Creating Pro-Innovation Fintech Regulation

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The views expressed are those of the author in his personal capacity and not in his official/professional capacity.

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Executive Summary

Innovations in financial technology ("fintech") are changing the landscape of financial services. These changes include the use of the internet as a means of connecting borrowers and lenders through innovative non-bank "fintech" lending (including peer-to-peer and marketplace), crowdfunding, mobile payments, the use of algorithms and unique data sets to help underwrite people poorly served by traditional methods, automated investment advice that seeks to provide investors with the benefits of investment advice at a fraction of the cost, and the use of distributed ledger technology (DLT) to facilitate transfers of value and the memorialization of contracts and property ownership. These innovations have the potential to make the financial system more efficient, and inclusive, and safe.

Unfortunately, misregulation of these innovations risks hampering their progress. As regulators and lawmakers come to grips with the dramatic and rapid changes to financial services they all too often seek to apply existing rules that do not fit the new reality. Regulators sometimes also chill innovation by placing undue risk on companies seeking to innovate. While regulation to protect consumers may be warranted, applying regulations that do not take account of just what makes these new products and services innovative, or which discourage both start-ups and established companies from trying new things risk depriving the public of the benefits these new methods could provide. This chapter will briefly discuss how fintech, discussed through the example of fintech lending, can improve our lives and how poor regulation risks harming the very people it seeks to help.

I. The Benefits of Fintech

A. Efficiency

Fintech can allow firms to provide services more efficiently than traditional methods. In the context of lending, a lender's fixed costs affect the rates they are able to charge borrowers.[1] There is evidence that the use of technology can allow fintech lenders to have lower overhead costs.[2] This in turn can allow them to offer borrowers better terms than they would have otherwise received from a traditional lender.[3] There is also evidence that fintech lenders' use of innovative underwriting metrics may allow them to offer some borrowers better prices than they are able to obtain from

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[1] Thomas A. Durkin, Gregory Elliehausen & Min Hwang, *Rate Ceilings and the Distribution of Small Dollar Loans from Consumer Finance Companies: Results of a New Survey of Small Dollar Cash Lenders* 3-6 (Dec. 2, 2014) *available at* http://ssrn.com/abstract=2533143.

[2] Miklos Dietz et al., *Cutting through the Noise around Financial Technology*, MCKINSEY & CO. (Feb. 2016), https://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology ("For example, many fintech lenders have up to a 400-basis-point cost advantage over banks because they have no physical-distribution costs.")

[3] *Id.* ("While [the cost advantage enjoyed by FinTech lenders] puts a premium on the importance of the first marker, it also enables fintech businesses to pass on significant benefits to customers with regard to cost and time to process loan applications.") *See also* Yuliya Demyanyk & Daniel Kolliner, *Peer-to-Peer Lending Is Poised to Grow*, FED. RESERVE BANK OF CLEVELAND (Aug. 14, 2014), https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2014-economic-trends/et-20140814-peer-to-peer-lending-is-poised-to-grow.aspx.

more traditional lenders. [4] This evidence indicates that a fintech lender can use an underwriting method with relatively low correlation with traditional FICO scores[5] with the loan grading providing relatively accurate predictions as to loan risk.[6]

While price is an important attribute for a loan, speed and convenience are also important. Here, again, fintech appears to show promise. The approval process for innovative firms can often be easier to complete and quicker than for traditional lenders.[7] This can be especially important for borrowers who need capital quickly and cannot devote significant time to the application process, such as small business owners.[8]

B. Inclusion

Innovations in non-bank lending also have the potential to make lending more inclusive, providing credit to borrowers who might otherwise be excluded.[9] A challenge facing traditional lenders is that making small loans is frequently almost as expensive as making large loans, just less profitable.[10] This risks excluding customers, such as small businesses, that are looking for relatively small loans.[11] Thanks to their greater efficiency and lower cost structure, innovative lenders are able to service the small loan market.[12] Fintech lenders are also helping to replace bank lending in areas that have seen significant bank closures.[13] Finally, online lending may lead to more equitable outcomes among borrowers. For example, while women own approximately a third of small businesses, they receive

