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ARTIFICIAL INTELLIGENCE SERVICES FOR FINANCIAL INSTITUTIONS: REGULATORY AND CONTRACTUAL CONCERNS

By Huu Nguyen

1. INTRODUCTION

Artificial Intelligence ("AI") is being used in Fintech at an increasing rate and is poised to have a major impact in Fintech. AI applies and refines, or "trains," a series of algorithms on a large data set in order to identify patterns and make predictions for new data.[1] The U.S. Department of the Treasury, in its recent report, states that "PricewaterhouseCoopers estimated that by 2030, AI technologies could increase North American gross domestic product (GDP) by $3.7 trillion and global GDP in $15.7 trillion. Within the financial services sector, large banks report that AI could help cut costs and boost returns."[2]

Commentators and regulators have been increasingly grappling with how AI impacts Fintech.[3] But practically, how should financial institutions contract for AI services given the evolving regulatory view of AI? Like many other forms of Fintech services technology, when financial institutions contract for AI services, they should follow the guidance of the *Federal Financial Institutions Examination Council* ("FFIEC")'s Outsourcing Technology Services' handbook ("Handbook")[4], but the Handbook does not mention AI specifically. As Governor Lael Brainard of the Federal Reserve discussed in her November 13, 2018 speech on AI, financial institutions' use of AI tools such as "chatbots, anti-money-laundering/know your customer compliance products, or new credit evaluation tools" will likely be classified as services to the financial institutions.[5] Indeed, citing the Handbook, Governor Brainard states:[6]

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> [O]ur guidance on vendor risk management (SR 13-19/CA 13-21), along with the prudential regulators' guidance on technology service providers, highlights considerations firms should weigh when outsourcing business functions or activities—and could be expected to apply as well to AI-based tools or services that are externally sourced . . . The vendor risk-management guidance discusses best practices for supervised firms regarding due diligence, selection, and contracting processes in selecting an outside vendor. It also describes ways that firms can provide oversight and monitoring throughout the relationship with the vendor, and considerations about business continuity and contingencies for a firm to consider before the termination of any such relationship.

So how should financial institutions apply the Handbook to specific AI services? This article addresses certain regulatory concerns about AI currently expressed by financial regulators—specifically AI bias, explainability and accountability, in order to understand the general guideposts in contracting for AI services. It then addresses certain contractual areas noted in the Handbook that should be accounted for when engaging an AI service provider - specifically, service provider selection, services scope, and ongoing monitoring.

2. TRADITIONAL AND NEWER AI FINANCIAL TECHNOLOGY

A. AI TO ADDRESS AML

While the FFIEC Handbook does not specifically mention AI, financial regulators have regulated AI before under the Bank Secrecy Act and other anti-money laundering laws. The FFIEC's Bank Secrecy Act Anti-Money Laundering Examination Manual discusses one use of AI, specifically rule based and intelligence systems for automated surveillance monitoring:

> A surveillance monitoring system, sometimes referred to as an automated account monitoring system, can cover multiple types of transactions and use various rules to identify potentially suspicious activity. In addition, many can adapt over time based on historical activity, trends, or internal peer comparison.. . .
>
> Surveillance monitoring systems include rule-based and intelligent systems. Rule-based systems detect unusual transactions that are outside of system-developed or management-established "rules." Such systems can consist of few or many rules, depending on the complexity of the in-house or service provider product.. . .
>
> Intelligent systems are adaptive and can filter transactions, based on historical account activity

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> or compare customer activity against a pre-established peer group or other relevant data. Intelligent systems review transactions in context with other transactions and the customer profile. In doing so, these systems increase their information database on the customer, account type, category, or business, as more transactions and data are stored in the system.[7]

B. NEWER AI TECHNOLOGY

These rule-based systems are one form of AI that has been used for many years. However, newer AI technology is increasingly more complicated and are being used for many other financial functions, in addition to risk mitigation through the use of surveillance monitoring systems. Governor Brainard notes four areas where AI could impact banking:[8]

> First, customer-facing uses could combine expanded consumer data sets with new algorithms to assess credit quality or price insurance policies. And chatbots could provide help and even financial advice to consumers, saving them the waiting time to speak with a live operator. Second, there is the potential for strengthening back-office operations, such as advanced models for capital optimization, model risk management, stress testing, and market impact analysis. Third, AI approaches could be applied to trading and investment strategies, from identifying new signals on price movements to using past trading behavior to anticipate a client's next order. Finally, there are likely to be AI advancements in compliance and risk mitigation by banks. AI solutions are already being used by some firms in areas like fraud detection, capital optimization, and portfolio management.

