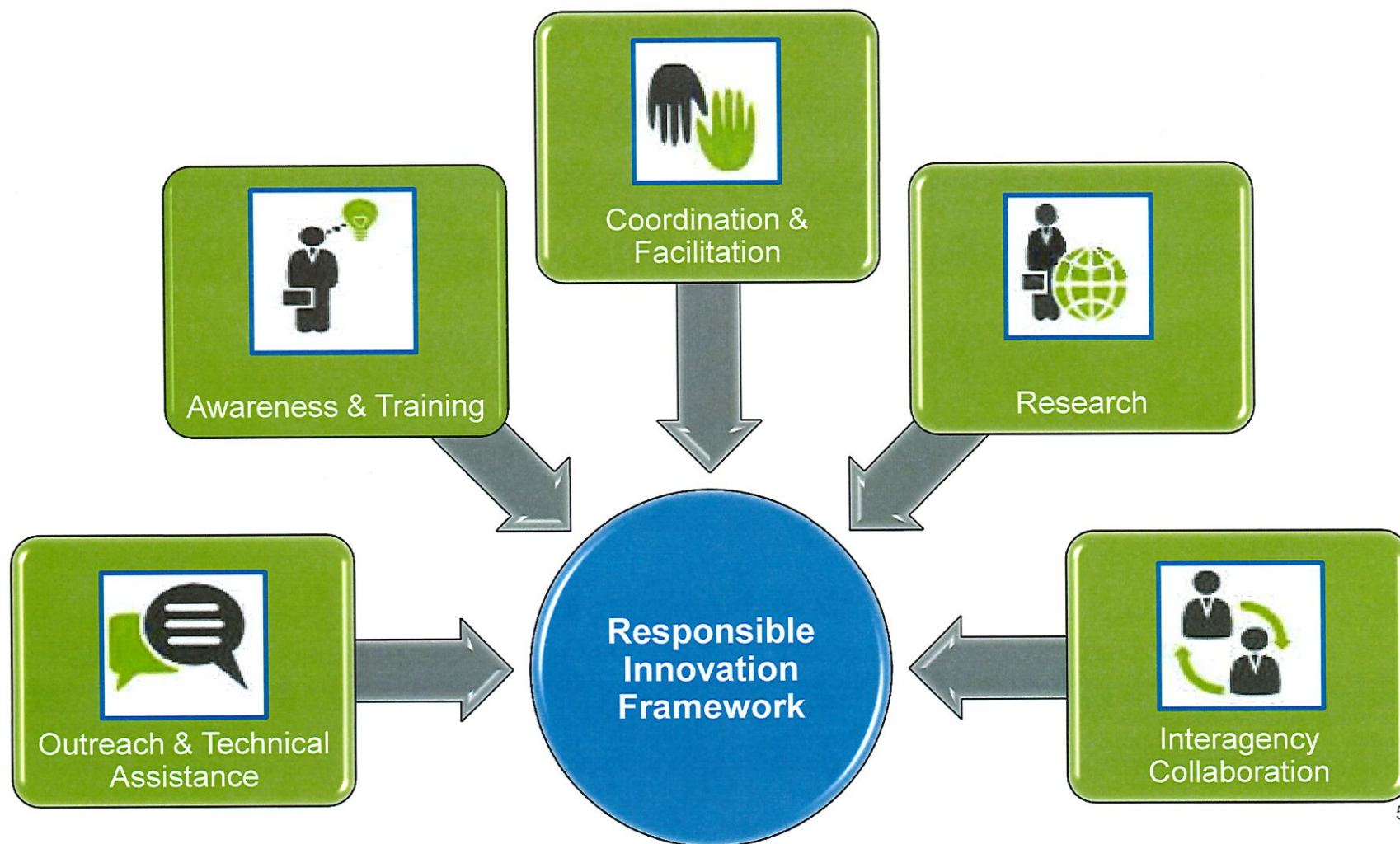
- Examines national banks, federal branches and agencies of foreign banks, and federal savings associations (collectively “banks”);
- Approves or denies applications for new charters, branches, capital, or other changes in corporate or banking structure;
- Takes supervisory actions against banks that do not conform to laws and regulations or that engage in unsound banking practices;
- Issues rules and regulations concerning banking practices and governing bank lending and investment practices and corporate structure.

Primary Federal Bank Supervisor

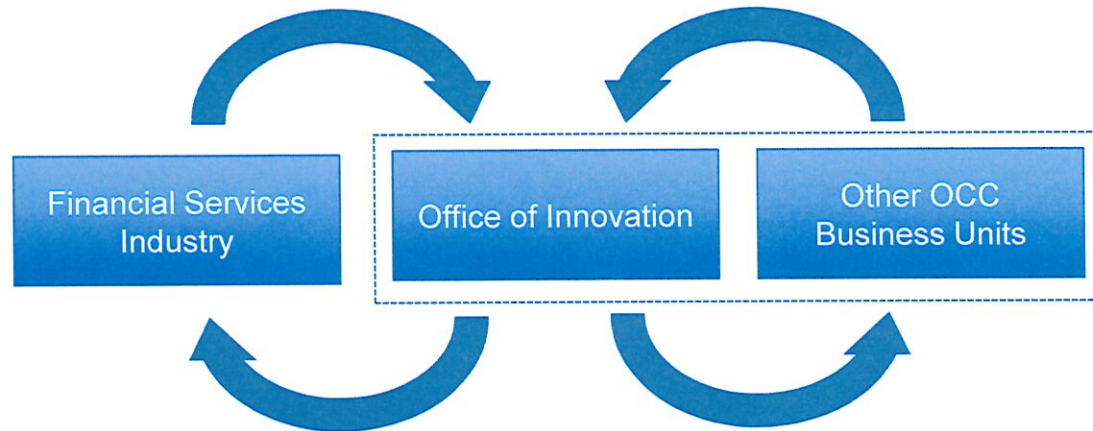


Definition and Responsible Innovation Framework

Responsible Innovation is the use of new or improved financial products, services, and processes to meet the evolving needs of consumers, businesses, and communities in a manner that is consistent with sound risk management and is aligned with the bank's overall business strategy.



Introduction to the OI



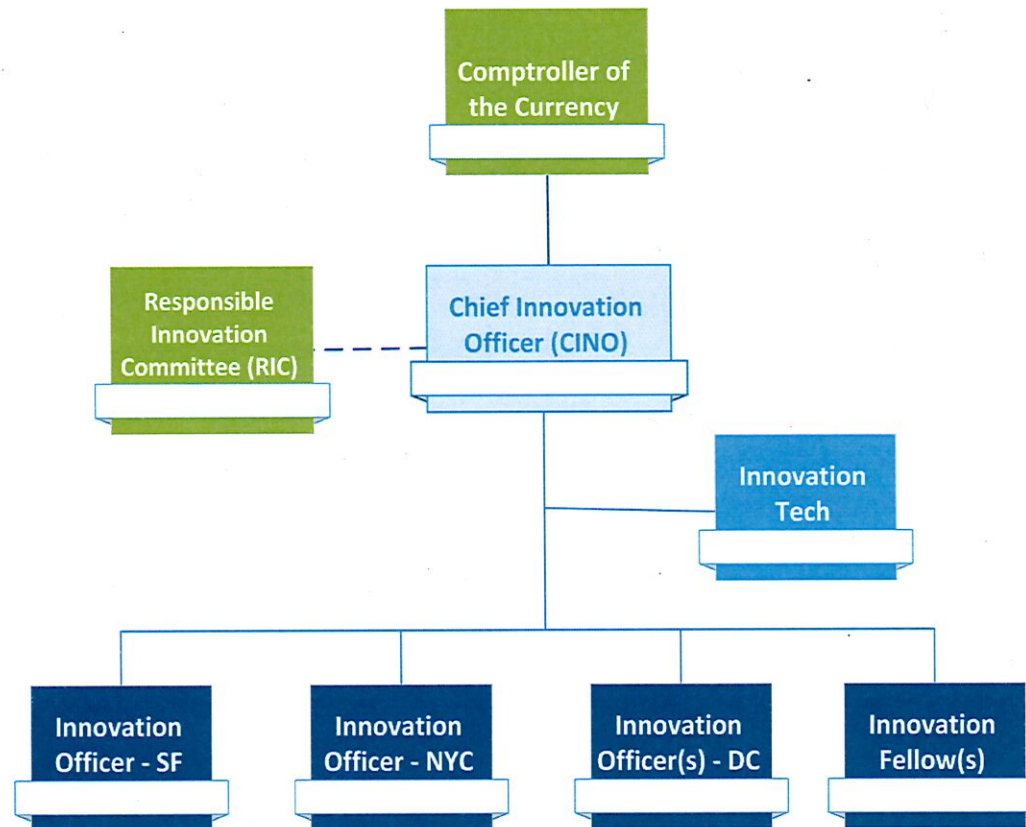
- Established in October 2016 to implement the OCC's framework to support responsible innovation in the federal banking system
- Central point of contact and clearinghouse to facilitate responses to inquiries and requests on innovation-related matters
- Enhances the OCC's ability to identify, understand, and respond to emerging trends and related risks in the financial services industry
- Provides an open forum to discuss regulatory principles, processes, and expectations

Office of Innovation Structure

The Office of Innovation (OI) is led by a Chief Innovation Officer (CINO). Permanent staff also includes Innovation Officers located in New York, San Francisco, and Washington, D.C.

The CINO will be advised by a Responsible Innovation Committee (RIC). The RIC is composed of Deputy Comptrollers from various divisions within the OCC.

The OI is also developing a Fellowship program to bring in expertise from the private sector.



OI Accomplishments to Date

- Held nearly 100 meetings and calls with banks, fintechs, industry trade groups, and other regulators
- Attended or presented at numerous internal and external conferences and held two Office Hours events
- Developed standardized outreach materials
- Hired 4 Innovation Officers (2-DC, 1NY, 1SF)
- Overhauled both external (occ.gov) and internal (occNET) Responsible Innovation web pages

- On December 2, 2016, the OCC issued white paper on special purpose charters
- On March 15, issued draft supplement to *Comptroller's Licensing Manual* describing how the OCC will evaluate applications for special purpose charters from fintechs
- OCC accepted comments on the draft supplement through April 14, 2017.
- The OCC is currently determining whether it will accept applications for special purpose charters.

Third Party Risk Management

- Due Diligence
- Contractual Management
- Ongoing Monitoring
- Subcontractors
- Exit Strategies

Cybersecurity

- Connections
- Assessment of Readiness
- Resilience

Model Management

- Algorithms
- Governance
- Ongoing testing

Anti-Money Laundering and Bank Secrecy Act

- Transaction Monitoring
- SAR Filing
- Program Management

Compliance

- Compliance with Applicable Laws
- Personnel and Skillsets
- Monitoring and Testing

Contacting the Office of Innovation

When should I
contact the Office
of Innovation?

- If you have questions about partnering with a bank
- If you have questions about innovation topics or emerging industry trends

How can the
Office of
Innovation help
me?

- Assist in understanding what questions to ask and what issues to consider
- Provide background and specific information on participating in the federal banking system.

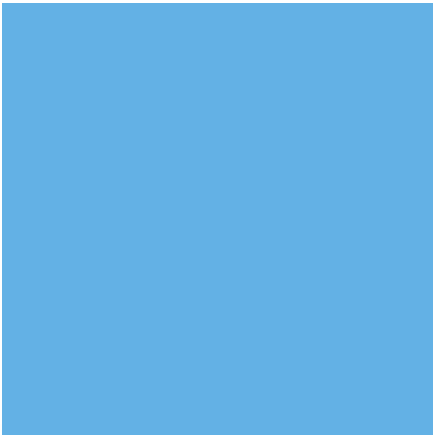
How can I
contact the Office
of Innovation?

- Contact Office of Innovation (contact information below)
- Go to the Responsible Innovation webpage on occ.gov

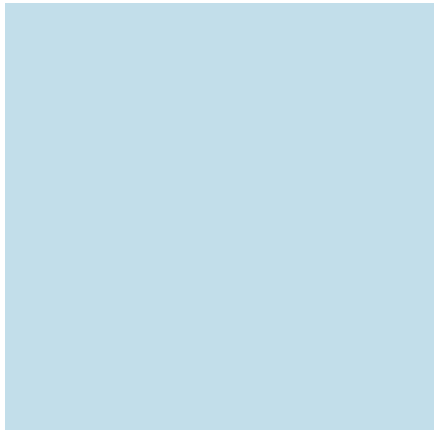
innovation@occ.treas.gov

202.649.5200

occ.gov/innovation



Banking Regulation and Regulators: The Basics



Jeremy R. Newell

CORE CONCEPTS

1. The Essence of Bank Regulation
2. The Structure of Bank Regulation: Insured Depository Institutions & Bank Holding Companies
3. IDI Powers & Activities
4. BHC Powers & Activities
5. Prudential Regulation
6. Types of Banks & Their Charters
7. The U.S. Bank Regulatory Agencies



THE ESSENCE OF BANK REGULATION



THE ESSENCE OF BANK REGULATION: WHAT'S A “BANK,” ANYWAY?

