Beyond FinTech: The OCC's Special Purpose National Bank Charter

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The OCC's proposed framework for granting a special purpose national bank charter (the "**Charter Proposal**") could hold significant promise by providing the benefits of federal preemption and a stable regulatory structure for those business models that are willing to accept the regulatory and supervisory burdens of the national bank charter, including marketplace lenders, money transmitters and a range of others.[1] It is an important and innovative step, and the Comptroller should be applauded for taking it.[2] The OCC's **Charter Proposal**, innovative as it is, however, reflects a mindset that varies significantly from that underlying the United Kingdom's regulatory sandbox initiative, which offers lighter touch regulation during the early phases of a company's development.[3] For many business models or early stage companies, the regulatory and supervisory burdens of the special purpose charter may outweigh its benefits.

The Charter Proposal is broader than expected. The special purpose charter has potential applicability for not only what are commonly referred to as FinTech companies, but also other companies that engage in payment services, lending or other bank-like activities. It is thus important to read the proposal in light of its potential application to a broad range of business models. The path forward for those considering a special purpose charter is also marked by uncertainty and potential regulatory pitfalls, which require careful consideration. In particular, the charter may be of limited practical utility to businesses that engage in deposit-taking activity. The Charter Proposal only alludes to the potential responses of the FDIC and the Federal Reserve to the special purpose charter, and their reactions will be important drivers of the value of the charter. Moreover, as Comptroller Thomas Curry's current term expires in 2017, a new Comptroller appointed by the incoming administration could change the OCC's direction on the special purpose national bank charter.

The OCC is soliciting public comment on its Charter Proposal until January 15, 2017.[4]

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[1] In this memorandum, we will refer to "business models" rather than the more popular term "FinTech" because the OCC Charter Proposal will apply to a broad range of business models, only some of which are FinTech as commonly understood. Among the many business models that might benefit are marketplace lenders, money transmitters, payment processors, nonbank consumer lenders, nonbank mortgage lenders and a range of others.

[2] This announcement follows on the heels of the OCC's *Responsible Innovation Framework* released in October 2016, which outlined a series of initiatives the OCC is undertaking to support innovation in the financial sector but was silent on the topic of charters, as we discussed in our BeyondSandbox blogpost, available **here**. *See* Office of the Comptroller of the Currency, *Recommendations and Decisions for Implementing a Responsible Innovation Framework* (Oct. 2016), available **here**.

[3] Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies* (Dec. 2016), available **here**. More information on the U.K.'s regulatory sandbox can be found on the Financial Conduct Authority's website, available **here**.

[4] Press release, Office of the Comptroller of the Currency, OCC to Consider Fintech Charter Applications, Seeks Comment (Dec. 2, 2016), available **here**.

In this memorandum, we first provide an overview of the key takeaways from the Charter Proposal and how a special purpose charter might, or might not, work for different business models. We then briefly discuss the chartering process given the range of supervisory, financial and operational conditions attached to the charter. Throughout the memorandum, we address the potential actions of other regulators based upon their historical views in more detail than is provided in the Charter Proposal.

Key Takeaways from the OCC's Charter Proposal

Applies to Many Business Models Engaged in Core Banking Functions

The OCC's power to grant charters and supervise special purpose national banks stems from its existing statutory and regulatory authority under the National Bank Act of 1864 to grant special purpose national bank charters to institutions that engage in at least one of three core banking functions—receiving deposits, paying checks or lending money.[5] Accordingly, an institution must engage in at least one of these activities in order to qualify for the special purpose charter, although the OCC has reserved its discretion to determine (and expand) the scope of these qualifying activities.[6] The OCC also has complete discretion in whether or not it grants a charter to any particular applicant.[7]

The Charter Proposal states that discounting notes, purchasing bank-permissible debt securities, engaging in lease-financing transactions and making loans are considered forms of lending money.[8] In addition, the Charter Proposal considers issuing debit cards and engaging in other means of facilitating payments electronically as the "modern equivalent" of paying checks.[9] We read the expansion of the check-paying authority to mean that not only marketplace lenders, but also a broad array of companies engaged in payments or facilitating payments could be eligible for the special purpose charter. In each case, greater clarity on the scope of activities constituting lending and paying checks under the Charter Proposal will be needed to determine the full utility of the special purpose charter. Notably, although firms engaged in deposit-taking would also be eligible for the special purpose charter, the requirement for such firms to obtain federal deposit insurance, as more fully discussed below, may limit the practicality of the charter for these firms.