Governor Brainard notes that the Federal Reserve's "Guidance on Model Risk Management" (SR Letter 11-7) highlights the importance to safety and soundness of embedding critical analysis throughout the development, implementation, and use of models, which include complex algorithms like AI. The guidance defines a model as "a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates."[9] This echoes the FFIEC's examination of surveillance monitoring systems.

3. REGULATORY CONCERNS

Along with the FFIEC's focus on surveillance monitoring systems, and the Federal Reserve's interest in AI, the FTC and CFPB are also concerned about AI, as further discussed below. In addition to the Bank Secrecy Act concerns, certain financial regulations related to explainability and managing the risk to consumers will likely play a role in how regulators will view the risks of newer AI financial services. For example, the Fair Credit Reporting Act ("FCRA"), 15 U.S.C.A. § 1681 et seq., and the Equal Credit Opportunity Act ("ECOA"), 15 U.S.C.A. § 1691 et seq. are two financial laws that will likely have an impact on how newer Fintech AI technology will be adopted by financial institutions. Governor Brainard highlighted these laws and related issues in her speech:

> Importantly, the Equal Credit Opportunity Act (ECOA) and the Fair Credit Reporting Act (FCRA) include requirements for creditors to provide notice of the factors involved in taking actions that are adverse or unfavorable for the consumer. These requirements help provide transparency in the underwriting process, promote fair lending by requiring creditors to explain why they reached their decisions, and provide consumers with actionable information to improve their credit standing. Compliance with these requirements implies finding a way to explain AI decisions. However, the opacity of

> some AI tools may make it challenging to explain credit decisions to consumers, which would make it harder for consumers to improve their credit score by changing their behavior. Fortunately, AI itself may play a role in the solution: The AI community is responding with important advances in developing "explainable" AI tools with a focus on expanding consumer access to credit.

The FTC recently conducted a hearing on AI and sought public comment on 25 related AI topics,[10] and public comments may be submitted until February 15, 2019. Questions include:

- What are the main consumer protection issues raised by algorithms, artificial intelligence, and predictive analytics?
- What roles should explainability, risk management, and human control play in the implementation of these technologies?
- What choices and notice should consumers have regarding the use of these technologies?

Academics, and representatives from financial institutions, Fintechs, general technology service providers, and government agencies testified on various topics, including "Perspectives on Ethics and Common Principles in Algorithms, Artificial Intelligence, and Predictive Analytics," "Consumer Protection Implications of Algorithms, Artificial Intelligence, and Predictive Analytics," "Algorithmic Collusion," and more.[11] While the FTC has not yet issued a report or guidance based on the hearings, the transcripts of the hearings and the FTC's questions are informative of the speakers' and the FTC's concerns with respect to AI, which includes FCRA and ECOA issues, consumer protections, algorithmic bias and explainability.[12]

A. FCRA

Under the FCRA, among other requirements, any financial institutions that uses a credit report or another type of consumer report to deny a consumer's application for credit, insurance, or employment—or to take another adverse action against the consumer—must tell the consumer, and must give the consumer the name, address, and phone number of the agency that provided the information.[13] Under the FCRA, "adverse action" means:[14]

> (i) a denial or cancellation of, an increase in any charge for, or a reduction or other adverse or unfavorable change in the terms of coverage or amount of, any insurance, existing or applied for, in connection with the underwriting of insurance;
>
> (ii) a denial of employment or any other decision for employment purposes that adversely affects any current or prospective employee;
>
> (iii) a denial or cancellation of, an increase in any charge for, or any other adverse or unfavorable change in the terms of, any license or benefit described in section 1681b(a)(3)(D) of this title; and
>
> (iv) an action taken or determination that is—
>
> > (I) made in connection with an application that was made by, or a transaction that was initiated by, any consumer, or in connection with a review

> of an account under section 1681b(a)(3)(F)(ii) of this title; and
>
> (II) adverse to the interests of the consumer.