- Although many definitions are possible, U.S. banking law generally views a “bank” as an entity that:
 - Takes deposits;
 - Makes loans; and
 - Pays checks and transacts payments.

- The U.S. bank regulatory framework takes as its primary point of focus the first of these functions – deposit-taking.
 - Generally, an entity must be chartered and licensed as a bank in order to accept deposits.
 - This is *not* true of lending or payments activities.

- Accordingly, it is most useful to think of a “bank” as a *regulatory* concept – a special legal status that comes with both special privileges but also special responsibilities.



THE ESSENCE OF BANK REGULATION: THE GRAND BARGAIN

➤ The Benefits of Structuring a Business as a Bank

- Cheap, widely available debt funding (in the form of deposits)
- Funding stability provided by the Federal safety net
 - FDIC insurance
 - Access to Federal Reserve emergency loans (i.e., the “discount window”)
- Operational flexibility and simplicity of preemption of (some) state laws and regulation

➤ The Costs of Structuring a Business as a Bank

- Limitations on activities and affiliations
- Prudential regulation of the balance sheet, governance and risk management
- The intrusion and constraint of direct government supervision and examination

➤ U.S. bank regulation is effectively all about enforcing the latter half of this bargain

- FinTech, like all forms of innovation, raises new and novel questions about how new business models and ideas fit into the traditional rubric of this bargain.



THE STRUCTURE OF BANK REGULATION

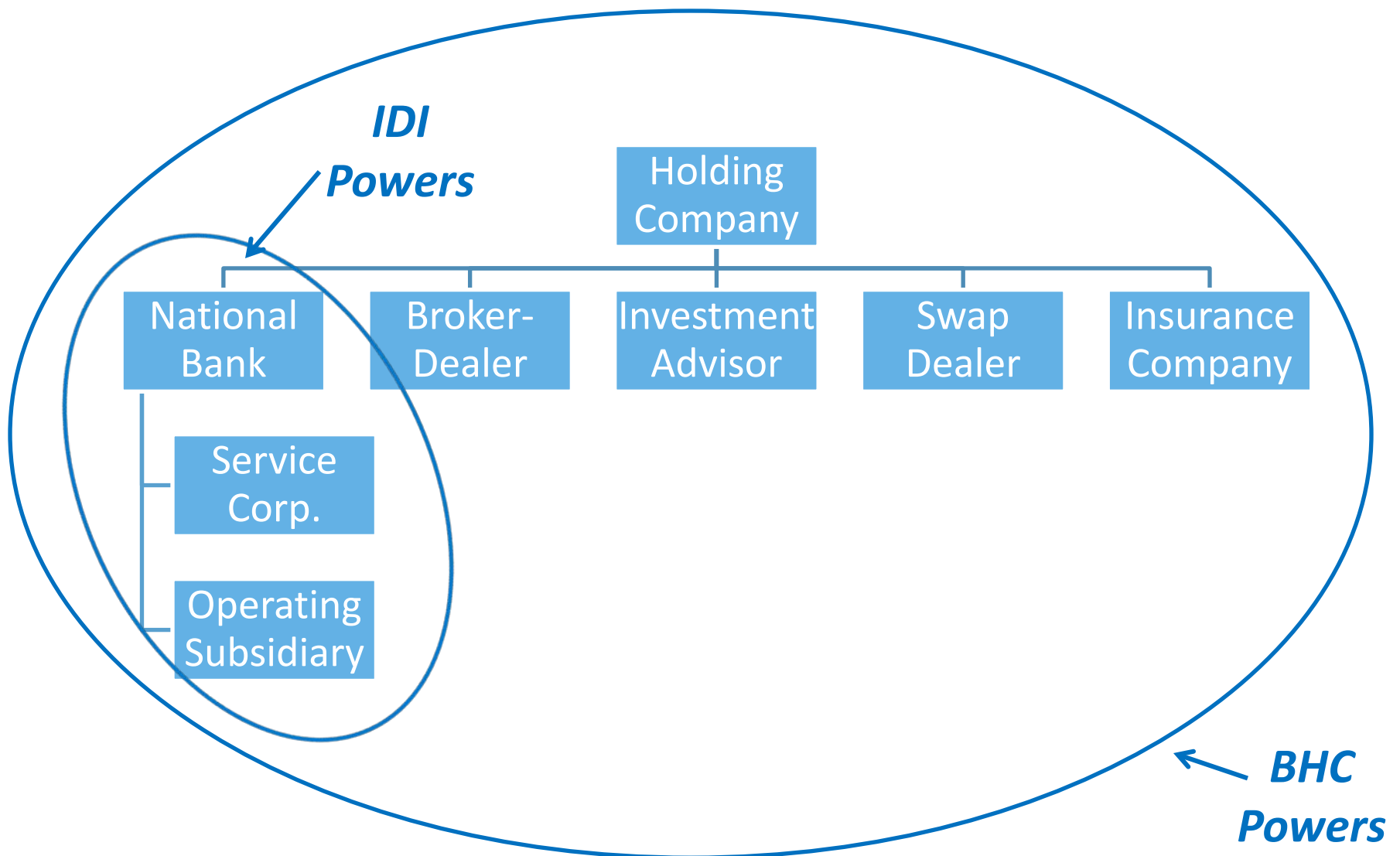


THE STRUCTURE OF BANK REGULATION: THREE BIG IDEAS

1. Deposit-taking activities may only take place within a specially-chartered and licensed form of legal entity – the “insured depository institution” or “IDI.”
 - The IDI’s deposits must be insured by the Federal Deposit Insurance Corporation (“FDIC”).
 - The IDI’s activities must be limited to banking and those incidental thereto.
2. An IDI may *affiliate* with companies engaged in a broader range of activities closely related to banking or other financial activities under a bank holding company (“BHC”).
3. An IDI may *not* affiliate with companies engaged in commercial activities (i.e., “the separation of banking and commerce”).
 - Note: An important loophole applies.



THE STRUCTURE OF BANK REGULATION – ILLUSTRATED



IDI POWERS & ACTIVITIES



IDI POWERS AND ACTIVITIES: *KEY TAKEAWAYS*

- Unlike typical corporations, the legal authority of banks and thrifts (i.e., IDIs) to engage in various activities is severely restricted by federal (and in some cases state) law
- Strong historical and policy reasons for this framework
- Relevant statutory law and regulation governing and restricting bank powers varies depending on the charter type
- “Permissibility analysis” remains one of the core tasks of bank regulatory practitioners – and core challenges to business and technological innovation
- Governing law often includes not only statutes and regulations, but also agency interpretations over time and case law



IDI POWERS: KEY SOURCE LAW AND REGULATION

	Federal Charter	State Charter
Bank	<i>12 U.S.C. § 24</i> <i>(12 C.F.R. Part 1 et seq.)</i>	<i>Relevant state law</i> <i>§ 24 of the Federal Deposit Insurance Act</i>
Thrift	<i>12 U.S.C. § 1464(c)</i> <i>(12 C.F.R. Part 160)</i>	<i>Relevant state law</i> <i>§ 24 of the Federal Deposit Insurance Act</i>



IDI POWERS & ACTIVITIES: AT A GLANCE

- Deposit-taking
- Lending and leasing
- Payments activities
- Most derivatives dealing
- Very limited securities and insurance activities – generally agency in nature
- Trust/fiduciary activities (not automatic – subject to regulatory approval)
- Limited investment activities (generally not equity investment)



IDI POWERS & ACTIVITIES: REGULATION OF EXPANSION

- Bank Merger Act: Generally requires federal agency review and approval of any acquisition of deposit liabilities
- Change in Bank Control Act: Generally requires federal agency review and non-objection of any acquisition of (i) more than 25% of any class of voting securities by a company or (ii) more than 10% of any class of voting securities by a person
- Deposit Caps:
 - Riegle-Neal Nationwide Deposit Cap: restricts transactions that would result in any single bank holding more than 10% of national deposits
 - Statewide deposit caps



BANK HOLDING COMPANY (“BHC”) POWERS & ACTIVITIES



BHC POWERS & ACTIVITIES: A LITTLE HISTORY

- 1900 to 1956: Emergence of BHC structure, but no restriction/regulation of BHC activities (other than Glass-Steagall barriers and affiliate transaction rules)
- 1956: Bank Holding Company Act (“BHCA”) enacted, limits activities in which BHCs and their subsidiaries can engage
- 1970: BHCA amended to eliminate “one bank holding company” loophole
- 1999: Gramm-Leach-Bliley Act (“GLBA”) enacted, creates new “financial holding company” designation and substantially expands permissible activities



BHC POWERS & ACTIVITIES: TRIGGERS & IMPLICATIONS OF REGULATION AS A BHC

- BHCA applies to any:
 - COMPANY that ...
 - CONTROLS a ...
 - BANK.
- “Company” includes a variety of legal vehicles and entities.
 - Does not include natural persons (but see Change in Bank Control Act), but may include groups of people “acting in concert.”
- “Control” for these purposes is an exceedingly expansive (and somewhat subjective) concept, which acts as a significant obstacle to banks as both investors and investees.
- Core implications of BHC status include:
 - Approval requirements: Applications and Fed approval needed to become a BHC, acquire an interest in additional banks, and engage in nonbanking activities
 - Activity limits: Limits on activities conducted throughout the BHC

BHC POWERS & ACTIVITIES: WHAT IS A “BANK” FOR PURPOSES OF THE BHCA?

- NOT simply an insured depository institution.
- Key exclusions:
 - Thrifts (but see S&L holding company regime);
 - Credit card banks;
 - Certain trust companies;
 - Edge Act/agreement corporations; and
 - Industrial loan companies (“ILCs”).
- We typically refer to these excluded entities as “nonbank banks.”
- Major policy fights in the 1980s over nonbank banks, and especially ILCs.



BHC POWERS & ACTIVITIES: SCOPE

- BHCs can engage in banking and control or manage banks – § 3 of the BHCA
- BHCs can also engage in activities closely related to banking – § 4 of the BHCA:
 - Making/acquiring/brokering/servicing loans;
 - Leasing real/personal property;
 - Operating a thrift or trust company;
 - Acting as investment/financial advisor;
 - Securities – brokerage, private placement, underwriting/dealing in bank-eligible securities;
 - Management consulting;
 - Courier/check/payments services;
 - Community development; and
 - Processing banking/financial/economic data.



BHC POWERS & ACTIVITIES: EXPANDED POWERS FOR BHCs THAT QUALIFY AS “FHCs”

- As part of the GLBA in 1999, Congress created a new “type” of BHC, which is defined by statute as a “financial holding company” or FHC.
 - In general, FHCs are authorized to engage in a much wider range of activities.

- In order for a BHC to become an FHC, it must satisfy three key criteria:
 - Must be “well-capitalized” and “well-managed”;
 - Must have a satisfactory Community Reinvestment Act (“CRA”) record; and
 - Must file an election to become an FHC.



BHC POWERS & ACTIVITIES: PERMISSIBLE ACTIVITIES FOR AN FHC

- Includes nonbanking activities that are permissible for a BHC under § 4(c)(8) (important advantage – unlike BHCs, no prior approval required).
- Also includes “activities that are financial in nature” under § 4(k):
 - Full range of securities dealing and underwriting activity through a registered broker dealer;
 - Insurance activities;
 - Merchant banking activities; and
 - Others as permitted by Fed over time.
- Also includes activities deemed by the Fed to be “complementary” to a financial activity (e.g., commodities trading activities).



PRUDENTIAL REGULATION



PRUDENTIAL REGULATION: OVERVIEW

➤ “Prudential regulation”

- Primarily focused on the safety and soundness of the institution
- Applies at both the BHC and IDI level – though underlying legal regimes differ, and often more stringent at the IDI level
- Distinguish from “market regulation”

➤ Rationales for prudential regulation in banking:

- Protect depositors;
- Protect FDIC;
- Protect banking system; and
- Limit moral hazard.

➤ Prudential regulation of banks has a substantial impact on the economics, design, and management of activities in which the bank engages – and therefore both the business model of individual banks and of the banking industry as a whole.