[4] Julapa Jagtiani & Catharine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information* 26 (Fed. Reserve Bank of Phila., Working Paper No. 17-17, 2017).
[5] *Id.* (showing the correlation between FICO and Lending Club grading of borrowers declining from approximately 80% in 2007 to under 40% by 2015.)
[6] *Id.* at 30-34.
[7] *Can P2P Lending Reinvent Banking*, MORGAN STANLEY (Jun. 17, 2015), http://www.morganstanley.com/ideas/p2p-marketplace-lending ("One of the driving factors behind the growth of online lenders is better customer satisfaction due to faster response times, quicker loan approval times, and faster funding") (quoting Smittipon Srethapramote). *See also* Tim Sablik, *Tomorrow's Lenders*, ECON FOCUS, Second Quarter (Richmond Fed. Reserve, V.A.), 2016, *available at* https://www.richmondfed.org/publications/research/econ_focus/2016/q2/cover_story ("According to surveys, borrowers rate the speed and ease of use of these new lenders relative to traditional banks very highly."); Miriam Segal, SMALL BUS. ADMIN. OFFICE OF ADVOCACY, *Peer-to-Peer Lending: A Financing Alternative for Small Businesses*, Issue Brief Number 10, at 3 (Sept. 10, 2015), *available at* https://www.sba.gov/sites/default/files/advocacy/Issue-Brief-10-P2P-Lending_0.pdf.
[8] Karen Gordon Mills & Brayden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation* 45 (Harvard Bus. Sch., Working Paper No. 17-042), http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf.
[9] *Opportunities and Challenges in Online Marketplace Lending*, U.S. DEP'T OF THE TREASURY 21 (May 10, 2016) [hereinafter *Treasury Report*], *available at* https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf.
[10] Mills & McCarthy, *supra* note 8, at 42.
[11] *Id*. at 24.
[12] Segal, *supra* note 7, at 3.
[13] Usman Ahmed et al., *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, 10 Innovations 35-48 (2015); Jagtiani & Lemieux, *supra* note 4.

under 20% of small business loans from banks.[14] Online loans made to women-owned small businesses approximates their market-share.[15] Whether this is because online lending is a better fit than applying through a bank or that the process is somehow fairer is unclear,[16] but online lending does appear to be a more attractive option for many women entrepreneurs.

C. Safety

Innovative lending is also potentially safer than traditional bank lending. This is driven by two factors. First, the loans are not backed by a customer's bank deposits that the lender is obliged to make available on demand.[17] This means that in the event of a crisis, the people who fund the loans cannot pull their money out on demand. It also means that in the event an innovative lender fails, the federal government's depository insurance fund is not threatened. Second, fintech lenders may also make banks safer, especially small banks with limited geographic reach, by allowing them to diversify their loan portfolio with loans outside their traditional service area.[18]

II. The Risks of Misregulation

While the benefits of innovative lenders are significant, they are threatened by misregulation. These services were created subject to regulations that were designed without them in mind. These regulations, while well-meaning, can make it harder for companies to innovate and decrease access to high quality credit.

Lending is highly regulated, and fintech lending is no exception. Fintech lenders are subject to the same consumer protection laws as banks.[19] However, unlike banks, fintech lenders are subject to state-by-state regulation. This often requires the lender to become licensed in every state they extend credit in and prevents them from offering consistent products nationwide because of differences in what constitutes "interest" and what rate of interest they can charge.[20] Conversely, under federal law, banks are able to extend credit nationwide under the laws governing interest of their home state.[21]

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[14] Penny Crossman, *Does Automation Eliminate Bias from Small-Dollar Lending?,* AMERICAN BANKER (Dec. 20, 2016), http://www.americanbanker.com/news/bank-technology/does-automation-eliminate-bias-from-small-business-lending-1092957-1.html?zkPrintable=1&nopagination=1.

[15] *Id*.

[16] *Id*.

[17] *Treasury Report* at 5 ("[Innovative non-bank lenders] rely on a variety of funding sources, including institutional investors, hedge funds, individual investors, venture capital, and depository institutions.") It should be noted that while depository institutions may purchase loans from a fintech lender, the funds are not treated as insured demand-deposits.

[18] *Community Banks Face Risks, Opportunities in P2P Alliance*, FITCH RATINGS (Feb. 17, 2015, 12:31 PM), https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Community-Banks-Face?pr_id=979915 ("Banks could improve portfolio geographic diversity and reduce concentration by purchasing loans originated outside of their footprint.")

[19] *Treasury Report* at 10.

[20] *Treasury Report* at 5.

[21] National Banks are empowered to do so under Section 85 of the National Bank Act (12 U.S.C. § 85 (2012)), State Chartered Banks are empowered under the Depository Institutions Deregulation Act of 1980. (12 U.S.C. § 1831d(a) (2012)).