Upon the request of a consumer for a credit score, a consumer reporting agency shall supply to the consumer a statement and notice that includes "all of the key factors that adversely affected the credit score of the consumer in the model used," and any consumer reporting agency shall provide trained personnel to explain to the consumer any information required to be furnished to the consumer under the Act.[15]

Using AI that makes decisions that are not easily explainable increases the burden for Fintech companies and creditors under the Act. But credit reporting agencies, the prototypical Fintech companies, have traditionally grappled with explainable AI. Credit reporting agencies use technology and controls to comply with laws that impact AI. Equifax recently debuted their machine learning-based credit scoring system that addresses some of the issues related to AI systems, and compared their systems to others:

> While other companies use machine learning methodologies in portions of the model building process, the final score is not based on a machine-learning regulatory compliant model . . . These techniques inherently lack the explain-ability and transparency that is required for compliance and regulatory purposes.[16]

FICO also aims to create AI that are compliant with regulations. They state that there are "various ways to explain AI when used in a risk or regulatory context: . . . **Scoring algorithms that inject noise** and score additional data points around an actual data record being computed, to observe what features are driving the score in that part of decision phase space. . . . Models that are built to express interpretability on top of inputs of the AI model. . . . Models that change the entire form of the AI to make the latent features exposable." [17]

B. ECOA

Credit reporting goes hand in hand with lending decisions. In the lending context, the ECOA prohibits certain discrimination in the financial context and requires notices of adverse actions as well.[18] The ECOA states:[19]

> (a) ACTIVITIES CONSTITUTING DISCRIMINATION It shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction—
>
> (1) on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract);
>
> (2) because all or part of the applicant's income derives from any public assistance program; or
>
> (3) because the applicant has in good faith exercised any right under this chapter.
>
> . . .
>
> (d)(6) For purposes of this subsection, the term "adverse action" means a denial or revocation of credit, a change in the terms of an existing credit arrangement, or a refusal to grant credit in substantially the amount or on substantially the terms requested. Such term does not include a refusal to extend additional credit under an existing credit arrangement where the applicant is delinquent or otherwise in default, or where such additional credit would exceed a previously established credit limit. . . .

Similar to FCRA concerns, the themes of AI transparency and accountability in lending is echoed by the US Treasury in its recent report:[20]

> In the lending context and many other financial services use-cases, the underlying complexity of

> AI and machine learning-based models (often referred to as "black boxes") raises challenges in the transparency and auditing of these models. Many U.S. laws or regulations have been designed around a baseline expectation of auditability and transparency that may not be easily met by these models. As these types of models are deployed in increasingly high-value decision-making use-cases, such as determining who gets access to credit or how to manage an investment portfolio, questions regarding how to maintain accountability become fundamental. With respect to lending, for example, U.S. rules require that a creditor provide a notification when a borrower has been denied credit. In light of the increasing complexity of machine learning, it can be challenging to express the underpinnings of these analytical insights to firms, borrowers, and regulators.

The FTC has also advised on the use of big data (and by implication AI and machine learning) and in particular disparate impact arising from use of big data under the ECOA:[21]

> Disparate treatment occurs when a creditor treats an applicant differently based on a protected characteristic. For example, a lender cannot refuse to lend to single persons or offer less favorable terms to them than married persons even if big data analytics show that single persons are less likely to repay loans than married persons. Disparate impact occurs when a company employs facially neutral policies or practices that have a disproportionate adverse effect or impact on a protected class, unless those practices or policies further a legitimate business need that cannot reasonably be achieved by means that are less disparate in their impact. For example, if a company makes credit decisions based on consumers' zip codes, such decisions may have a disparate impact on particular ethnic groups because certain ethnic groups are concentrated in particular zip codes. Accordingly, the practice may be a violation of ECOA. The analysis turns on whether the decisions have a disparate impact on a protected class and are not justified by a legitimate business necessity.