PRUDENTIAL REGULATION: SAFETY & SOUNDNESS FRAMEWORK AT A GLANCE

- Activity restrictions (as described above)
- Capital and liquidity rules
 - Capital standards are generally based on international standards developed by the Basel Committee on Banking Supervision, and require banks to meet minimum ratios of equity capital relative to both total assets and to “risk-weighted assets” – that is, assets based on a weighting system that attempts to differentiate the varying risks of different asset classes
 - Liquidity rules are recent (i.e., post-crisis) – most important here is the liquidity coverage ratio, which require larger banks to hold minimum amounts of “high quality liquid assets” relative to the risk that their deposit and other liabilities might “run”
- Governance standards
- Risk management standards
- Supervision, examination, and enforcement
- Special regimes for loans to one borrower, insider lending, and affiliate transactions



PRUDENTIAL REGULATION: THE LONG ARM OF THE BANKING LAW

- In many cases, aspects of prudential bank regulation, examination and enforcement framework apply not only to IDIs and BHCs, but extend to the conduct and actions of:
 - So-called “institution-affiliated parties” (“IAPs”), which include individual owners, directors, officers, and executives; and
 - Service providers to banks.



TYPES OF BANKS AND THEIR CHARTER



TYPES OF BANKS AND THEIR CHARTERS

- Key elements to understand:
 - What type of bank is it?
 - Under what law is the bank *chartered* (i.e., incorporated)?

- Understanding the types of banks and their charters is crucial, because this will determine:
 - Who regulates the bank;
 - What laws and regulations apply to the bank; and
 - What activities the bank can engage in.



TYPES OF BANKS AND THEIR CHARTERS: *VISUAL OVERVIEW*

	Federal Charter	State Charter
Bank	<i>National Bank</i>	<i>State Member Bank</i> <i>State Non-Member Bank</i>
Thrift	<i>Federal Savings Association</i>	<i>State Savings Bank</i> <i>State Savings & Loan</i> <i>State Savings Association</i>

TYPES OF BANKS AND THEIR CHARTERS: NATIONAL BANKS

- Chartered under Federal law – National Bank Act of 1864
- Regulated and supervised by the Office of the Comptroller of the Currency (“OCC”)
- Typically engage in a variety of deposit-taking, retail lending (e.g., mortgage lending) and commercial lending
- Primary charter choice for larger banks, particularly over the last 25 years
- Must be a member of the Federal Reserve System
- Deposits must be insured by the FDIC



TYPES OF BANKS AND THEIR CHARTERS: STATE BANKS

- Chartered under state law – individual state laws vary
- Primarily regulated and supervised by their state banking agency (e.g., the New York Department of Financial Services)
 - But also subject to Federal regulation and supervision (either Fed or FDIC)
- Typically engage in a variety of deposit-taking, retail lending (e.g., mortgage lending) and commercial lending
- More frequently the charter of choice for smaller community banks
- May or may not be a member of the Federal Reserve System:
 - Determines whether the bank is a “state member” or “state non-member” bank
 - Important because it determines which Federal agency provides supplementary regulation and supervision
- Deposits insured by the FDIC



FEDERAL SAVINGS ASSOCIATIONS

- Chartered under Federal law – Home Owners Loan Act of 1933
- Regulated and supervised by the OCC
 - Prior to Dodd-Frank Act, regulator was the Office of Thrift Supervision
- Typically focus on deposit-taking and mortgage lending, with only limited commercial lending activity
 - Must meet a “qualified thrift lender” test
- Deposits must be insured by FDIC



STATE THRIFTS

- Chartered under state law – individual laws vary
- Primarily regulated and supervised by their state banking agency (e.g., the New York Department of Financial Services)
 - But also subject to Federal regulation and supervision (FDIC)
- Again, typically focused on deposit-taking and mortgage lending
- More frequently the charter of choice for smaller thrifts
- Deposits insured by the FDIC



THE U.S. BANK REGULATORS



U.S. BANK REGULATORY AGENCIES: *KEY TAKEAWAYS*

- The U.S. regulatory structure for banking is immensely complex, cumbersome and inefficient
 - Largely a product of U.S political and economic history
 - Frequently the subject of detailed – and unsuccessful – efforts to rationalize and harmonize the agencies
- Regulatory authority is driven on a legal-entity, not functional, basis
- Overall framework is one in which multiple regulatory agencies often have similar or overlapping authority for the same banking organization
 - This trend was further entrenched by the Dodd-Frank Act
- Key functions of the bank regulatory agencies:
 - Implement and interpret statutes;
 - Supervise and examine banks; and
 - Enforce laws and regulations.



U.S. BANK REGULATORY AGENCIES: *OVERVIEW*

Primary Federal regulators

- Board of Governors of the Federal Reserve System (“Federal Reserve Board”)
- Office of the Comptroller of the Currency (“OCC”)
- Federal Deposit Insurance Corporation (“FDIC”)

Other key regulators

- State banking agencies
- Securities & Exchange Commission (“SEC”)
- Commodity Futures Trading Commission (“CFTC”)
- State insurance regulators
- Financial Crimes Enforcement Network (“FinCEN”)
- Consumer Financial Protection Bureau (“CFPB”)
- National Credit Union Administration (“NCUA”)
- Financial Stability Oversight Council (“FSOC”)



FEDERAL RESERVE BOARD

- Created in 1913
- Primary Federal regulator for bank holding companies (“BHCs”) and (since 2012) savings and loan holding companies (“SLHCs”)
 - Provides consolidated regulation and oversight for entire organization, not just the holding company
 - But subject to a general principle of “functional regulation” – general deference to functional regulator of each subsidiary (e.g., SEC oversight of a broker-dealer subsidiary)
- Also serves as Federal regulator for state member banks
 - Supplements state banking agency regulation/supervision and provides uniform “floor” of Federal regulation/supervision
- Federal Reserve Board exercises rulemaking authority but in practice often delegates supervision duties to local Federal Reserve banks

OCC

- Created in 1864
- Primary Federal regulator for national banks and Federal savings association
 - Authority also extends to subsidiaries of national banks/Federal savings associations
- Performs its supervision and examination functions through a combination of its principal office in Washington, D.C. and regional offices throughout the United States

FDIC

- Created in 1933
- Insures the deposits of all Federal and state banks and thrifts pursuant to Federal law
 - Maintains the Deposit Insurance Fund (the “DIF”)
- Primary Federal regulator for state non-member banks and state thrifts
 - Supplements state banking agency regulation/supervision and provides uniform “floor” of Federal regulation/supervision
- Because of its interest as deposit insurer, effectively acts as a “secondary” Federal regulator for all IDIs
- Insolvency and receivership powers:
 - By statute, is responsible for closing any failed IDI
 - Under Dodd-Frank Act, also has special authority to resolve failed systemically-important financial institutions

THE DEVIL YOU KNOW: WORKING WITH LAWYERS IN A REGULATED INDUSTRY

October 12, 2017

Paul T. Clark



Intersection of Lawyers and Finance

Client: “Mr. Darrow, how can I ever show my appreciation?”

Clarence Darrow: “My dear sir, ever since the Phoenicians invented money there has been only one answer to that question.”





What is FinTech?

- FinTech is not a body of law.
- FinTech is the application of new technologies, or existing technologies in new ways, to the delivery and support of financial services.
- Companies utilizing new technologies navigate existing banking and securities law rules and regulations to offer their products to the public or to financial services firms.



Objectives of Today's Presentation

- Review the history of key developments in banking technology and recent trends
- Contrast the role of the entrepreneur to the role of the lawyer
- Discuss the three rules for lawyers advising clients on new products
- Utilize a case study to discuss how a lawyer would advise a client
- Review the tools in the lawyer's toolbox to assist a client



“If I have seen further it is because I have stood on the shoulders of giants.” — Sir Isaac Newton

On the Shoulders of Giants: Predecessor Technologies and Products that Changed the Bank/Customer Relationship

Timeline of Key Developments

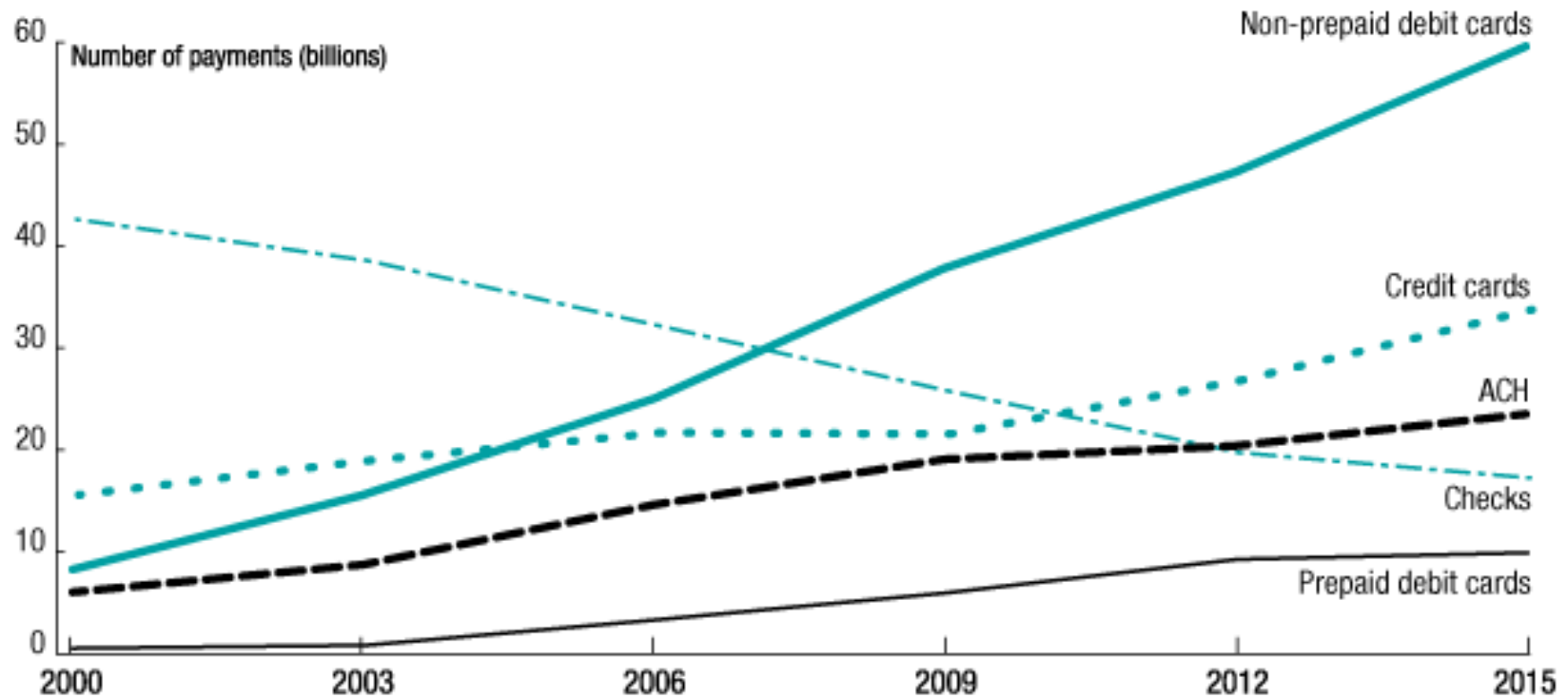
1967	<ul style="list-style-type: none">• First ATM, Barclays Bank, London.
1972	<ul style="list-style-type: none">• First debit card marketed by City National Bank (Columbus, OH).
1977	<ul style="list-style-type: none">• First shared ATM network.
1984	<ul style="list-style-type: none">• First nationwide debit card network created by Landmark Bank.
1985	<ul style="list-style-type: none">• Supreme Court holds that ATMs are not bank branches. Independent Bankers Association of New York State v. Marine Midland Bank, 757 F.2d 453 (2d Cir. 1985), cert. denied, 476 U.S. 1186 (1986).
1998	<ul style="list-style-type: none">• Debit card transactions outnumber checks globally for the first time.• Launch of LendingTree.
1999	<ul style="list-style-type: none">• First Internet Bank of Indiana opens as the first bank to operate solely online.
2000	<ul style="list-style-type: none">• PayPal attains 1 M Users.
2002	<ul style="list-style-type: none">• PayPal ruled not a bank by the State of New York based upon moving customer funds between customer's account and bank account/ money fund; does not address holding customer funds.

Timeline of Key Developments

2007	<ul style="list-style-type: none">• Apple introduces the iPhone.• Launch of Lending Club.
2009	<ul style="list-style-type: none">• Launch of Bitcoin.• USAA becomes first bank to permit customers to deposit checks with a smartphone.
2011	<ul style="list-style-type: none">• PayPal mobile payments reach \$4 B.• Launch of Google Wallet.
2013	<ul style="list-style-type: none">• Launch of Square Cash.• FinCEN issues guidance stating that virtual currency exchanges and administrators are money services businesses.
2014	<ul style="list-style-type: none">• Launch of Apple Pay.• FinCEN rules that bitcoin exchanges and payment processors are money transmitters under U.S. law.• IRS rules that it considers Bitcoin a form of property and is taxed at the capital gains rate when sold/spent.
2015	<ul style="list-style-type: none">• Facebook offers peer-to-peer (P2P) transfers.
2016	<ul style="list-style-type: none">• OCC releases FinTech White Paper.• OCC sets forth basis for its authority to grant applications by FinTech companies for a special purpose national bank charter.• CFPB releases stored value card rules.
2017	<ul style="list-style-type: none">• OCC releases draft licensing manual supplement for evaluating FinTech charter applications.• CSBS files a lawsuit challenging FinTech charter.• Launch of Zelle, a new P2P payments network from bank-owned Early Warning Services.