Federal Preemption Available to the Same Extent as for Full-Service National Banks

Exportation Doctrine and Other Federal Preemption for Lending Activities

Under the Charter Proposal, a firm granted a special purpose charter is entitled to federal preemption to the same extent as a full-service national bank.[10] In general, pursuant to preemption regulations issued by the OCC implementing Sections 1044 – 1046 of the Dodd-Frank Act,[11] state laws or requirements are preempted when they conflict with the exercise by a national bank of its federally granted powers.[12] Critically, national banks engaged in lending activities, a core banking function, are entitled to federal preemption of state usury laws so that a national

[5] 12 U.S.C. § 27(a); 12 C.F.R. § 5.20(e)(1). The OCC also has the authority to grant charters to limited purpose trust banks that engage solely in fiduciary activities.

[6] Thomas Curry, Comptroller, Office of the Comptroller of the Currency, Remarks Before the Chatham House "City Series" Conference (Nov. 3, 2016), available **here**.

[7] *See Camp v. Pitts*., 411 U.S. 138 (1973) (upholding the OCC's decision to deny a national bank charter without providing any reasons).

[8] *See* Charter Proposal at 4

[9] *Id*.

[10] *Id.* at 5.

[11] 12 U.S.C. § 25(b).

[12] *See* 12 C.F.R. §§ 7.4000 – 4008; Office of the Comptroller of the Currency, Office of Thrift Supervision Integration; Dodd-Frank Act Implementation, 76 Fed. Reg. 43,549, 43,555 – 57 (July 21, 2011), available **here** [*hereinafter* "OCC Preemption Final Rule"].

bank is permitted to export the maximum interest rate allowed in the state where the bank is located and make loans in other states without regard to the usury laws of those states.[13] The power to use one state's interest and usury provisions for interstate lending activities is commonly referred to as the Exportation Doctrine. Most national banks engaged in nationwide lending choose a state with no or very liberal usury limits as the locus for such activities.

A firm receiving a special purpose charter, accordingly, would be similarly entitled to take advantage of the Exportation Doctrine. Since many state laws provide that a usurious loan is void, the benefits of the Exportation Doctrine are very important. Without such benefits, stand-alone nonbank lenders must comply with the usury laws in each state in which they provide loans to avoid such loans being deemed void under state law. This consequence has been especially concerning in light of the uncertainty of the bank partnership, or "rent-a-charter," model raised by recent court decisions such as *CashCall* and *Madden*.[14]

Closely related to the Exportation Doctrine is the preemption of state licensing requirements for lending activities.[15] Many states require licenses and impose various other requirements on consumer lenders, and in particular mortgage lenders, while some also require licensing for commercial lenders. A firm with a special purpose charter would be exempt from such licensing requirements in the same manner as a full-service national bank.[16] Moreover, the OCC has taken the view that state laws interfering with the ability of national banks to underwrite and mitigate credit risk (e.g., laws related to loan amortization and repayment requirements, circumstances when a loan may be called due and payable, origination and purchasing and selling extensions of credit) would also be preempted.[17]

While the special purpose charter may provide a path for nonbank lenders to enjoy the benefits of preemption without the need to partner with a funding bank, there are still substantial questions regarding whether the funding models of such firms may trigger deposit insurance requirements, the applicability of the Bank Holding Company Act of 1956 ("**BHCA**") and the scope of capital and other regulatory obligations to be imposed by the OCC in connection with the charter, as more fully discussed below. On balance, however, given the uncertainty of the viability of some of the existing business models, the special purpose charter could prove to be a significant benefit for nonbank lenders.

Preemption of State Money Transmitter Licensing Requirements

As alluded to above for state-mandated lending licenses, national banks are entitled to federal preemption of state laws and regulations, including licensing requirements, when they conflict with a national bank's power to engage in

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[13] 12 U.S.C. § 85; 12 C.F.R. §§ 7.4001, 7.4008. State-chartered banks also benefit from the Exportation Doctrine. The Depository Institutions Deregulation and Monetary Control Act of 1980 entitles state-chartered banks insured by the FDIC to the same federal preemption with respect to usury laws. 12 U.S.C. § 1831d.