C. NO ACTION LETTER ISSUED TO FINTECH AI COMPANY

An example of a Fintech service provider that provides AI services in the context of the FCRA and the ECOA is Upstart Network which uses "algorithms and machine learning to decipher dimensions above and beyond the FICO score."[22] American Banker reports: "BankMobile has become the first bank to start using online lending software developed by Upstart, which is designed to use artificial intelligence and alternative data to determine the creditworthiness of consumers with thin or no credit files."[23] Of note, on September 14, 2018, the CFPB issued a No-Action Letter to Upstart Network which arguably gives Upstart and its bank customers some certainty:[24]

> Staff has no present intention to recommend initiation of an enforcement or supervisory action against Upstart with regard to application of the Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B, to Upstart's automated model for underwriting applicants for unsecured non-revolving credit, as that model is described in the Request and confidential Model Risk Management & Compliance Plan ("Compliance Plan"). This staff intention is subject to the statements and commitments set forth in the Request, the Compliance Plan, and Appendix A to this No-Action Letter.
>
> . . .
>
> This No-Action Letter is limited to Upstart's automated model for underwriting applicants for unsecured non-revolving credit, as described in the Request and Compliance Plan, and it does not pertain to: (i) Upstart's use of its automated model in a different manner; (ii) Upstart's offer or provision of different products or services, or

> with respect to other provisions or applications of these or other statutes and regulations, or with respect to other aspects of Upstart's automated model; or (iii) any person other than Upstart.

The CFPB also states that:

> Under the terms of the no-action letter issued by Bureau staff, Upstart will share certain information with the CFPB regarding the loan applications it receives, how it decides which loans to approve, and how it will mitigate risk to consumers, as well as information on how its model expands access to credit for traditionally underserved populations. The CFPB expects that this information will further its understanding of how these types of practices impact access to credit generally and for traditionally underserved populations, as well as the application of compliance management systems for these emerging practices.[25]

Clearly, the CFPB is balancing promotion of innovation with the protection of consumers in the use of AI to making lending decisions. The above laws are only examples of financial laws that may affect adoption of AI by financial institutions. But the common themes are controls, explainability and consumer protections. As with many financial functions, financial institutions can outsource these AI services to third parties, but they should do so with care, as discussed below.

4. CONTRACTUAL CONCERNS

Regulators have required financial institutions to have policies and procedures to control, review, test, document and understand their AI systems, in the case of surveillance monitoring systems, for example:[26]

> Once established, the bank should review and test system capabilities and thresholds on a periodic basis. This review should focus on specific parameters or filters in order to ensure that intended information is accurately captured and that the parameter or filter is appropriate for the bank's particular risk profile.
>
> . . .
>
> The authority to establish or change expected activity profiles should be clearly defined through policies and procedures. Controls should ensure limited access to the monitoring systems, and changes should generally require the approval of the BSA compliance officer or senior management. Management should document and be able to explain filtering criteria, thresholds used, and how both are appropriate for the bank's risks. Management should also periodically review and test the filtering criteria and thresholds established to ensure that they are still effective. In addition, the monitoring system's programming methodology and effectiveness should be independently validated to ensure that the models are detecting potentially suspicious activity. The independent validation should also verify the policies in place and that management is complying with those policies.

As with surveillance monitoring AI systems, financial institutions should also observe the guidance of the Handbook for the other types of AI discussed by Governor Brainard. Financial institutions should ensure proper controls, explainability and consumer protections. Governor Brainard noted in her speech:[27]

> For its part, AI is likely to present some challenges in the areas of opacity and explainability. Recognizing there are likely to be circumstances when using an AI tool is beneficial, even though it may be unexplainable or opaque, the AI tool should be subject to appropriate controls, as with any other tool or process, including how the AI tool is used in practice and not just how it is built. This is especially true for any new application that has not been fully tested in a variety of conditions. Given the large data sets involved

> with most AI approaches, it is vital to have controls around the various aspects of data—including data quality as well as data suitability. Just as with conventional models, problems with the input data can lead to cascading problems down the line. Accordingly, we would expect firms to apply robust analysis and prudent risk management and controls to AI tools, as they do in other areas, as well as to monitor potential changes and ongoing developments.