This places fintech lenders at a disadvantage that many seek to redress by partnering with banks and having the bank initiate the loan which the fintech lender then purchases and services.[22]

While the bank partnership model provides a work-around, it raises costs and increases complexity. It is also hard to justify given that fintech lenders are subject to the same consumer protection laws as banks. Why should a bank, but not a fintech lender, be able to extend credit nationwide on consistent terms, without the need to be licensed in every state?

Unfortunately, even the second-best option of bank partnerships is under attack. This attack is most direct in courts. A federal court of appeals in New York recently ruled that a loan that was valid when the bank made it can become invalid under state law if it is sold to a non-bank.[23] Courts are also conflicted as to whether the "true lender" is determined by the loan contract,[24] or by the court looking beyond the contract to determine the "economic reality of the transaction,"[25] creating a confusing morass of conflicting opinions and potentially undercutting the bank-partnership model further.

These court challenges are impacting the ability of fintech lenders to extend credit to the most in need. For example, research shows that in the wake of the Second Circuit's decision, the number of loans extended by certain fintech lenders to borrowers with poor credit (FICO scores under 625) in 2015 decreased in New York and Connecticut (two states covered by the ruling) by 52 percent compared to 2014, while it increased by 124 percent in states not covered by the ruling.[26] This represents a real harm to the borrowers least able to access credit.

The risks created by litigation would be bad enough, unfortunately regulators, whether intentionally or not, are also discouraging banks from partnering with fintech lenders. For example, the Federal Deposit Insurance Corporation's (FDIC) proposed guidance for banks that partner with third-party lenders tells banks that they will be held responsible for everything their partners do as if it was the bank who acted. [27] This guidance ignores that the fintech lender is an independent entity that should

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[22] *Treasury Report* at 6; *see also* Thomas P. Brown & Molly E. Swartz, *Competition Policy in Consumer Financial Services: The Disparate Regulation of Online Marketplace Lenders and Banks*, 11 Competition Pol'y Int'l 38, 41-42 (2015).

[23] Madden v. Midland Funding, LLC, 786 F.3d 246 (2nd Cir. 2015)

[24] *See, e.g.*, Krispin v. May Dep't Stores, 218 F.3d 919 (8th Cir. 2000); Sawyer v. Bill Me Later, Inc., 23 F. Supp. 3d 1359 (D. Utah 2014)*;* Hudson v. ACE Cash Express, Inc., No. 01-1336, 2002 U.S. Dist. LEXIS 11226, *4, *16 (S.D. Ind. May 30, 2002); Beechum v. Navient Solutions, Inc., No. 15-08239, 2016 U.S. Dist. LEXIS 129782 (C.D. Cal. Sept. 20, 2016).

[25] *See e.g.* CashCall, Inc. v. Morrisey, No. 12-1274, 2014 W. Va. LEXIS 587, *18 (May 30, 2014); Spitzer v. Cty. Bank of Rehoboth Beach, 846 N.Y.S.2d 436 (App. Div. 2007); Kane v. Think Finance, Inc., No. 14-7139, 2016 U.S. Dist. LEXIS 178392 (E.D. Pa. Mar. 31, 2016) (refusing to grant a motion to dismiss a charge of conspiracy to avoid Pennsylvania usury law by a non-bank lender who partnered with a bank and a Native American tribe); Consumer Fin. Prot. Bureau v. CashCall, Inc., No. 15-7522, 2016 U.S. Dist. LEXIS 130584 (C.D. Cal. Aug. 31, 2016) (granting summary judgment).

[26] Colleen Honigsberg, Robert J. Jackson, Jr. & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending?* Evidence from a Natural Experiment 26-27 (Columbia Bus. Sch., Research Paper No. 16-38, 2017), *available at* https://ssrn.com/abstract=2780215.

[27] *Examination Guidance for Third-Party Lending*, FED. DEPOSIT. INS. CORP. (July 29, 2016), https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf.

be held responsible for its own actions, not the bank. The prospect of liability for actions the bank has no knowledge or control over will discourage banks from working with fintech lenders, which will discourage innovation and limit people's access to credit.

More generally, there is a risk that regulators are going to needlessly prevent innovation in a misguided effort to protect the legacy banking system. President and CEO of the St. Louis Federal Reserve James Bullard has said that there is a risk that regulators could "wake up one day and most of the big banks have been eviscerated and most of the activity has moved elsewhere" and that the banks could be "eviscerated" by fintech.[28] While a reasonable level of concern about the impact of non-bank fintech firms on the economy could be warranted, there is a risk that regulators tasked with preventing banks from failing view non-bank competition as a threat to banks and therefore dangerous, rather than as pro-consumer and a possible evolution of financial services.