[14] *See CashCall v. Morrisey*, No. 12-1274 (W. Va. 2014); *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015). Under the "rent-a-charter" model, a marketplace lender typically enters into a contractual arrangement with an existing chartered bank pursuant to which the bank initially funds the loan but the marketplace lender purchases the loan from the bank at the time of or shortly after origination. The marketplace lender may also assume loan servicing, collection and other administrative functions of the original funding bank. Both *CashCall* and *Madden* called into question the viability of the rent-a-charter model by holding that the original funding bank is the "true lender" of the loan and, thus, must retain a predominant economic interest in the loan in order for preemption of state usury law to apply to the nonbank lender. While cases in other states have upheld the rent-a-charter model, the differences across jurisdictions and resulting regulatory uncertainty create new operational challenges for marketplace lenders. *See, e.g.*, *Sawyer v. Bill Me Later, Inc.*, 23 F. Supp.3d 1359 (D. Utah 2014). The proper use of the special purpose charter and the ongoing involvement of a firm with a special purpose charter in owning and servicing the loans generated should resolve the true lender issues highlighted in *CashCall* and *Madden.*

[15] *See* OCC Preemption Final Rule at 43,555.

[16] *See, e.g.*, 12 C.F.R. § 7.4008.

[17] *See* OCC Preemption Final Rule at 43,557. The Preamble to the OCC Preemption Final Rule states that state laws "concerning the protection of collateral value, credit enhancements, risk mitigation, loan-to-value standards, loan amortization and repayment requirements, circumstances when a loan may be called due and payable, escrow standards, use of credit reports to assess creditworthiness of borrowers, and origination, managing, and purchasing and selling extensions of credit or interests therein" would "meaningfully interfere" with the exercise by a national bank of its lending powers and its responsibilities to manage the risks associated with its lending business. *Id*. *See also* 12 C.F.R. § 7.4008.

a broad range of payment services.[18] Accordingly, national banks are able to avoid state-level money transmitter licensing requirements and, in turn, the expensive and time-consuming state-by-state money transmitter licensing process, in order to engage in such activities.[19]

Currently, virtually every state has some form of licensing requirement for businesses engaged in the transmission of money,[20] with one state having a separate licensing regime for businesses engaged in virtual currency business activity.[21] These laws, while certainly covering traditional money transmitters such as Western Union and MoneyGram, may also catch nonbank firms engaged in payment services—including online, mobile payment and virtual currency providers—subjecting them to an array of regulatory and compliance issues. The scope of activities considered to be money transmission varies by state,[22] so that nonbank firms with multistate operations must comply with varying standards and complex licensing and registration requirements that typically include financial requirements, audits, bonding, investment limitations and the like.

In contrast, firms with special purpose charters, like full-service national banks, could avoid state-level money transmitter licensing requirements, allowing them to avoid the costly state-by-state licensing regime and potentially significantly reducing their compliance costs and complexity. Such firms would still be required to comply with federal anti-money laundering ("**AML**") laws, as discussed further below.

State and Federal Consumer Protection Laws Still Apply

Federal preemption does not mean that firms with a special purpose charter would be exempt from all state-level regulations. In particular, based on changes to federal preemption of state consumer protection laws under the Dodd-Frank Act that arguably narrowed the grounds for preemption of such laws, firms with special purpose charters that engage in activities subject to a "state consumer financial law"[23] would generally remain subject to such laws, unless the explicit grounds for preemption under the Dodd-Frank Act were met.[24] Examples of state consumer protection laws that would generally apply include state laws on anti-discrimination and fair lending.[25] Moreover, the OCC explicitly states in the Charter Proposal that state laws aimed at unfair or deceptive treatment of customers also apply to federally chartered banks.[26] For nonbank lenders in particular, our expectation, however, is that the benefits of the Exportation Doctrine are sufficiently advantageous even though the charter would not eliminate the

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[18] *See* OCC Preemption Final Rule at 43,555. The OCC has taken the view that payment services are permissible activities for national banks as incidental to the business of banking. *See generally*, Office of the Comptroller of the Currency, Activities Permissible for a National Bank, Cumulative (April 2012), available **here**.

[19] State-level licensing requirements that prevent, or significantly interfere or conflict with the exercise by a national bank of its federally granted powers, including the power to engage in payment services, are preempted in accordance with the legal standard established in *Barnett Bank v. Nelson* (517 U.S. 25 (1996)). *See* OCC Preemption Final Rule at 43,556.

[20] *See, e.g.*, N.Y. Code, Banking 13-B; Tex. Fin. Code § 151; Ca. Fin. Code § 2000; Fla. Stat. § 560.

[21] *See* Davis Polk, New York's Final "BitLicense" Rule: Overview and Changes from July 2014 Proposal (June 5, 2015), available **here**.