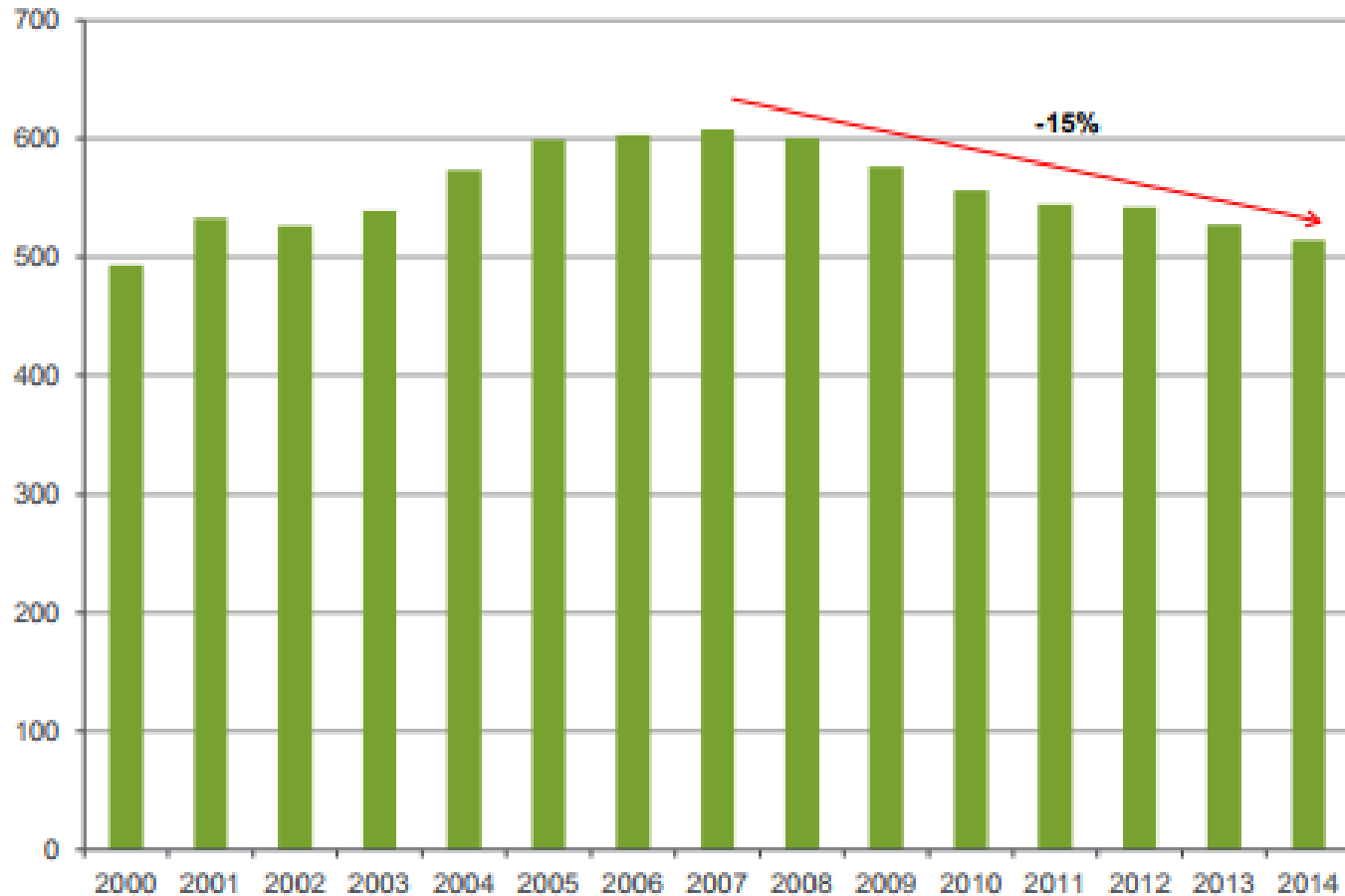
Recent Trends

Changes in Noncash Payments 2000-2015 (by Number and Type of Transaction)



Source: The Federal Reserve Payments Study 2016

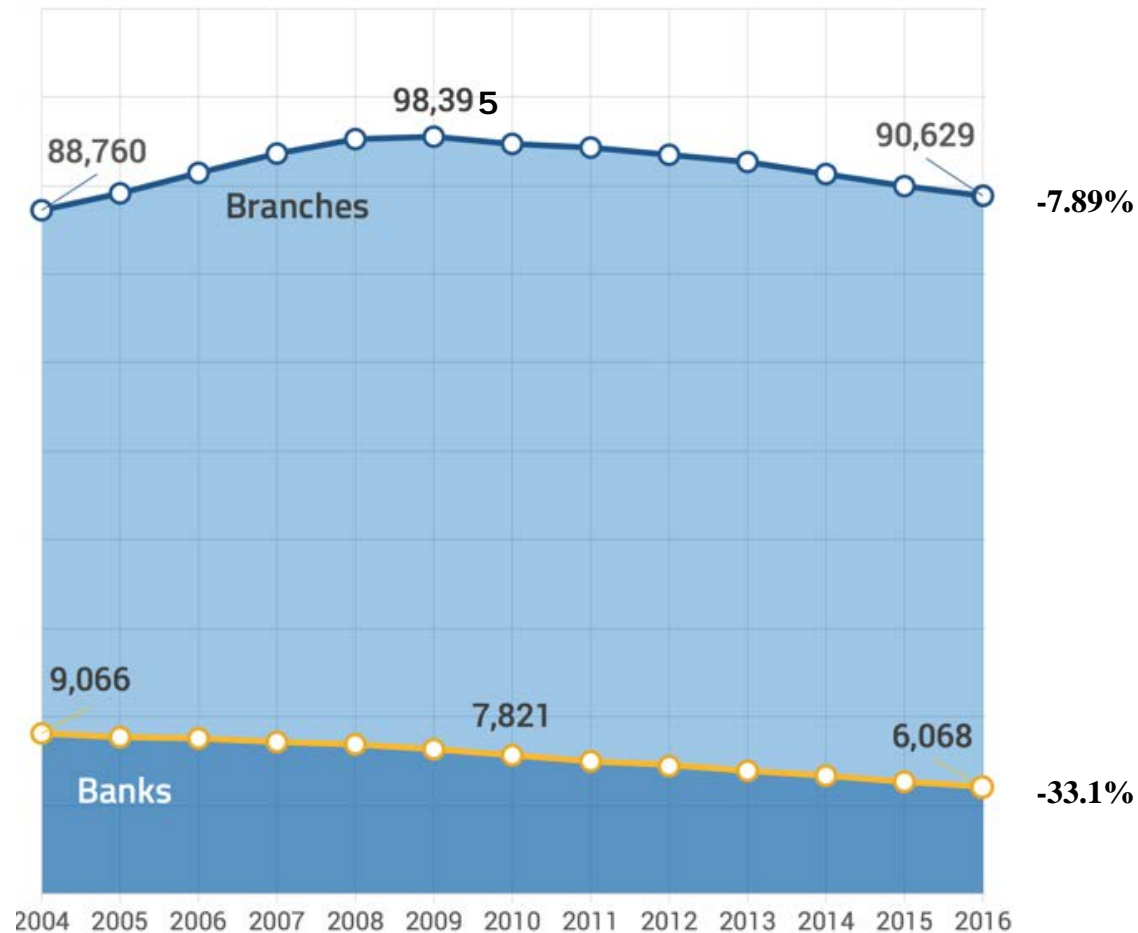
Number of Bank Tellers Declined 15% from Peak in 2007 through 2014



Source: Citi GPS: Global Perspectives & Solutions, Digital Disruption: How FinTech is Forcing Banking to a Tipping Point (March 2016)

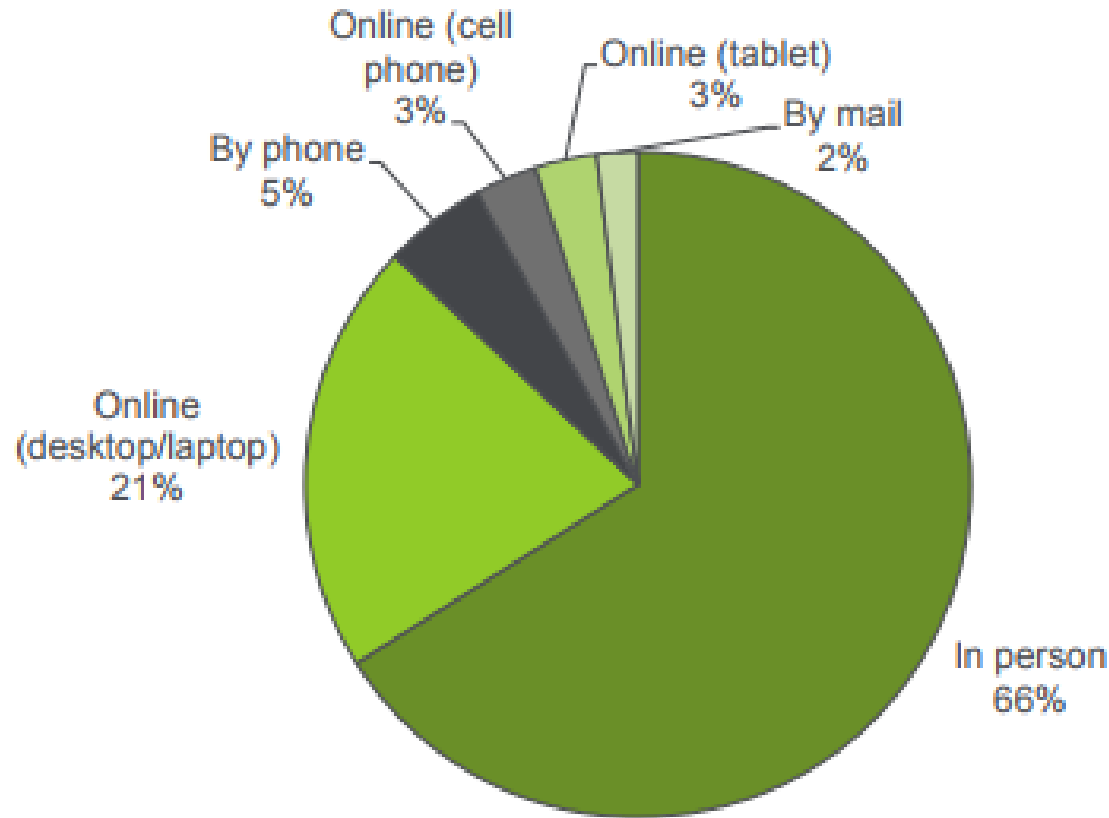
Number of U.S. Banks & Branches 2004-2016

Compiled from FDIC June Call Reports



Source: DepositAccounts.com analysis of FDIC data

As of November, 2015, Two-Thirds of Consumers Opened Their Checking Account in Person



Source: Citi GPS: Global Perspectives & Solutions, Digital Disruption: How FinTech is Forcing Banking to a Tipping Point (March 2016)



The Rise of Mobile Payments

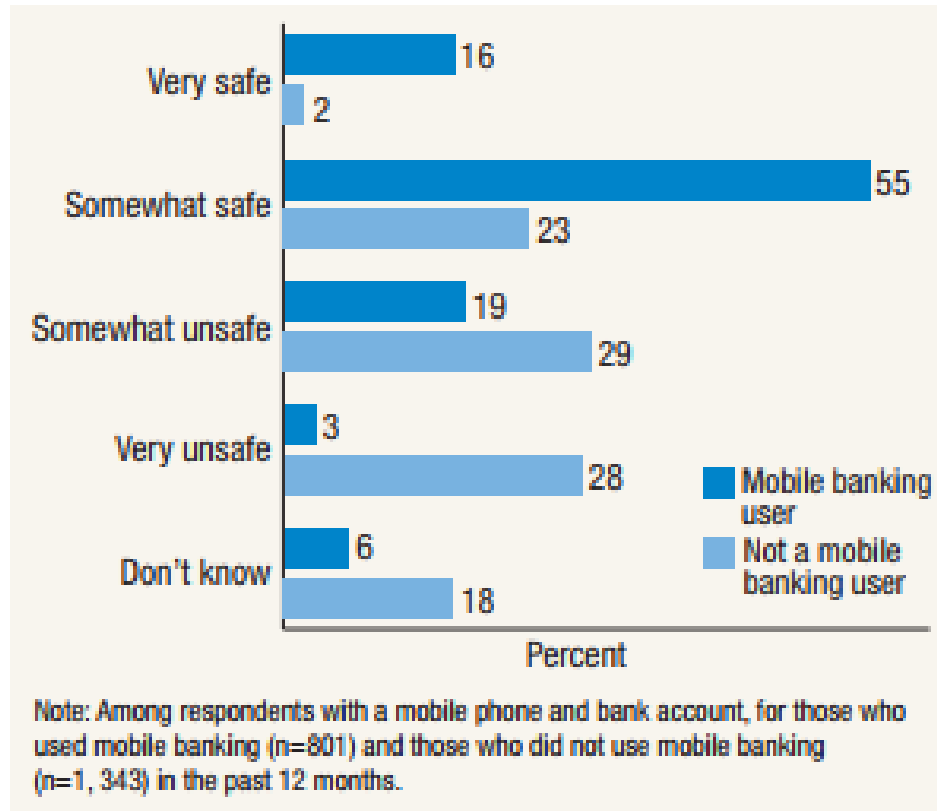
- The decline of check and teller transactions reflects the rise of alternative payment mechanisms such as prepaid cards and peer-to-peer payments.
- As of March 31, 2017, PayPal (including Venmo) customers held approximately \$15 billion in their accounts.*
- If PayPal were a bank, its customer account balance totals would make it the **17th-largest bank in the nation (by amount of demand deposits).****

*Source: PayPal Holdings, Inc. 10-Q filed with the SEC for the first quarter of 2017.