III. Efforts at Regulatory Innovation

Regulators have at least rhetorically acknowledged the importance of modernizing regulation to allow for innovation. For example, the Office of the Comptroller of the Currency (OCC) has established an Office of Innovation that is tasked with helping to encourage "responsible innovation" within the national banking system.[29] Likewise, the Commodity Futures Trading Commission (CFTC) has established an innovation program called LabCFTC to "promote responsible innovation and fair competition for the benefit of the American Public."[30] One of the earliest programs of this most recent, nominally pro-innovation, regulatory trend is the Consumer Financial Protection Bureau's (CFPB) Project Catalyst, a program designed to allow the CFPB to engage with innovators and provide guidance, and in some cases regulatory relief, to firms.[31]

While these efforts sound appealing, there is a very real question whether they represent a meaningful change in a regulatory dynamic that is often seen as hostile to innovation. For example, the CFPB has only granted one no-action letter to a firm[32] and that letter[33] provides almost no actual limitation to the CFPB's enforcement power. Likewise, it fails to provide meaningful guidance or information to the public that would allow other firms to assess how the CFPB views the law. This

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[28] Michelle Price & Howard Schneider, *Fed's Bullard warns bank regulators are 'complacent' over fintech risks*, REUTERS (Oct. 12, 2017, 1:56 PM), https://www.reuters.com/article/us-fed-bullard-fintech/feds-bullard-warns-bank-regulators-are-complacent-over-fintech-risks-idUSKBN1CH2NG.

[29] Press Release, Office of the Comptroller of the Currency, *OCC Issues Responsible Innovation Framework* (Oct. 26, 2016), https://www.occ.treas.gov/news-issuances/news-releases/2016/nr-occ-2016-135.html.

[30] *LabCFTC Overview*, COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/LabCFTC/Overview/index.htm (last visited Dec. 12, 2017).

[31] *Project Catalyst*, CONSUMER FIN. PROT. BUREAU, https://www.consumerfinance.gov/about-us/project-catalyst/ (last visited Dec. 12, 2017).

[32] *CFPB Announces First No-Action Letter to Upstart Network*, CONSUMER FIN. PROT. BUREAU (Sept. 14, 2017), https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/.

[33] Letter from Christopher M. D'Angelo, Assoc. Dir. for Supervision, Enforcement & Fair Lending, Consumer Fin. Prot. Bureau, to Thomas P. Brown, Paul Hastings, LLP (Sept. 14, 2017), *available at* http://files.consumerfinance.gov/f/documents/201709_cfpb_upstart-no-action-letter.pdf.

risks creating an environment where regulatory favor provides a significant advantage to some competitors over others.

A more concrete step to modernize regulation has been taken by the OCC with the proposed non-depository "fintech" special purpose national bank charter.[34] This charter would allow fintech firms that lend or provide money-transmission services, but do not accept deposits, to become national banks.[35] This would allow fintech firms to tap into the existing laws that govern national banks, including the ability to export the laws governing interest of the bank's home state, and to remove the need to obtain state licenses for lending and money transmission.[36]

The OCC's fintech charter offers some potential to help fintech firms rationalize their regulation and compete more fairly with incumbents. However, it also presents significant questions as to whether it will actually be a meaningful option for all but a few firms. First, the exact scope of requirements to obtain a charter, and the OCC's wiliness to issue one, are not yet determined.[37] Second, some of the requirements, whether imposed by statute or contemplated by the OCC itself, may place an unnecessary burden on fintech firms. For example, national banks are not permitted to go through bankruptcy.[38] This means that even though a firm could utilize bankruptcy as a non-bank, it must be wound down by the OCC in a receivership as a bank. As a result, the OCC has indicated that they will expect fintech firms obtaining bank charters to meet certain capital and liquidity requirements[39] that may exceed what would be necessary to allow a firm to close out its business and be liquidated in bankruptcy. Additionally, the OCC has announced its intention to require firms that obtain charters to implement a "Financial Inclusion Plan"[40] that might approximate, or even exceed, the requirements imposed on depository institutions by the Community Reinvestment Act.[41] These requirements, and others like them, create a significant risk that the OCC's charter will only be viable for the largest and most established fintech firms, preventing new competitors from taking advantage of the regulatory improvement.