Foremost, the financial institutions should diligence the service providers and evaluate the service providers' proposals for use of AI in light of the financial institution's needs, including any differences between the institution's solicitation and the service provider proposal.[28]

- Can the service provider deliver AI capabilities that suits the financial institution's needs? For example, the AI system should be capable of managing the volume of big data required for AI.
- The AI provider should have policies and procedures to control, review, test, document and understand the AI.
- If the AI is used for sensitive functions of the financial institutions, then greater care and diligence should be performed.
- The AI vendor should be evaluated on how well the AI service providers' models, systems and processes cope with AI bias and explainability.
- Another important diligence step is that the (big) datasets used for training the AI and the providers of those datasets should also be carefully reviewed in order to prevent bias.
- The service provider being vetted by regulators, such as having a no-action letter issued, may be an important factor in diligence as well.

Next, the agreement with the AI service provider should clearly describe the rights and responsibilities of the parties to the contract, and more generally, the service scope.[29]

- Implementation provisions should take into consideration the other existing systems or interrelated systems to be developed by different service providers and the financial institutions' own systems. For example, a vendor's customer-facing chatbot should be able to integrate safely with existing core account information of the financial institution.
- Lending decisions should be recorded and documented, or controls should be put in place for when customers ask for explanations for adverse decisions.
- The AI should be able to route the consumer to a human for additional explanations about lending decisions for example, when required.
- The AI should have controls like "circuit-breakers" or other mechanisms as mentioned by Governor Brainard, for when AIs may malfunction.

Finally, another key consideration is controls. The financial institutions should consider implementing contract provisions that address the controls for the use of the AI services.[30]

- A contract with the AI service provider should require the service provider to have

internal controls and record keeping of decisions made by their AI.

- The financial institutions should have access to such records and have the right to audit the records.
- The controls should permit the financial institution to control, review, test, document and understand the AI deployed.
- The financial institution should have proper controls on the dataset used for training to prevent bias, including protecting against disparate impact.
- The AI system should be regularly tested, reviewed, and audited to comply with laws, such as the FCRA or the ECOA.
- The financial institution should have internal resources who understand these AI systems and how to manage them.

In addition to the guidance from the Handbook and the FFIEC's Bank Secrecy Act Anti-Money Laundering Examination Manual, the various banking regulators' guidance on vendor management will also be informative. For example, the Federal Reserve's outsourcing guidance recommends maintaining an exit strategy, including a pool of comparable service providers, in the event that a contracted service provider is unable to perform. In the context of AI vendors, an alternate vendor may be a traditional service provider that provides the financial functions using people instead of algorithms.

5. CONCLUSION

The Bank Secrecy Act, FCRA, and ECOA are only examples of financial laws that may affect adoption of AI by financial institutions to take into account when engaging AI Fintech service providers. Other laws that may also affect adoption of AI includes the Fair Debt Collection Practices Act, 15 U.S.C.A § 1692 et seq. (which may apply to AI collection agents), the Telephone Consumer Protection Act, 47 U.S.C.A. § 227 (which may apply to chatbots and voice bots that contacts consumers), California's bot disclosure law (which may require a fintech bot to disclose it is a bot)[31] and the EU General Data Protection Regulation Articles 22(1) and (4) (which may restrict Fintech companies from performing certain automated processing and requiring Fintech companies to provide consumers in the EU and UK with the right to meaningful information about the logic involved in the automated processing) . Moreover, the above discussion about how to apply the Handbook to AI are only some of the general guidelines of the Handbook, and a financial institution should apply all applicable guidelines when evaluating an AI vendor, including service levels, and privacy and data security concerns while taking into account common AI themes such controls, explainability and consumer protections. Like AI itself, Artificial Intelligence Law is a quickly evolving area. Financial institutions should keep abreast not only of the new technologies, but also the new regulatory concerns related to AI usage. And when contracting with Fintech providers, financial institutions should apply well established legal principles and control in their usage of AI.

ENDNOTES:

[1]What Are We Learning about Artificial Intelligence in Financial Services? https://www.federalreserve.gov/newsevents/speech/brainard20181113a.htm available as of 11/27/2018, citing

Executive Office of the President, Preparing for the Future of Artificial Intelligence; and Financial Stability Board, Artificial Intelligence and Machine Learning in Financial Services (PDF) (Basel: Financial Stability Board, November 1, 2017).