**Source: "Banks Ranked by Demand Deposits" (compiled by U.S. Bank Locations, based upon first quarter 2017 call report data).

Mobile Security

In a survey conducted for the Federal Reserve Board, respondents were asked: how safe do you believe people's personal information is when they use mobile banking?



Source: Board of Governors of the Federal Reserve System, Consumer and Mobile Financial Services 2016 (March 2016)



Increase in Lending through Platforms Maintained by Lending Club and Prosper, the 2 Largest Non-Bank Marketplace Lenders

Loans Originated 2013 — 2016	
2013	\$3.3 Billion
2016	\$33 Billion

Source: 10-Ks Filed with the SEC by Lending Club and Prosper for Fiscal Years Ending December 2013 and 2016.

Contrasting Roles of Entrepreneurs and Lawyers



Entrepreneurs

- Think “outside the box” to develop new products and services that create new markets or improve existing markets.
- “Disrupt” existing distribution channels in order to provide better products and services.
- Challenge the burdens placed on financial services companies by the existing legal regimes.
- Make money.



Lawyers

- Fit the product or service into a pre-existing box.
- Explain to the client the rationale or policy behind the current legal regime.
- Suggest alternative strategies and, when appropriate, seek modification of existing interpretations of current law or of current law itself.
- Assist the client in avoiding fines and penalties that cost the client money or put the client out of business.



California Rule of Professional Conduct 3-120

- A lawyer shall not advise the violation of any law or rule unless the member believes in good faith that such law or rule is invalid.
- A lawyer may take appropriate steps in good faith to test the validity of any law or rule.

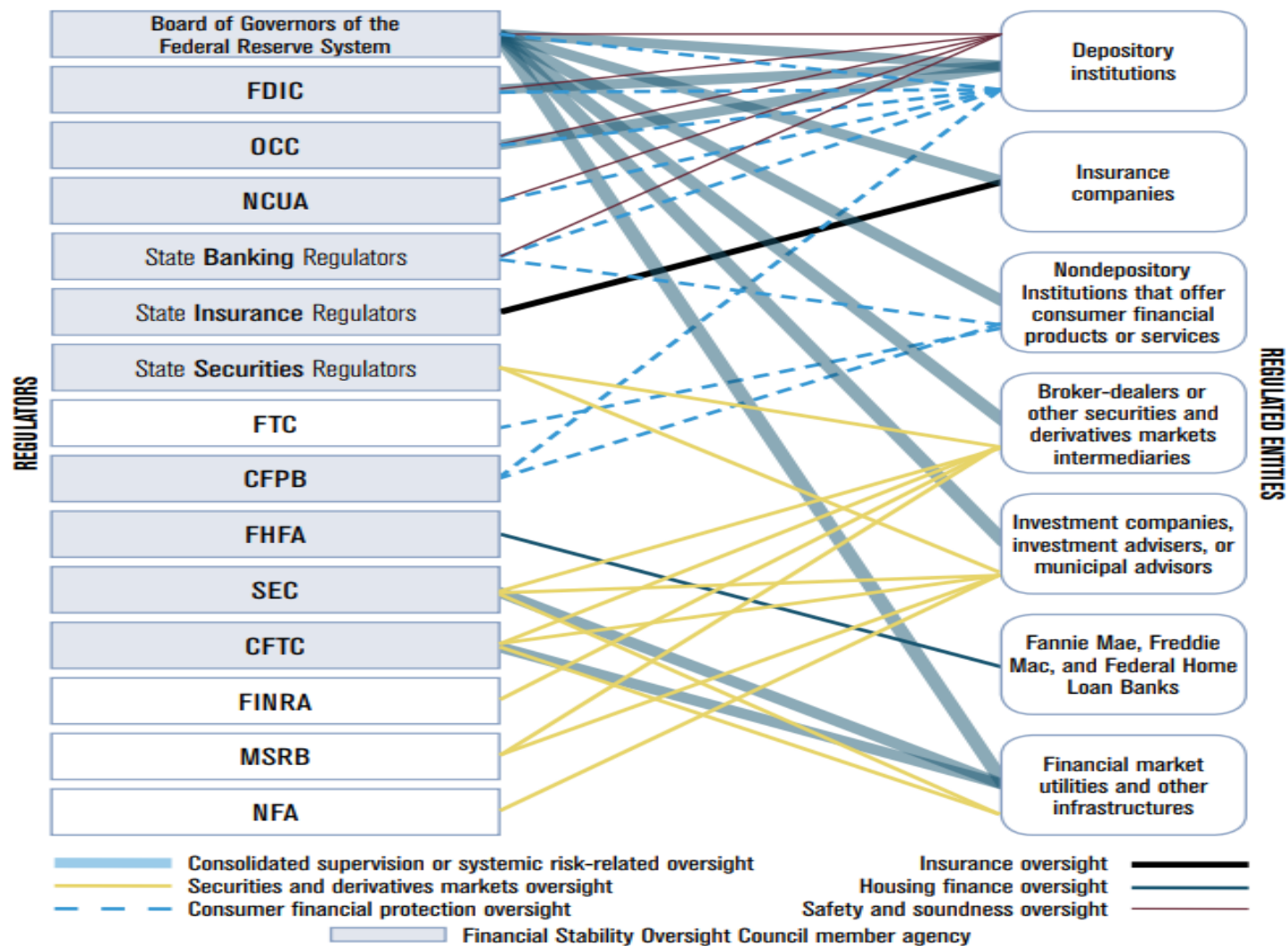


ABA Model Rule of Professional Conduct 1.2

- A lawyer shall not counsel a client to engage, or assist a client, in criminal or fraudulent conduct; a lawyer may discuss the legal consequences of proposed conduct.
- A lawyer may counsel or assist a client in a good faith effort to determine the validity, scope, meaning, or application of the law.

Overview of U.S. Regulatory Framework

U.S. Financial Regulatory Structure, 2016



Source: U.S. Dept. of Treasury, "A Financial System That Creates Economic Opportunities"

Examples of Federal Laws and Regulations Relevant to Mobile Payment Transactions

Law or regulation	Example of relevant requirements or provisions	Applicability to mobile payment transactions	Federal agencies with regulatory or enforcement authority
Bank Service Company Act	Provides the federal banking agencies with the authority to regulate and examine the performance of certain services by a third-party service provider for a depository institution (or for any subsidiary or affiliate of a depository institution that is subject to examination by that agency) "to the same extent as if such services were being performed by the depository institution itself on its own premises."	Applies when a mobile payment provider is a third-party service provider to a depository institution.	FRS, OCC, FDIC
Electronic Fund Transfer Act (Regulation E)	Provides certain consumer rights regarding the electronic transfer of funds to and from consumers' bank accounts. Requires disclosure of terms and conditions of electronic transfers, limits consumer liability for unauthorized transfers, and establishes procedures for preauthorizing transfers and error resolution procedures. ^a	Applies when the underlying payment is made to or from a consumer's account via an electronic fund transfer.	OCC, FRS, FDIC, NCUA, FTC, CFPB
Truth in Lending Act (Regulation Z)	Requires creditors to provide meaningful disclosures concerning certain terms and conditions of certain loan and credit transactions with consumers; intended to help consumers understand the cost of credit and compare credit options. ^a	Applies when the underlying source of payment is a credit card (or other credit account covered by the Truth in Lending Act and Regulation Z).	CFPB, FRS, OCC, NCUA, FDIC, FTC
UDAAP	Prohibits unfair, deceptive, or abusive acts or practices (UDAAP).	Applies to all mobile payments regardless of underlying payment source.	CFPB, FRS, FDIC, OCC, NCUA
Section 5 of the Federal Trade Commission Act	Prohibits unfair or deceptive acts or practices (UDAP).	Applies to all mobile payments regardless of underlying payment source.	FTC, FRS, FDIC, OCC, NCUA

Examples of Federal Laws and Regulations Relevant to Mobile Payment Transactions

Law or regulation	Example of relevant requirements or provisions	Applicability to mobile payment transactions	Federal agencies with regulatory or enforcement authority
Title V of the Gramm- Leach-Bliley Financial Modernization Act (Regulation P)	Limits when a financial institution may disclose a consumer's "nonpublic personal information" to nonaffiliated third parties; requires financial institutions to notify their customers about their information-sharing practices and to tell consumers of their right to "opt out" if they do not want their information shared with certain nonaffiliated third parties.	Applies when a financial institution handles information of a "consumer" or "customer."	FTC, CFPB, FRS, OCC, NCUA, FDIC
Truth in Billing	Requires wireless carriers to provide certain billing information to customers.	Applies when mobile payment results in charges to mobile phone bill.	FCC

Legend

CFPB – Bureau of Consumer Financial Protection, known as the Consumer Financial Protection Bureau

FCC – Federal Communications Commission

FDIC – Federal Deposit Insurance Corporation

FRS – Board of Governors of the Federal Reserve System

FTC – Federal Trade Commission

NCUA – National Credit Union Administration

OCC – Office of the Comptroller of the Currency

Source: GAO and FDIC information. | GAO-17-361

Note: This table is not exhaustive, and other federal laws and regulations may apply.

^aAdditional requirements will become effective at a later date, including comprehensive consumer protections for prepaid accounts under Regulation E, implementing the Electronic Fund Transfer Act, and Regulation Z, implementing the Truth in Lending Act. Prepaid Accounts Under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z), 81 Fed. Reg. 83934 (Nov. 22, 2016). CFPB issued a proposed rule in March 2017 to extend the effective date of these provisions an additional six months to April 2018. 82 Fed. Reg. 13782 (March 15, 2017).