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[34] Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies* (Dec. 2016), https://www.occ.treas.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf.

[35] Office of the Comptroller of the Currency, *Evaluating Charter Applications From Financial Technology Companies* 2 (Mar. 2017), https://www.occ.treas.gov/publications/publications-by-type/licensing-manuals/file-pub-lm-fintech-licensing-manual-supplement.pdf.

[36] Brian Knight, *Modernizing Financial Technology Regulations to Facilitate a National Market*, MERCATUS ON POLICY (Mercatus Ctr., V.A.), July 2017, at 2, https://www.mercatus.org/system/files/knight_-_mop_-_modernizing_fintech_regulations_-_v2_1.pdf (internal citations omitted).

[37] *See* Keith A. Noreika, Acting Comptroller of the Currency, Remarks Before the Exchequer Club (July 19, 2017), *available at* https://www.occ.treas.gov/news-issuances/speeches/2017/pub-speech-2017-82.pdf ("That said, at this point, the OCC has not determined whether it will actually accept or act upon applications from nondepository fintech companies for special purpose national bank charters that rely on this regulation" [12 C.F.R. 5.20(e)(1)]).

[38] 11 U.S.C. § 109(b)(2), (d) (2012) preclude almost all banks from utilizing bankruptcy. *See also* Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy*, 67 Wash. & Lee L. Rev. 985, 986-87 (2010).

[39] *See supra* note 33, at 9-10.

[40] *Id.* at 4.

[41] Lalita Clozel, *Financial Inclusion Rules Tougher than CRA in OCC Fintech Charter*, AMERICAN BANKER (Apr. 3, 2017, 1:54 PM), https://www.americanbanker.com/news/financial-inclusion-rules-tougher-than-cra-in-occ-fintech-charter.

The OCC's proposed charter is flawed, but it would at least represent some effort at making regulation more innovation friendly. It is unfortunate then that the OCC is being sued by the Conference of State Bank Supervisors (CSBS),[42] the trade group for state bank regulators, and the New York Department of Financial Services[43] to stop the OCC from issuing any fintech charters. The CSBS and NYDFS argue that the OCC is exceeding its authority to issue charters to non-depository firms absent an explicit statutory grant of authority, has failed to follow the appropriate procedure to promulgate the charter, and that the charter would prevent the states from protecting their citizens from predatory behavior.

While the states' use of litigation to try and impede regulatory innovation is unfortunate, they do have at least one legitimate complaint. Under federal law a state-chartered bank must be an FDIC-insured depository to be able to export the law of their home state governing interest.[44] This is one of the key advantages of being a bank, and while the OCC arguably has the authority to charter non-depository national banks that could take advantage of interest rate export,[45] the states do not. This makes it hard for states to compete with the federal government on innovation.

While the states have sought to impede innovation on some fronts, they have embraced it on others. State banking regulators have embarked on a program called "Vision 2020"[46] that is designed to help make it easier for state-licensed financial services firms to operate in a multi-state environment. While the project seeks to make multi-state licensure and examination more streamlined it remains to be seen whether these innovations will be sufficient.

Other state initiatives may hold more promise. For example, states are beginning to contemplate establishing their own "regulatory sandboxes" as a way to encourage innovative financial services companies to pilot programs within a particular state. The Attorney General of Arizona has called for Arizona to establish a sandbox[47] that would provide a path for firms lacking a license or charter to engage in a limited trial of a product before they have to obtain full licenses. This effort follows

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[42] Conference of State Bank Supervisors v. OCC, No. 17-763 (D.D.C. filed Apr. 26, 2017).

[43] Vullo v. OCC, No. 17- 3574 (S.D.N.Y. filed May 12, 2017).

[44] 12 U.S.C. § 1813(c)(2) (2012) (defining "Insured depository institution" to mean banks or savings associations whose deposits are insured by the FDIC); 12 U.S.C. § 1831d(a) (2012) (granting state-chartered insured depository institutions the ability to export the interest rates of their home state); General Counsel's Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 19258 (Apr. 17, 1998) (citing 12 C.F.R. § 7.4001(a) (1997) and 12 C.F.R. § 560.110(a) (1997) and interpreting 12 U.S.C. § 1831d(a) to allow state insured depository institutions to use their home state's definition of what constitutes interest nationwide)); Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992) ("The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act *in pari materia*. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way.")