[22] *See, e.g.*, Md. Code Ann., Fin. Inst. § 12-401 ('Money transmission" includes the business of selling or issuing payment instruments or stored value devices, or receiving money or monetary value, for transmission to a location within or outside the United States by any means, including electronically or through the Internet, bill payer services, accelerated mortgage payment services, and any informal money transfer system engaged in as a business for, or network of persons who engage as a business in, facilitating the transfer of money outside conventional financial institutions to a location within or outside the United States.).

[23] "State consumer financial law" is generally defined as any state law that regulates any "financial transaction [or related] account . . . with respect to a consumer." *See* 12 U.S.C. § 25b(a)(2).

[24] 12 U.S.C. § 25(b)(1). The Dodd-Frank Act provided that state consumer financial laws are preempted only if the application of the law would have a discriminatory effect on national banks (compared to state banks), the OCC determines on a case-by-case basis that the law "prevents or significantly interferes" with the exercise by the national bank of its powers, or the state law is preempted by another federal law. *Id*. We will not repeat here the well-worn debate regarding the extent to which the Dodd-Frank Act carves back the preemption of state consumer protection laws, or the extent to which the OCC Preemption Final Rule may change the scope of preemption under the Dodd-Frank Act.

[25] *See* Charter Proposal at 5.

[26] *Id*.

obligations associated with state consumer protection laws, as these laws would generally apply to their lending activities anyway. The nonbank lender would clearly have to weigh the other regulatory burdens associated with the charter in light of its business activities and ownership structure.

In addition, a firm with a special purpose charter that engages in consumer financial activities would remain subject to federal consumer protection regulations and would be supervised by either the Consumer Protection Financial Bureau ("**CFPB**") or the OCC for purposes of such rules depending on whether it is FDIC-insured and its asset size, although the CFPB has supervisory authority over a more limited scope of consumer financial activities with respect to uninsured institutions.[27] Firms with a special purpose charter would also be subject to the prohibitions on engaging in unfair or deceptive acts or practices under Section 5 of the Federal Trade Commission Act and unfair, deceptive, or abusive acts or practices under Section 1036 of the Dodd-Frank Act.[28]

Taking Deposits

The Charter Proposal reflects the OCC's policy position that any special purpose national bank that takes deposits, other than trust deposits, must be insured by the FDIC.[29] As a result, any firm that takes deposits, other than trust funds, will be required to obtain federal deposit insurance and will be regulated and supervised by the FDIC as an insured depository institution ("**IDI**"). The scope of activities that would be considered as taking deposits under the Charter Proposal is unclear. The Federal Deposit Insurance Act defines "deposit" broadly, and the application of this expansive interpretation could sweep in many types of liability funding.[30] Accordingly, business models that have not traditionally viewed themselves to be taking deposits could technically be considered a deposit-taking institution under the OCC's Proposal, thus again implicating the BHCA and limiting the practical utility of the charter for such firms, as discussed further below. On the other hand, if deposit-taking is interpreted more in line with the views of such institutions that do not see themselves as receiving deposits, these institutions could find significant value in a special purpose charter.

It is also unclear how attractive obtaining deposit insurance will be. On the one hand, funding should be substantially easier and potentially less expensive with FDIC insurance. On the other hand, deposit insurance will put the FDIC in a position to evaluate and attach its own conditions to any approval it might grant. Deposit insurance also directly implicates the BHCA, for an insured national bank is treated as a bank under the BHCA (with very limited exceptions), and an entity controlling such a bank would become subject to the requirements and limitations imposed by the BHCA. Under the BHCA, the Federal Reserve would become the primary federal regulator of the controlling company, and it is unclear what conditions or limitations it might impose in connection with its approval of the controlling company as a bank holding company. This is one of the very sensitive areas that

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[27] The CFPB has exclusive supervisory authority and primary enforcement authority over special purpose national banks that are IDIs and have assets greater than $10 billion. *See* 12 C.F.R. § 5515. The OCC generally has exclusive supervisory and enforcement authority over special purpose national banks that are IDIs and have assets of $10 billion or less. *See* 12 U.S.C. §§ 5516, 5581(c)(1)(B). With respect to uninsured special purpose national banks, the CFPB has supervisory authority over such firms regardless of asset size if they offer or provide mortgage-related products or services, payday loans or private student loans. *See* 12 U.S.C. § 5514.

[28] *See* Charter Proposal at 5, 7 – 8.

[29] *See id.* at 7. We assume that trust deposits will only be attractive to a limited number of business models.