Examples of Federal Laws and Regulations Relevant to Marketplace Lending

Law or regulation	Example of relevant requirements or provisions	Federal agencies with regulatory or enforcement authority
Bank Service Company Act	Provides the federal banking agencies with the authority to regulate and examine the performance of certain services by a third-party service provider for a depository institution (or for any subsidiary or affiliate of a depository institution that is subject to examination by that agency) "to the same extent as if such services were being performed by the depository institution itself on its own premises."	FRS, OCC, FDIC
Electronic Fund Transfer Act (Regulation E)	Provides certain consumer rights regarding the electronic transfer of funds to and from consumers' bank accounts. Requires disclosure of terms and conditions of electronic transfers, limits consumer liability for unauthorized transfers, and establishes procedures for preauthorizing transfers and error resolution procedures. ³	OCC, FRS, FDIC, NCUA, FTC, CFPB
Equal Credit Opportunity Act (Regulation B)	Prohibits creditors from discriminating against credit applicants with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, sex or marital status, or age, or the fact that all or part of the applicant's income derives from any public assistance program or the fact that the applicant has in good faith exercised any right under the federal Consumer Credit Protection Act or any applicable state law. Authorizes disparate treatment and disparate impact claims. Requires creditors to provide borrowers with notice of any action taken on their application for credit.	OCC, FRS, FDIC, NCUA, FTC, CFPB, SEC
Fair Credit Reporting Act (Regulation V)	Requires a permissible purpose to obtain a consumer credit report, and requires persons to report information to credit bureaus accurately; imposes disclosure requirements on creditors who take adverse action on credit applications based on information contained in a credit report; requires creditors to develop and implement an identity theft prevention program.	OCC, FRS, FDIC, NCUA, SEC, FTC, CFPB

Examples of Federal Laws and Regulations Relevant to Marketplace Lending

Law or regulation	Example of relevant requirements or provisions	Federal agencies with regulatory or enforcement authority
Truth in Lending Act (Regulation Z)	Requires creditors to provide meaningful disclosures concerning certain terms and conditions of certain loan and credit transactions with consumers; intended to help consumers understand the cost of credit and compare credit options. ^a	CFPB, FRS, OCC, NCUA, FDIC, FTC
Investment Advisers Act of 1940	Persons that engage, for compensation, in the business of advising others as to matters involving securities meet the definition of investment adviser under the Investment Advisers Act. The Investment Advisers Act of 1940 and rules thereunder require investment advisers to meet recordkeeping, custodial, reporting and other regulatory responsibilities.	SEC
Securities Act of 1933 (Public Offerings and Private Offerings)	Public Offerings: Online marketplace lenders engaged in the public offering of securities are required to register the securities offerings with SEC, unless the securities or offerings are exempt from the registration requirements of the Securities Act of 1933. Private Offerings: Online marketplace lenders may engage in private offerings of their securities, including offerings made in reliance on the safe harbors in Regulation D.	SEC
UDAAP	Prohibits unfair, deceptive, or abusive acts or practices (UDAAP).	CFPB, FRS, FDIC, OCC, NCUA
Section 5 of the Federal Trade Commission Act	Prohibits unfair or deceptive acts or practices (UDAP).	FTC, FRS, FDIC, OCC, NCUA
Title V of the Gramm- Leach- Bliley Financial Modernization Act (Regulation P)	Limits when a financial institution may disclose a consumer's "nonpublic personal information" to nonaffiliated third parties; requires financial institutions to notify their customers about their information-sharing practices and to tell consumers of their right to "opt out" if they do not want their information shared with certain nonaffiliated third parties.	FTC, CFPB, FRS, FDIC, OCC, NCUA

Legend

CFPB – Bureau of Consumer Financial Protection, known as the Consumer Financial Protection Bureau

FDIC – Federal Deposit Insurance Corporation

FRS – Board of Governors of the Federal Reserve System

FTC – Federal Trade Commission

NCUA – National Credit Union Administration

OCC – Office of the Comptroller of the Currency

Source: GAO and Department of the Treasury information. | GAO-17-361

Three Rules for Lawyers

First Rule: Do No Harm and Get it Right!

✓ Google Wallet funds are now FDIC insured, says report - The Verge

<https://www.theverge.com/2015/4/19/.../google-wallet-funds-are-now-fdic-insured> ▼

Apr 19, 2015 - If you happen to keep money in your **Google Wallet** account, your cash is now protected. According to a statement provided to Yahoo Finance, ...

✓ Cheat Sheet: Why Google Wallet's FDIC Insurance Matters to Banks ...

<https://www.americanbanker.com/.../cheat-sheet-why-google-wallets-fdic-insurance-m...> ▼

Apr 20, 2015 - **Google** will provide deposit **insurance** backing for funds stored with its **wallet** service, positioning the technology giant along with stored-value ...

How is Google Providing FDIC Insurance?

How is Google providing FDIC insurance?

Google is using its multiple bank partners to provide the insurance, according to a Google spokesperson quoted by *Yahoo Finance*, which first reported the news. (A Google spokesperson declined to discuss the issue further with *American Banker*.)

This would indicate that Google is likely taking advantage of "pass-through" insurance, which is the typical means that a prepaid card issuer offers FDIC coverage. Essentially, an agent — which in this case is Google — stores funds on behalf of a customer in either one or multiple bank accounts. As long as the agent and bank keep accurate records on each customer's funds, the FDIC pledges backing up to its full insurance limit for each individual user of the service should the insured institution fail.

The arrangement, however, usually requires clear disclosures to consumers about the treatment of their funds. Google has "to tell you what bank it's in," said Paul Clark, a partner at Seward & Kissel. Google has yet to do so.

The FDIC released a legal opinion in 1996 providing guidance on the "insurability" of stored value cards, and updated that opinion in 2008. The FDIC said it recognizes the holder of stored-value accounts as being a depositor as long as certain requirements are satisfied. For example, the insured bank has to disclose the relationship with the agent, and either the bank or the custodian must maintain records on the identities of accountholders and the amounts of their funds.

"I'm sending money that's in an account in Google's name at a bank but where Google is acting as my agent, and Google is keeping records that they owe me" the money back, Clark said.

Source: *American Banker*, "Cheat Sheet: Why Google Wallet's FDIC Insurance Matters to Banks," April 20, 2015.



Is Google Actually Providing FDIC Insurance?

As of July 2017, per Google's Terms of Service, funds held by Google in connection with the processing of a payment transaction are **NOT** insured for the benefit of a customer by the FDIC.



Second Rule: Seek Creative Applications of Existing Law to a New Product

- **Problem:** In 2009, USAA, a financial services firm that offers banking and securities brokerage services to members of the U.S. military, sought to implement an “anytime, anywhere” banking strategy.
- **Objective:** Develop a process for accepting the deposit of checks from its members serving all over the world.



Second Rule: Seek Creative Applications of Existing Law to a New Product (cont'd)

Solution:

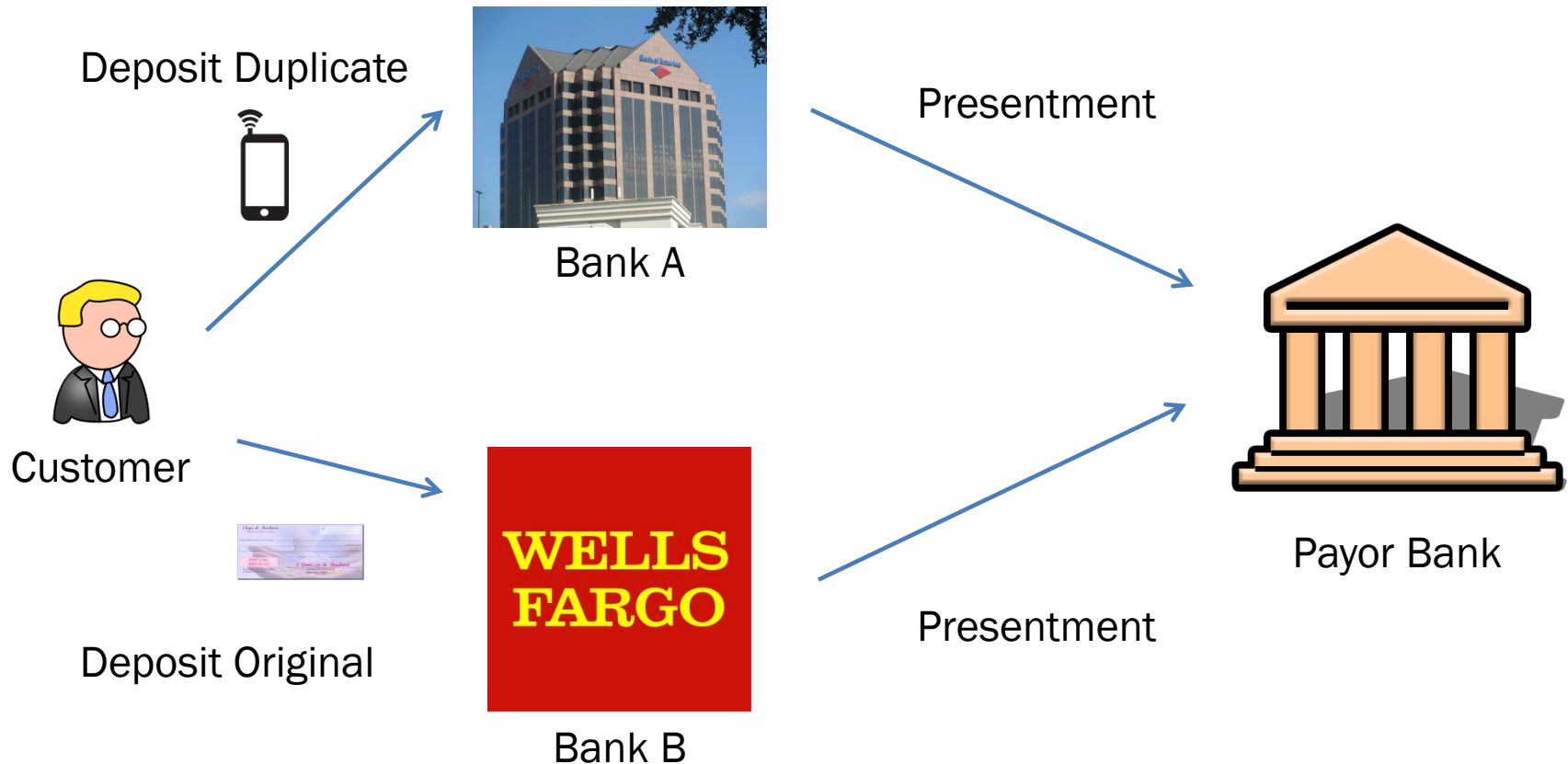
- Utilize a 2004 federal law (*Check Clearing for the 21st Century “Check 21” Act*) that was designed to enable banks to process checks electronically by submitting copies of the original checks —“substitute checks”— to the Federal Reserve. Check 21 was adopted after 9/11 to address check processing problems caused by grounded flights.
- USAA permitted depositors to deposit substitute checks via computer or mobile device.



How Mobile Deposits Work

- Customers seeking to deposit a check send an image of a paper check to their bank via their mobile device.
- The bank accepts that image as a substitute for the paper check.
- The bank presents the substitute check to the payor bank.
- The bank credits the customer's account for the amount of the check.

Risks of Mobile Deposits: Duplicative Deposits



How is this resolved?



Check 21 Protects Payor Banks

- How it works:
 - Bank A submits a substitute check to Payor Bank.
 - Bank A warrants to Payor Bank that the substitute check meets all requirements for legal equivalence.
 - Bank A agrees to indemnify Payor Bank for any losses it may incur for making a payment on a substitute check rather than the original check.
 - If Bank B submits the original check to Payor Bank, Bank A must indemnify Payor Bank.
- Uniform Commercial Code
 - Holders of duplicate checks (Bank A) are NOT *Holders in Due Course* (UCC § 3-302).
 - Bank B is Holder in Due Course because it holds the original check.



Risk Mitigation Options

- There is NO comprehensive cross-bank, real-time duplicate detection system.
- Potential options available to depository banks:
 - Delay crediting the customer's account until payment is made by the Payor Bank.
 - Require customers to endorse original check with account number and language indicating it is for mobile deposit only.
 - Include warranties from the customer in mobile deposit service agreements to indemnify the bank for any loss suffered as a result of Check 21 warranties.



Mobile Deposits

- *Increased Usage*

- “When you look at deposit transactions you can see that 21% of all deposits are made through mobile devices today. That's the equivalent of what 1,000 financial centers do.” -Brian Moynihan, Bank of America CEO and Chairman (July 2017)¹

- *Cost Efficiencies*

- JPMorgan Chase has said it costs \$0.65 to handle a deposit transaction in a branch, \$0.08 per ATM transaction, and just \$0.03 per mobile deposit.²

¹ <https://www.fool.com/investing/2017/07/19/5-things-brian-moynihan-wants-bank-of-america-shar.aspx>

² <http://www.businessinsider.com/wells-fargo-is-closing-450-branches-2017-7>



Third Rule: Offer Viable Alternatives for Accomplishing an Objective

First step is to identify the component parts of the proposed product or service and the applicable regulatory requirements that may apply.



Preliminary Checklist of Issues: Status Questions

1. Is the product or service to be offered directly by you to the public?
2. If yes, will you be accepting or otherwise touching customer funds?
3. If yes,
 - A. Will you merely facilitate the movement of funds from one bank product to another?
 - B. Will you hold funds for a period of time?
 - C. Will you use the funds in your own business?
4. What is the relationship between you and your customer?
 - A. Agent?
 - B. Custodian? Fiduciary?
 - C. Debtor/Creditor?
 - D. Broker?
5. Will you be extending credit? If yes:
 - A. What types of credit?
 - B. To consumers?
6. Will you be utilizing investment discretion to direct the placement of customer funds?
 - A. Into bank deposits?
 - B. Into securities?
7. Will you be issuing a security or effecting a transaction in a security?