[45] 12 U.S.C. § 85 (2012) (Allowing any national bank association to export the interest rate of their home state without requiring FDIC deposit insurance); *see also* Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299 (1978); 12 C.F.R. § 7.4001(a) (1997) (allowing banks to use their home state's definition of what constitutes interest nationwide); Smiley v. Citibank (South Dakota), N.A., 517 U.S. 735 (1996) (upholding same).

[46] *Vision 2020 for Fintech and Non-Bank Regulation*, CONFERENCE OF STATE BANK SUPERVISORS (Oct. 26, 2017), https://www.csbs.org/vision2020.

[47] Mark Bronvich, *Regulatory sandboxes can help states advance fintech*, AMERICAN BANKER (Sept. 5, 2017, 9:30 AM), https://www.americanbanker.com/opinion/regulatory-sandboxes-can-help-states-advance-fintech.

the successful deployment of regulatory sandboxes in other countries, with the United Kingdom's Financial Conduct Authority (FCA) regulatory sandbox [48] being the first and most developed. As Arizona Attorney General Mark Brnovich notes, states could establish different sandboxes with different rules or focuses, allowing for more innovation and experimentation that could be translated from states to the national market.[49]

IV. How Should Regulators Approach Fintech?

Regulators fill an important role, but if they aren't careful their policies can hurt the people they are supposed to help. Rules that are unclear, outdated, or needlessly discourage companies from experimenting deny the public the benefits that new products and services can provide. For example, the borrowers denied access to fintech loans they would otherwise view as their best opportunity are not being protected, they are being forced to go to the next worse option.

Further, to the extent that regulators are tempted to conflate the fate of particular firms or ways of providing services (such as banks) with the national interest, they risk harming customers to benefit incumbents.

Fortunately, regulations can fulfill their legitimate and important role of protecting the public while being more innovation friendly. However, this will require regulators to be willing to change rules and processes that are outdated or a poor-fit to the reality of new transactions.

First, regulators must realize that there is nothing *per se* sacred about any specific method of providing financial services, and that what matters is the ability of the public to meet their financial needs while being protected from fraudulent or unfair bad-acts. As such they should accept that innovation may threaten traditional services and service providers and that that can be ok. For example, if banks become threatened by non-bank fintech firms *because customers prefer the new firms* regulators should not seek to protect incumbents. Instead, regulators and policy-makers should work to ensure that public policy is not too entwined with the fate of any type of service provider so that market innovations can proceed and help customers obtain the services they need as effectively as possible.

Second, regulators should accept that facilitating innovation will also require regulators to be willing to change how they do business, even if it means forgoing authority or jurisdiction. For example, establishing "regulatory sandboxes" can provide a space where companies can try new things under regulatory supervision. However, a fragmented and overlapping regulatory environment can negate a regulator's efforts to provide such a space. To work, regulators must be willing to defer to their colleagues in other agencies, whether within the federal government or at the state level, and let one regulator operate their sandbox and take lead in any enforcement decisions. Processes exist to enable this but regulators need to be willing to use those processes.

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[48] *Regulatory sandbox*, FIN. CONDUCT AUTH., https://www.fca.org.uk/publications/documents/regulatory-sandbox (last updated Sept. 11, 2016).
[49] *See supra* note 45.

Likewise, state regulators should stop opposing regulatory innovation at the federal level. Instead, state regulators should pursue federal enabling legislation to allow state licensed or chartered fintech firms to compete with federally chartered firms in the national market. The states may try to accomplish this via harmonization of state requirements, and such efforts should be encouraged, but it is likely that changes in federal law will be required for truly durable change. This could take the form of changing the law to allow state chartered non-depository banks or state licensed financial service providers like lenders and money transmitters to export their license and at least some of their home state law similarly to the exportation enjoyed by federally insured depositories.

Finally, regulators should revise existing policies to better facilitate innovation. For example, the CFPB should change its No Action Letter process to provide greater transparency to the public and the market on its view of what the law requires and how the firm seeking the letter plans to meet those requirements (without divulging trade secrets). This enhanced transparency will allow competitors to develop their products to achieve compliance, making it easier for market participants to comply with the law and seek their own letters. Enhanced transparency will also allow interested parties, whether market participants, consumers, or policymakers to assess the CFPB's position and, if necessary, take action in the form of litigation or legislation to correct any errors the CFPB has committed.

Done properly, regulation helps create an environment where innovation and consumers can thrive. However, when regulation stifles innovation and prevents people from accessing better products and services, it is failing in its mission. Regulators can become more innovation friendly without jeopardizing legitimate consumer protection; it is time they do so.