[30] *See* 12 U.S.C.§ 1813(l) (defining "deposit" to include "the unpaid balance of money or its equivalent received or held by a bank or savings association in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account . . . [and] money received or held by a bank or savings association, or the credit given for money or its equivalent received or held by a bank or savings association, in the usual course of business for a special or specific purpose, regardless of the legal relationship thereby established . . ."). S*ee, e.g.*, Federal Deposit Insurance Corporation, Insurability of Funds Underlying Stored Value Cards and Other Nontraditional Access Mechanisms, 73 Fed. Reg. 67,155 (Nov. 13, 2008), available **here** (stating that the statutory definition of "deposit" at 12 U.S.C. 1813(l) is "very broad" and pursuant to such definition, all funds underlying stored value or prepaid products will be considered "deposits" if held at an IDI). There may be an opportunity for wholesale funded entities to avoid having their liabilities characterized as deposits.

any firm seeking the special purpose charter must carefully evaluate. We discuss the implications under the BHCA further below.

Conversely, under the Charter Proposal, firms with a special purpose charter that are not engaged in deposit-taking activity (other than trust funds) would not be required to be FDIC-insured and thus, would not be subject to the rules and standards applicable solely to IDIs.

Community Reinvestment Act-Type Obligations

Regardless of whether deposit insurance is required, however, the Charter Proposal states that the OCC may impose requirements that are similar to those applicable only to IDIs as a condition of a firm's charter approval if appropriate for the risks and business model of the firm. We read the Charter Proposal as strongly signaling that requirements similar to those under the Community Reinvestment Act ("**CRA**") will be imposed upon any business model that involves lending, and may well be applied to entities engaged in other consumer-facing activities such as payment or deposit services.[31] While the CRA only applies to IDIs, the OCC has the power to impose CRA-like or other financial inclusion obligations with respect to a firm's business plan or in the charter itself.[32] Moreover, Dodd-Frank Act amendments added access to financial services and fair treatment of customers to the OCC's main mission, providing the OCC with the authority to impose financial inclusion obligations as it sees fit as a condition of charter approval. We recommend that any firm seeking a special purpose charter think proactively regarding methods of addressing the financial needs of low- and moderate-income communities and individuals consistent with its business plan.

Activity Limitations

Firms with a special purpose charter, like all national banks, must limit their activities to those permissible for national banks.[33] For firms that value the flexibility to change their business models rapidly as conditions change, this regulatory overlay may prove quite constraining. We anticipate that institutions obtaining the special purpose charter would be subject to comprehensive business plans and operating agreements, similar to those imposed on newly chartered banks today. Deviations from and changes to the business plans will likely require, at a minimum, consultation with the OCC. And obviously, a special purpose bank will be subject to ongoing supervision and examination by the OCC, something unusual for a technology company.

Potential Supervision by the Federal Reserve Board

There are two very different ways that the Federal Reserve might become involved in the regulation and supervision of a firm with a special purpose charter. We expect that one will be acceptable to most business models that might benefit from a special purpose charter and the other will be quite uncomfortable for many such business models. The first path is the requirement that every national bank become a member of the Federal Reserve System. The second path is through potential supervision of the controlling investors in the firm with a special purpose charter as bank holding companies if the firm is treated as a bank under the BHCA.

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[31] *See* Charter Proposal at 12.

[32] *See id.* at 12 – 13.

[33] *See* Charter Proposal at 4 (stating that "[a] special purpose national bank may engage only in activities that are permissible for national banks. Bank-permissible activities are identified in statutes, in the OCC's regulations, and in legal opinions and corporate decisions that the OCC regularly publishes."). Bank-permissible activities generally include activities that are "part of, or incidental to, the business of banking," including, among others, engaging in general banking activities (e.g., receiving deposits, making loans, leasing, branching), certain insurance and annuities activities, securities and derivatives activities, fiduciary activities and investment activities. 12 U.S.C. 24 (Seventh); *see* Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial Regulation: Law and Policy* 183 – 212 (2016).

Membership in the Federal Reserve System

As national banks, firms with special purpose charters will be required to be members of the Federal Reserve System pursuant to the Federal Reserve Act[34] and will be subject to direct oversight as member banks by the Federal Reserve Board. Member banks have access to the Federal Reserve discount window and other Federal Reserve services, although these services are also available to all IDIs.[35] To become members of the Federal Reserve System, national banks must subscribe to the capital stock of the Federal Reserve in a sum equal to six percent of the bank's capital and surplus and meet certain capital, liquidity, investment and lending limits, most of which we view as no more burdensome than the similar requirements imposed by the OCC.[36] The key additional business constraint we see, as a practical matter, from Federal Reserve membership is that the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act would apply.[37]