Legal Regimes to Consider When Determining Status

- State banking laws
 - Deposit solicitation and receipt
 - Lending
 - Mortgage broker licensing
- State money transmitter laws
- Financial Crimes Enforcement Network (“FinCEN”, a bureau of the U.S. Treasury Department) money services business registration
- Federal securities laws
 - Registration of securities
 - Registration of brokers and dealers
 - Registration of investment advisors
- State securities laws



California Banking Law

- “No person who has not received a certificate from the [Commissioner of Business Oversight] authorizing it to engage in the banking business shall solicit or receive deposits, issue certificates of deposit with or without provision for interest, make payments on checks, or transact business in a way or manner of a bank or trust company.”
- Penalty:
 - \$100 for each day that the violation continues;
 - Ancillary relief, including restitution, disgorgement, or damages; and
 - The Commissioner may issue a cease and desist order.



What is a “Deposit”?

- A deposit of funds into an account at a bank creates a debtor-creditor relationship between the bank and the depositor.
- The debtor-creditor relationship differs from a custodial relationship. A positive balance in a deposit account is not the property of the depositor in the sense of owning specific funds. The balance is simply a reflection of the amount owed by the bank to the depositor under the terms of the account.
- Unlike a custodian, a bank can use deposits in its business to make loans and, therefore, make a profit.



State Money Transmitter Laws: Default Regulatory Regime for FinTech Companies

- Currently, 49 states, DC, Puerto Rico and U.S. Virgin Islands have laws regulating the transmission of money.*
- While definitions vary by state, CA defines “money transmission” as:
 - Selling or issuing payment instruments; or
 - Selling or issuing stored value; or
 - Receiving money for transmission.**
 - “Receiving money for transmission” means receiving money or monetary value in the United States for transmission within or outside the United States by electronic or other means.
- Obtaining a money services business license from FinCEN will not satisfy state money transmitter licensing requirements.

*Montana is the only state that does not regulate money transmission.

**Money Transmission Act, Cal. Fin. Code § 2003(q)



Examples of Money Transmitters

- Western Union
- MoneyGram (used by Walmart for P2P payments)
- PayPal, Inc.
- Square, Inc.
- Google Payment Corp.
- Facebook Payments Inc.

Case Study:

A Proposed Peer-to-Peer Payment System



Overview of Peer-to-Peer (P2P) Payment Systems

- P2P payment systems are intermediary services that facilitate the transfer of funds from a person's bank account or credit card to another person's bank account or credit card by using a computer, smartphone or other device to instruct the transfer.
- Some P2P systems permit a user to establish an account with the vendor and have funds held by the vendor for a specified or potentially undetermined period of time.



Client's Proposed P2P Product For Analysis

- Proposed Product Features
 - P2P payment system linked to bank accounts and credit cards
 - The customer and others can deposit funds into the customer's account with the client; **client will hold funds indefinitely for future use**
 - Client branded debit card to access balances held by client anytime (in stores, online, at ATMs)
- Proposed Relationship with Client
 - With respect to funds deposited into an account, customers are general creditors with unsecured claims against the client
 - Client may invest the funds in securities and other liquid assets for its benefit
- What banking or securities laws may be implicated?



California Banking Law

- “No person who has not received a certificate from the [Commissioner of Business Oversight] authorizing it to engage in the banking business shall solicit or receive deposits, issue certificates of deposit with or without provision for interest, make payments on checks, or transact business in a way or manner of a bank or trust company.”
- Penalty:
 - \$100 for each day that the violation continues;
 - Ancillary relief, including restitution, disgorgement, or damages; and
 - The Commissioner may issue a cease and desist order.



California Money Transmitter

- While definitions vary by state, CA defines “money transmission” as:
 - Selling or issuing payment instruments; or
 - Selling or issuing stored value; or
 - Receiving money for transmission.*
 - “Receiving money for transmission” means receiving money or monetary value in the United States for transmission within or outside the United States by electronic or other means.

*Money Transmission Act, Cal. Fin. Code § 2003(q)



Tools in the Lawyer's Toolbox

- Review applicable statute, agency rules and/or regulations, agency interpretations, staff guidance and case law.
- If an activity is clearly permissible (e.g., not prohibited, does not require a license or registration, etc.), a lawyer can commit his or her professional reputation by preparing a legal memorandum or opinion of counsel for the client.
- If it is unclear whether an activity is permissible, consider the following:
 - File a Freedom of Information Act request (or state law equivalent) with the agency requesting interpretations or other guidance that are not currently publicly available;
 - Have informal, no-names conversations with agency staff; and/or
 - Formally request an interpretation from the agency.
- Does any of the above permit the lawyer to prepare a reasoned legal memorandum or opinion of counsel that concludes that the activity is permissible or likely permissible?



Tools in the Lawyer's Toolbox (cont'd)

- If the agency's position is that the activity is not permissible:
 - Does the agency have the statutory authority to take this position?
 - If so, has it utilized appropriate procedures to adopt regulations?
 - If so, is its position consistent with its regulations?
- If the activity is not permissible (e.g., prohibited, requires a license or registration, etc.) has the agency enforced its position against other industry participants?
- If not, can the lawyer advise the client of the potential risk without concluding it is permissible?

Description of Features of Existing P2P Products Based on Review of Each Vendor's Customer Agreement

Feature	PayPal's Venmo Service (Venmo)	PayPal	Google Wallet's P2P Service	Square Cash	Facebook's P2P Transfer
Funding Your Account	You may receive funds from senders into your Venmo account and request payments. You may not fund your own account.	You may receive funds from senders into your PayPal account and request payments. You may fund your own account.	You may receive funds from senders into your Google Wallet Balance account and request payments. You may not fund your own account.	You may receive funds from senders and request payments. You may not fund your own account.	You may receive funds from senders directly to your debit card and request payment. No account to fund.
Maintaining Balances	May hold funds in Venmo account, subject to 30 day reminder or return policy.	May hold funds in PayPal balance. No time limit disclosed.	May hold funds in Google Wallet Balance. No time limit disclosed.	May hold funds in the Cash App, subject to amount limitations Square may impose.	No balances. Funds sent directly to debit card.
Payment Methods/ Connection to Bank	Credit, Debit, Bank Transfer, Venmo Balance	Credit, Debit, Bank Transfer, PayPal Balance, PayPal Credit, PayPal-branded debit or credit card, E-check	Credit, Debit, Bank Transfer, Google Wallet Balance	Credit, Debit, Cash App	Debit Card

Description of Features (cont'd)

Feature	PayPal's Venmo Service (Venmo)	PayPal	Google Wallet's P2P Service	Square Cash	Facebook's P2P Transfer
Cash-Out Option	Upon direction, can transfer to linked bank account or debit card	Upon direction, can transfer to linked bank account; ATM withdrawal (PayPal-branded debit card only); request a check from PayPal.	Upon direction, can transfer to linked bank account or debit card	Upon direction, can transfer to linked bank account. Can set up Instant Deposit for a fee.	N/A
Purchases Using Balances	App Purchases	Online retail websites and marketplaces; physical retail stores; app purchases; recurring payments	Google Play Store	Cash for Business Sellers	None (FB Payments has other options)
Relationship to User	Independent Contractor	PayPal's relationship with user under the user agreement is as a payment service provider, and PayPal is an independent contractor for all purposes. PayPal is not an agent or trustee.	No disclosure	Independent Contractor for all purposes except acts as limited agent with respect to the custody and transfer of funds for P2P only	Facebook Payments Inc. assumes no responsibility for the underlying transaction of funds
Disclaimers	Venmo is not a bank or other chartered depository institution. Funds held in balance are an ancillary function of enabling money transmission and not for other benefit.	No disclaimer regarding PayPal's status.	Google Payment Corp. (GPC) is not a bank or other chartered depository institution.	No disclaimer regarding Square's status.	No disclaimer regarding Facebook's status

Description of Features (cont'd)

Feature	PayPal's Venmo Service (Venmo)	PayPal	Google Wallet's P2P Service	Square Cash	Facebook's P2P Transfer
Use of Balances by Vendor	Pooled and placed in one or more bank accounts in Venmo's name. Funds are not insured for the benefit of the user by the FDIC.	Pooled and invested in liquid investments, but held separate from PayPal's corporate funds. Funds are not used for operating expenses or any corporate purposes. Funds are not insured for the benefit of the user by the FDIC.	Held in deposit accounts at one or more US banks. Funds are not insured for the benefit of the user by the FDIC.	Pooled and placed in one or more bank accounts in Square's name. No disclosure re: FDIC insurance.	N/A
Interest on Balances	Venmo does not typically receive interest on funds held for Venmo users, but the right to any interest is assigned to Venmo in consideration for use of the service.	PayPal invests customer funds and owns the interest or other earnings on these investments.	The right to earn interest is assigned to GPC in consideration for use of the service.	Square likely receives interest on funds held for its users. The right to any interest is assigned to Square in consideration for use of the service.	N/A
Status of Unpaid Funds if Vendor Fails	Venmo will not voluntarily make your funds available to its creditors in the event of bankruptcy.	PayPal balances represent unsecured claims against PayPal. PayPal will not voluntarily make your funds available to its creditors in the event of bankruptcy.	No disclosure	Square will not voluntarily make your funds available to its creditors in the event of bankruptcy.	N/A

Recent Enforcement Actions



Non-Compliance is an Existential Risk

- Enforcement actions brought by regulators present a financial risk to a company that can significantly damage it or, in some cases, cause it to fail.
- All federal regulators, and many state regulators, have the authority to impose financial penalties and, in some cases, extract settlements to benefit consumers.
- Even if a company survives the imposition of monetary penalties by a regulator, it may confront class action lawsuits brought on behalf of consumers and reputational risk.

Examples from the FinTech Industry

- Blue Global (2017): FTC fined the online lead generator \$104 million, which caused the company to cease operations. The FTC alleged that the company misled consumers into providing personal financial information and later sold the data in violation of the FTC Act.
- LendUp (2016): CFPB fined online lender \$1.8 million and ordered it to pay \$1.83 million in consumer refunds for conduct related to illegal fees, credit reporting, and credit disclosures. California fined the company \$1.06 million and ordered it to pay \$1.62 million in consumer refunds for the same conduct.
- Prosper (2008): SEC found that Prosper's loan notes were securities that the company had not registered, violating the Securities Act. Prosper was ordered to stop all new lending until registering with the SEC. State securities regulators fined the company \$1 million for the same conduct and also ordered the company to stop lending until registering.
 - Prosper also faced a class action lawsuit from purchasers of loan notes which the company settled for \$10 million.

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Education

- J.D., University of California, Berkeley, Boalt Hall School of Law, 1980
- A.B., with *High Honors and Distinction*, University of California, Berkeley, 1976

Bar Admissions

- District of Columbia

Summary

Paul Clark is Managing Partner of the Washington, D.C. office of Seward & Kissel LLP and a member of the firm's Financial Services Regulatory Group. For over 30 years Paul has advised banks, broker-dealers and their trade associations on legislative and regulatory issues enabling or challenging new financial products.

During the course of his career at Seward & Kissel, Paul has advised on the structuring of many new financial products that have required addressing both banking and securities law issues, including the first major broker-dealer bank "sweep program" (Merrill Lynch), the first reciprocal deposit program (CDARS) and numerous novel CD products. Paul has developed the documentation and legal structures that currently support approximately 10% of all domestic deposits in U.S. banks. In addition, Paul has advised issuers of stored value cards, operators of social "crowd funding" sites, RoboAdvisors and providers of mobile payment products.

Paul was invited to give the "FinTech" lecture at the American Bar Association's 2016 and 2017 Fundamentals of Banking Law seminars. Paul will teach a course on FinTech at Berkeley Law in the Fall of 2017.

Paul is the author of "Just Passing Through: A History and Critical Analysis of FDIC Insurance of Deposits Held by Brokers and Other Custodians" (Review of Banking and Financial Law, 2012-2013) and the co-author of "Regulation of Savings Associations After the Financial Institutions Reform, Recovery and Enforcement Act of 1989" (The Business Lawyer, 1990).

Since 2010, Paul has been a member of the Advisory Board of the Berkeley Center for Law, Business and the Economy.

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Regulatory Consequences of Being a Bank Vendor

Gerry Tsai, Director - Applications & Fintech (CA Bar # 220477)
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Federal Reserve Bank of San Francisco

CAL/Berkeley – Fintech Legal | Fundamentals for Entrepreneurs,
Executives and Investors
October 12, 2017

The views and opinions expressed are those of the presenter and may not necessarily reflect the views or legal positions of the Federal Reserve Bank of San Francisco, the Federal Reserve Board of Governors, or any other part of the Federal Reserve System.



THE BIG PICTURE

“We are a service provider to [Bank], and as such, we are subject to audit by [Bank] in accordance with FDIC guidance related to management of third-party vendors. We are also subject to the examination and enforcement authority of the FDIC [under] the Bank Service Company Act.”