Since we believe that the business impact of these restrictions will be new to most business models considering a special purpose charter, we will set forth one simplified example. For the purposes of this example, we will assume most business models seeking a charter will be composed of either a holding company or controlling investors, with the special purpose national bank and one affiliate engaged in providing services as the sole subsidiaries or controlled entities.[38] Under Section 23A, the firm with a special purpose charter will not be able to enter into certain transactions creating credit exposures, such as loans, with its parent holding company, its controlling shareholders or companies controlled by either of such entities unless the transaction falls within certain limits and is fully collateralized.[39] In addition, all relationships between the controlling investors, the holding company and the service affiliate, on the one hand, and the special purpose national bank, on the other hand, for services would have to be on market terms and at arm's length.[40] Except for Section 23A and Section 23B, each of which must be carefully examined in much more detail than we have done here, we expect that any business model ready to take on the burdens of a special purpose charter will find the obligations of Federal Reserve membership to be a marginal burden.

Applicability of the Bank Holding Company Act

The much more difficult scenario, which is likely unacceptable as a practical business matter, relates to the question of whether the entities controlling a firm with a special purpose charter would be subject to regulation and supervision by the Federal Reserve as bank holding companies under the BHCA.[41] The BHCA defines "control" expansively, and control exists whenever a company owns or controls 25% or more of any class of voting stock of another company.[42] Control is evaluated on a stair-step or tiered basis, so that, for instance, a company that owns 30% of the voting stock of one company that owns 35% of the voting stock of another company, which in turn owns

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[34] 12 U.S.C. § 222.

[35] 12 C.F.R. pt. 201.

[36] *See* Section 2, Federal Reserve Act (partly incorporated at 12 U.S.C. § 282), available **here**. *See also* FR 2030, Application for the Issuance of Federal Reserve Bank Stock – Organizing National Bank, available **here**.

[37] *Id*. Under current law, the restrictions of Sections 23A and 23B also apply to state-chartered member banks. 12 U.S.C. § 371c, § 371c-1. We believe, however, that they will be a new business restriction for the business models that might take advantage of the special purpose charter and should, therefore, be carefully considered.

[38] We understand other business models are possible.

[39] *See* 12 U.S.C. **§ 371c**.

[40] *See* 12 U.S.C. §§ 371c, **371c-1**. Sections 23A and 23B of the FRA are a vastly complex area which we have deliberately simplified above. Those who desire a more in-depth treatment, *see* Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial Regulation: Law and Policy* 223 – 228 (2016); *see also* Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act, SR Letter 03-2 (Jan. 9, 2003).

[41] An individual controlling investor would not be treated as a "company" under the BHCA. It is our experience, however, that the vast majority of individual investors operate, for tax, estate and other purposes, out of a legal entity that would be a company under the BHCA.

[42] 12 C.F.R. § 225.2(e). *See also* Policy Statement on Equity Investments in Banks and Bank Holding Companies, 12 C.F.R. § 225.144, available **here**.

28% of the voting stock of a bank, is deemed to control the bank, regardless of whether this ownership gives rise to actual or practical control.[43] Different business models would be affected differently and would face different risks.

Under the BHCA, the definition of "bank" includes insured depository institutions.[44] If a firm with a special purpose charter takes deposits other than trust deposits and would, therefore, under the OCC's policy and Federal Deposit Insurance Act, be required to obtain deposit insurance,[45] it would be treated as a "bank" under the BHCA. Its holding company and any controlling investors that are companies would have to register as bank holding companies, and would be subject to ongoing supervision and activity restrictions. Bank holding companies are subject to strict restrictions on their activities and may engage only in certain businesses relating to the business of banking.[46] In our experience, controlling investors, especially private equity and venture capital funds, are not in a position to consider being regulated as bank holding companies.[47] As a result, if the parent holding company or controlling investors need or wish to avoid regulation under the BHCA, the firm with a special purpose charter must avoid the need for deposit insurance (that is, not take any deposits other than trust deposits).

Reading the Charter Proposal together with the BHCA, a parent holding company or the controlling investors of a special purpose bank that avoids deposit funding and engages only in lending or payments activities could potentially operate outside the scope of the BHCA.[48]

It is clear, however, that the Federal Reserve is not comfortable with commercial companies controlling banking organizations. It has a long history of seeking to bring such entities within the scope of the BHCA through expansive interpretation of the BHCA and its implementing regulations, and as recently as September 2016, recommended that Congress close remaining statutory provisions that have allowed commercial companies to escape BHCA regulation.[49] All of this suggests that the Federal Reserve may be hesitant to embrace firms with a special purpose charter as a new type of banking entity outside the scope of the BHCA and thus permit a new class of commercial owners to avoid the restrictions of the BHCA, and may seek to narrow the opportunities for entities with special

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[43] *See id.*

[44] 12 C.F.R. § 225.2(a)(2). There are also various exemptions from the definition of "bank" in the BHCA, such as limited purpose trust companies and certain industrial banks. *See* 12 U.S.C. § 1841.

[45] *See* Charter Proposal at 7. *See also* 12 U.S.C. § 1815(a); 12 C.F.R § 303.14(a).

[46] *See, e.g.*, 12 C.F.R. pt. 225.

[47] The most common solution is to structure the investor's investment as noncontrolling. Whether this structuring would be feasible in a start-up company and whether the Federal Reserve, especially a Trump Administration Federal Reserve, would be more flexible than in the past is an open question.

[48] Since a "bank" under the BHCA is defined as an institution that both receives "demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others" and makes "commercial loans," a firm that takes no deposits whatsoever is safely outside of the BHCA. As a result, marketplace lenders, making any type of loans, which funded themselves through securitization and bonds and did not receive deposits should not face BHCA regulation. The situation for payments companies and money transmitters is less clear as the Federal Reserve may, as the OCC has done, broadly interpret "deposits that the depositor may withdraw by check or similar means for payment to third parties or others." "Commercial loan" is defined as "a direct loan to a business customer for the purpose of providing funds for that customer's business" (12 C.F.R. § 225.145), the Federal Reserve's interpretation of which is not determined from the face of the instruments, but from the application of the Supreme Court's interpretation in *Board of Governors v. Dimension Financial Corporation*, 474 U.S. 361 (1986).

[49] *See* Omarova, Saule T. and Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulations in the United States*, Cornell Law Faculty Publications 113, 153 – 4 (2012). *See also* Federal Reserve, FDIC and OCC, Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act (Sept. 8, 2016) [*hereinafter*, the "Section 620 Report"], available **here**. As an example, the number of industrial loan companies ("**ILCs**"), which are state-chartered IDIs whose holding companies are not regulated by the Federal Reserve under the BHCA due to a specific exemption, is essentially frozen and the Federal Reserve has recommended to Congress a complete repeal of the existing exemption. Pursuant to this exemption, ILCs with FDIC-insured retail deposits, and accordingly, the business entities that control them, are permitted to remain outside the scope of the BHCA, subject to certain requirements. In 2005, however, partly in response to the Federal Reserve's opposition to Walmart's attempt to form an ILC, the FDIC placed a moratorium on granting any new FDIC insurance for ILCs that continues today, essentially preventing any new ILC charters. *See* Omarova and Tahyar, *supra* at 159 – 68. Further, the Federal Reserve recommended that Congress completely repeal the exemption for ILCs under the BHCA in the Section 620 Report. *See* Section 620 Report at 28.

purpose charters to avoid becoming banks subject to the BHCA. It will be critical to watch how the OCC's desire to facilitate the use of the special purpose charter and the Federal Reserve's long-standing desire to regulate commercial firms controlling banking entities plays out. Just as with the interplay with the FDIC, how these issues get resolved may determine the ultimate attractiveness of the OCC's Proposal.

Coordination on Oversight of Payments Firms

In announcing the release of the Charter Proposal, Comptroller Curry specifically noted that oversight of payment services firms would require the OCC to coordinate with the Federal Reserve in its capacity as the overseer of national payment systems. The Federal Reserve sets forth policies and regulations concerning payment systems as part of its more general oversight of financial market infrastructures.[50] In his announcement, Comptroller Curry also remarked that the OCC would welcome public comment on this point.[51]

BSA/AML and Other Requirements Apply

While firms with a special purpose charter are entitled to the same advantages of a national bank charter as full-service banks, the Charter Proposal emphasizes that they will also generally be subject to the same laws, regulations, examination, reporting and ongoing supervision to which full-service national banks are subject. This includes, among other requirements, the Bank Secrecy Act, AML laws and the economic sanctions administered by the U.S. Department of the Treasury's Office of Foreign Assets Control.

Additional Minimum Capital and Liquidity and Other Prudential Requirements

Under the Charter Proposal, a firm with a special purpose charter will likely be required to maintain capital and liquidity levels above the minimum required for national banks, operate subject to an OCC-approved business plan, develop business continuity, recovery and exit strategies and comply with other prudential requirements as conditions of its charter approval. Relevant historical examples include the enhanced restrictions imposed on the first Internet-only banks in the late 1990s. These institutions were subject to heightened capital requirements, restrictions on changes to the company's strategic or operating plans, and ongoing review and reporting of data security and privacy controls, as well as notification requirements to certain third-party vendors of the OCC's examination and regulatory jurisdiction over the vendor.[52] In addition, as discussed above, the OCC will likely impose requirements similar to those under the CRA if the applicant engages in consumer lending activities even if the firm falls outside the technical scope of the CRA.