- From the most recent Form 10-K of a major fintech firm

OVERVIEW

1. Intro - Fintech/Bank Vendor and Similar Arrangements
2. Banking Agency Vendor Risk Management (“VRM”) Guidance
3. Bank Service Company Act
4. Questions?
5. Reference Materials

1. INTRO – FINTECH/BANK VENDOR & SIMILAR ARRANGEMENTS

- Fintech and Banks/Traditional FIs
 - Past: Disruption



- Present: Collaboration



Drivers for Vendor Relationships

- Collaboration ➡ Partnership ➡ Vendor?
- Fintech/Bank Relationships
 - Lending: Exportation/Uniformity; Funding; Loan Servicing
 - White Label: Customers
 - Digital Wallets: Payments Systems; Deposit Insurance;
 - Compliance: Expertise and Needs
 - Data: Source and Needs

2. BANKING AGENCY VRM GUIDANCE

- 1 FFIEC + 3 Agencies = Lots of Similar Guidance with (Slightly) Different Names
 - FDIC: *Guidance for Managing Third Party Risk*
 - FRB: *Guidance on Managing Outsourcing Risk*
 - OCC: *Third-Party Relationships: Risk Management Guidance*
 - FFIEC: *IT Handbook: Outsourcing Technology Booklet*
- Agency Efforts On Applying VRM to Fintech Relationships
 - FDIC: *Guidance for Third-Party Lending (Proposed)*
 - OCC: *Third-Party Relationships - FAQs*

VRM Guidance - Scope

- Bank is responsible for outsourced activities
 - Responsible for managing activities and identifying and controlling the risks to the same extent as if the bank conducted the activity
 - Risks: Compliance, Reputation, Concentration, Country, Operational, Legal
- Covers “service providers”
 - Any entity with a contractual relationship with a FI to provide business functions or activities (FRB)
 - A third-party relationship is any business arrangement between a bank and another entity, by contract or otherwise (OCC)

VRM Guidance – Scope:

Examples of Activities

Traditional IT: FFIEC HANDBOOK	Other Business Relationships: 3 AGENCIES	“Fintech” Activities : FFIEC HANDBOOK + 3 AGENCIES + NEW?
Core Processing	Accounting	Bank Originates Loans for 3 rd Parties
Creating Customer Accounts	Appraisal Management	Bank Uses 3 rd Party’s White Label Sources
Processing Payments	Internal Audit	Bank Uses Data Aggregation
Fiduciary & Trading	Human Resources	Bank Allows for Data Aggregation?
System Development	Sales & Marketing	“Payment Services”?
Network Ops	Loan Review & Servicing	“Deposit Services”?
Security Monitoring & Testing	Asset & Wealth Management	Regtech - Bank Uses 3 rd Party’s Anti-Money Laundering Artificial Intelligence Software

VRM Guidance – Risk Management

- Banks should have a risk management program for outsourcing
 - Risk focused, not one size fits all
- Program elements generally include

A. Risk Assessments	D. Incentive Compensation Review
B. Due Diligence & Selection of Service Providers	E. Oversight & Monitoring of Service Providers
C. Contract Provisions & Considerations	F. Business Continuity & Contingency Plans

Due Diligence & Selection of Service Providers



- Three Basic Elements
 - Business background, reputation & strategy
 - Financial performance & condition
 - Most recent financial statements, and sustainability
 - Operations and internal controls
 - Security; Support and delivery
 - Employee background checks
 - Adherence to applicable laws, regulations and guidance

Contract Provisions

- Lots of elements; includes
 - Right to Audit
 - Confidentiality & Security of Info (incl. Gramm Leach Bliley Act Privacy Requirements)
 - Business Resumption/Contingency Planning
 - Subcontractors
 - Same provisions should apply
 - Should specify how service providers will assess their subcontractor's financial performance.



3. BANK SERVICE COMPANY ACT (“BSCA”)

- 12 U.S.C. 1861-1867
- Mostly deals with service providers that are owned by banks
- But, also covers:
 - (1) Regulatory examination of services performed by vendors that are not bank owned
 - (2) Regulatory enforcement

Examinations

- BSCA Requirements (Distilled) (12 USC 1867(c)(1)) -
 - (1) whenever a bank, causes to be performed for itself, by contract or otherwise
 - (2) any services whether on or off its premises
 - (3) such performance shall be subject to regulation and examination by the bank's federal regulator to the same extent as if such services were being performed by the bank itself on its own premises
- BSCA examinations are discretionary

Examination Cases

- FFIEC
 - Program to coordinate examinations relating to certain technology service providers
 - Traditionally, IT focused
 - Management of technology
 - Integrity of data
 - Confidentiality of information
 - Availability of services
 - Compliance
 - Financial stability
 - <https://ithandbook.ffiec.gov/it-booklets/supervision-of-technology-service-providers.aspx>
- Agencies can conduct BSCA exams separate from FFIEC Program

Enforcement

- BSCA Authority to Issue Orders (12 USC 1867(d))
 - Also, FDI Act authority against institution affiliated parties (12 USC 1818(b))
- Sample Enforcement Cases
 - Lender Processing Services, Inc.
 - Higher One

CFPB Authority

- CFPB has BSCA-like exam/enforcement authority (12 USC 5514-5516) over service providers that provide services to:
 - Larger depository institutions (\$10B+)
 - Nonbank financial service providers that the CFPB has chosen to regulate
 - A “substantial number” of smaller depository institutions
- CFPB authority is parallel/additional to that of the prudential bank regulators

4. QUESTIONS?

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5. REFERENCE MATERIALS

- Agency VRM Guidance
 - FDIC: <https://www.fdic.gov/news/news/financial/2008/fil08044a.html>
 - FRB: <https://www.federalreserve.gov/supervisionreg/srletters/sr1319a1.pdf>
 - OCC: <https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html>
 - FFIEC: <https://ithandbook.ffiec.gov/it-booklets/outourcing-technology-services.aspx>
- Agency VRM Guidance w/Fintech Focus
 - FDIC: <https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf> (PROPOSED)
 - OCC: <https://www.occ.gov/news-issuances/bulletins/2017/bulletin-2017-21.html>
- Agency VRM Examination Procedures
 - FRB: <https://www.federalreserve.gov/boarddocs/supmanual/cbem/4000.pdf>
 - OCC: <https://www.occ.gov/news-issuances/bulletins/2017/bulletin-2017-7.html>
- BSCA
 - Statute: 12 USC 1861 – 1867
 - CFPB Statute: 12 USC 5514(e); 5515(d); and 5516(e)
 - FFIEC Examination Program: <https://ithandbook.ffiec.gov/it-booklets/supervision-of-technology-service-providers.aspx>
 - Lender Processing Services: <https://www.federalreserve.gov/newsevents/press/enforcement/enf20110413a11.pdf>
 - Higher One: <https://www.federalreserve.gov/newsevents/press/enforcement/20151223a.htm>



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Fintech Bank Charters and Other Hot Topics

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Red Riding Hood Financial



Red Riding Hood Financial

- Formed in Berkeley, California in 2016 by three college friends with initial funding from friends and family
- Offers an innovative online lending platform that uses machine learning to analyze big data, including social networking information, elementary school grades, and movie reviews to determine creditworthiness
- Originates and funds short-term credit
- Charges risk-based interest rate

Challenge #1 – Banking Services

- Red Riding requires banking services to get started, including basic checking services, wire transfer capabilities, and limited foreign exchange services
 - Voluminous legal disclosures
 - Detailed questionnaire

Red Riding founder goes to local bank branch to open a bank account and is given a stack of application materials, detailed due diligence questionnaire, and hundred of pages of legal disclosures.

Challenge #2 – Funding

- Red Riding funds itself with a combination of debt (bank lines of credit) and equity
 - Expensive
 - Time-consuming

Red Riding founder applies for a line of credit and is required to submit thousands of pages of documentation. On top of that, the line's fees and interest are costly.

Challenge #3 – Interest Rates

- Red Riding's loan products have capped interest rates
 - California usury rate of 10%

Red Riding cannot charge an interest rate in excess of 10% per annum under California state usury law

Challenge #4 – Regulation

- Red Riding offers personal loans to California residents, so it is regulated by the California Department of Business Oversight among other regulators
 - Licensed activity on state level
 - State-specific disclosure requirements

After a four month process, Red Riding obtains a license from the California Department of Business Oversight to offer personal loans and develops disclosures that comply with the DBO's requirements

Red Riding's Solution



Possible Benefits of Bank Relationship

- Exportation of interest rates
- Deposit funding
- Federal preemption (for certain banks)
- Uniform regulatory framework
- “Halo” effect from regulation

Options for Bank Relationships

- Acquisition – Red Riding pays cash to acquire all of the outstanding shares of a privately held bank
- De Novo/New Charter – Red Riding capitalizes a new entity that will operate as a bank
- Partnership – Red Riding partners with a bank to extend credit

Red Riding's Acquisition of 1st National Bank

- Regulatory approval required from the Federal Reserve and potentially other regulators, based on a number of factors:
 - Financial resources
 - Management
 - Effect on competition
 - Convenience and needs of communities
 - Anti-money laundering record
 - Systemic importance
- Important to find a bank that is a good fit – financials, culture, business plan, location, customers
- Selected regulatory issues
 - Bank holding company regulation – capital and liquidity, activity restrictions, source of strength, Federal Reserve supervision
 - Affiliate transaction restrictions

Red Riding Forms Red Riding National Bank

- Regulatory approval required from the FDIC and OCC based on similar factors as an acquisition
- It is important to retain directors and senior management who have banking expertise
- National bank charter offers distinct advantages and disadvantages in comparison to state bank charters
- Selected regulatory issues
 - Capital and liquidity requirements
 - Community Reinvestment Act
 - CFPB supervision
 - Deposit insurance assessments
 - Activity restrictions

Red Riding Partners with 1st National Bank

- Red Riding enters into an agreement with 1st National Bank for the bank to extend credit to customers originated by Red Riding
- In general, no formal regulatory approval required, although the bank will likely want to discuss the partnership with its regulator
- Selected regulatory issues
 - Third-party management
 - True lender
 - Compliance obligations, including anti-money laundering
 - Supervision of Red Riding under the Bank Service Company Act

Bank Licensing Process

1. Preparation of application
 - Business plan
 - Financial projections
 - Management biographical and financial information
 - Compliance information
 - Competition information
2. Meetings with agency staff
3. Filing of application
4. Notice publication and public comment
5. Application processing
6. Preliminary conditional approval
7. Final approval

OCC Special Purpose Charter

- OCC has proposed to offer special purpose national bank charters to fintech companies engaged in lending, accepting deposits, or cashing checks
 - Online lenders
 - Money transmitters

Benefits	Costs
National bank preemption	Application process
Uniform licensing regime	Bank supervision
Halo effect	No deposit funding?

OCC Special Purpose Charter – Timeline

- March 31, 2016 – OCC releases whitepaper on “responsible innovation”
- June 23, 2016 – OCC holds forum on responsible innovation
- October 26, 2016 – OCC issues framework for responsible innovation
- December 2, 2016 – Comptroller Curry announces intent to move forward with special purpose charter for fintech companies; OCC releases draft whitepaper for public comment
- March 6, 2017 – Comptroller Curry speaks at LendIt conference about charter
- March 15, 2017 – OCC issues draft licensing supplement for evaluating charter applications from fintech companies
- July 19, 2017 – Acting Comptroller Noreika discusses special purpose fintech charter at Exchequer Club lunch

OCC Special Purpose Charter – Reaction

- Proponents
 - Technology companies
 - Fintech companies (e.g., cryptocurrency providers, online lenders)
 - Members of Congress

- Opponents
 - Certain public interest and community groups
 - State regulators
 - Members of Congress

OCC Special Purpose Charter – Litigation

- Conference of State Bank Supervisors brings suit against OCC on April 26, 2017
- New York State Department of Financial Services brings suit against OCC on May 12, 2017
 - Complaints allege that the OCC does not have statutory authority to issue charter for fintech companies
 - OCC responses claim that suits are premature and that agency does have statutory authority

Industrial Loan Companies

- SoFi and Square have applied to form industrial loan companies
- Industrial loan companies are state-chartered banks that historically provided banking services to employees but now function as traditional commercial banks
- ILCs are exempt from the definition of bank in the Bank Holding Company Act – companies that control them are not subject to bank holding company supervision (e.g., activities restrictions, capital and liquidity)
- Politically charged debate about ILCs – separation of commerce and banking, Wal-Mart's application to acquire an ILC, Dodd-Frank moratorium on ILCs, Federal Reserve recommendation to eliminate ILC “loophole”

State BitLicenses

- New York began offering a “BitLicense” in August 2015 for companies that transmit virtual currency; store, hold, or control virtual currency for others; buy and sell virtual currency; perform exchange services as a business; and control or issue a virtual currency
 - Current license holders
 - Circle
 - Ripple
 - Coinbase
- Washington regulates virtual currency transmission as a form of money transmission
 - New rules require virtual currency exchanges to obtain licenses from Washington State Department of Financial Institutions

Questions

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