Taken together, the full scope of financial, operational and prudential requirements with which a firm may have to comply calls into question the practicality of the special purpose charter for small market participants or start-up companies. Conditions attached to the charter may reduce a firm's ability to remain nimble in response to changing market trends and conditions and limit its flexibility to test, for example, new business models and product offerings without prior OCC approval. The minimum capital and liquidity requirements, in particular, raise important questions around how growth-stage companies, which often have tight operating budgets, could comply with capital and other financial requirements.

Business Plan and Management

It is hard to overstate the importance that the OCC has attached to an applicant's business plan in granting charters in recent years. The OCC will require that the applicant develop a highly detailed business plan that includes, among other information, a detailed description of the firm's activities, a robust assessment of the risks associated

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[50] The Federal Reserve is currently engaged in an in-depth study of payment systems reform. Financial Services Policy Committee, *Federal Reserve Announces Sixth Triennial Study to Examine U.S. Payments Usage*, Federal Reserve System (Nov. 5, 2016), available **here**.

[51] *See* Georgetown Law Institute of International Economic Law, Exploring Special Purpose National Bank Charters for Fintech Companies: A Conversation with Comptroller of the Currency, Thomas J. Curry (Dec. 2, 2016), webcast available **here**.

[52] *See* OCC, Conditional Approval for Compubank, N.A. (Aug. 20, 1997); OCC, Conditional Approval for NextBank, N.A. (May 8, 1999).

with the business model, a description of how the business plan responds to the needs of the communities served (*e.g.*, promotes financial inclusion), the firm's plans for initial and future capital contributions and generally sufficient detail to demonstrate how the firm will operate in a "safe and sound manner."[53] The business plan will be binding on the firm for at least three years and cannot be changed without the OCC's prior approval. The OCC will also assess the quality of the firm's management as part of the chartering application and review process, which can be expected to involve multiple face-to-face meetings between the proposed management (and likely investors) and the OCC.

The OCC Chartering Process

The Charter Proposal states that charter applicants will be subject to the standard chartering application and review process for full-service national banks. In recent times, this process can take a year to 18 months, a frustratingly long time in the FinTech and start-up world. While nothing in the Charter Proposal suggests that time periods will be shortened, we believe this could be considered by the OCC, especially if, as expected, the vast majority of applicants will not take deposits. The Comptroller's Licensing Manual provides a full description of the charter application process and requirements.[54] Key components of a charter application include:

- prefiling consultations with OCC staff composed of a series of formal and informal meetings to discuss the applicant's proposal, the chartering process and application requirements;
- a robust business plan over a minimum three-year horizon, as discussed above;
- a board of directors and management with sufficient experience and expertise to manage the applicant, with the board playing a prominent role in the overall governance and risk management of the institution; and
- business continuity and recovery strategies, including specific triggers indicating the onset of financial stress, a range of credible options the applicant could take to restore financial strength and viability and specific governance mechanisms for escalation and notification to senior management and the board, as well as potential exit strategies.

Should the OCC determine that the applicant has a reasonable chance of success and will be operated in a "safe and sound" manner, the OCC will preliminarily approve the applicant's proposal.[55] Organizers of the proposed special purpose bank must raise capital within one year of conditional approval and the bank must open within 18 months.[56] Further, as a condition of preliminary approval, applicants may be required to enter into an "operating agreement" with the OCC containing substantive charter conditions and requirements. The OCC may, for instance, impose capital and liquidity requirements, CRA-like requirements and other operational conditions, as discussed above.

Conclusion

There is much to like in the OCC's Charter Proposal. It opens an important door for participants in the financial services industry to enter the bank-regulated world and obtain the benefits of a bank charter, which can be substantial. Those benefits, however, come with a price, and there are a number of serious questions that must be answered before we know quite how high that price will be. It is also possible that once the Trump principals are in place at the OCC, Federal Reserve and the FDIC, they, or Congress, will provide a more certain regulatory path to innovation.

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[53] *See* Charter Proposal at 9.

[54] Office of the Comptroller of the Currency, Comptroller's Licensing Manual: Charters (Sept. 2016), available **here**.

[55] *Id*.

[56] *Id*.

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