[2]A Financial System That Creates Economic Opportunities Nonbank Financials, Fintech, and Innovation (Washington: U.S. Department of the Treasury, June 3, 2018), https://home.treasury.gov/sites/default/files/2018-07/A-Financial-System-that-Creates-Economic-Opportunities—-Nonbank-Financi....pdf as of 11/27/2018.

[3]See e.g., id; Financial Stability Board, *Artificial Intelligence and Machine Learning;* Brainard, "Where Do Consumers Fit in the Fintech Stack?"; and American Bankers Association, "Understanding Artificial Intelligence."

[4]Outsourcing Technology Services, June 2004, https://ithandbook.ffiec.gov/ITBooklets/FFIEC_ITBooklet_OutsourcingTechnologyServices.pdf available as of 11/27/2018; see also FFIEC's vendor and TP management booklet, https://ithandbook.ffiec.gov/it-booklets/retail-payment-systems/retail-payment-systems-risk-management/operational-risk/vendor-and-third-party-management.aspx available as of 11/27/2018.; additionally banking agencies (CFPB, OCC, FDIC, and Federal Reserve) all have separate third party guidance.

[5]What Are We Learning about Artificial Intelligence in Financial Services? https://www.federalreserve.gov/newsevents/speech/brainard20181113a.htm available as of 11/27/2018.

[6]Id.

[7]Suspicious Activity Reporting—Overview (2014), https://www.ffiec.gov/bsa_aml_infobase/pages_manual/olm_015.htm available as of 11/27/2018.

[8]What Are We Learning about Artificial Intelligence in Financial Services? https://www.federalreserve.gov/newsevents/speech/brainard20181113a.htm available as of 11/27/2018.

[9]Board of Governors of the Federal Reserve System, "Guidance on Model Risk Management," Supervision and Regulation Letter SR Letter 11-7 (April 4, 2011), https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm available as of 11/27/2018

[10]FTC Hearing #7: Competition and Consumer Protection in the 21st Century. https://www.ftc.gov/news-events/events-calendar/ftc-hearing-7-competition-consumer-protection-21st-century available as of 11/27/2018.

[11]Speaker bios, https://www.ftc.gov/system/files/documents/public_events/1418693/hearings-bios-howardu-nov13-14.pdf available as of 11/27/2018.

[12] https://www.ftc.gov/system/files/documents/public_events/1418693/ftc_hearings_session_7_transcript_day_2_11-14-18.pdf and https://www.ftc.gov/system/files/documents/public_events/1418693/ftc_hearings_session_7_transcript_day_1_11-13-18.pdf available as of 11/27/2018.

[13]15 U.S.C.A. § 1681 et seq.

[14]15 U.S.C.A. § 1681a(k)

[15]15 U.S.C.A. § 1681g (f) and (g); see also 15 U.S.C.A. § 1681m for requirements of adverse action notices.

[16]Equifax debuts machine learning-based credit scoring system, https://www.ciodive.com/news/equifax-debuts-machine-learning-based-credit-scoring-system/520095/ available as of 11/27/2018.

[17]Explainable AI breaks out of the blackbox. https://www.fico.com/blogs/analytics-optimization/explainable-ai-breaks-out-of-the-black-box/ available as of 11/27/2018.

[18]15 U.S. Code § 1691

[19]Id at 1691(a) and 1691(d).

[20]A Financial System That Creates Economic Opportunities Nonbank Financials, Fintech, and Innovation at 58.

[21]Big Data A Tool for Inclusion or Exclusion? https://www.ftc.gov/system/files/documents/reports/big-data-tool-inclusion-or-exclusion-understanding-issues/160106big-data-rpt.pdf available as of 11/27/2018

[22]BankMobile deploys AI, alternative data to lend to thin-file millennials, https://www.

americanbanker.com/news/bankmobile-deploys-ai-alternative-data-to-lend-to-fico-poor-students available as of 11/27/2018.

[23]Id.

[24]No-Action Letter issued to Upstart, https://files.consumerfinance.gov/f/documents/201709_cfpb_upstart-no-action-letter.pdf available as of 11/27/2018.

[25]CFPB Announces First No-Action Letter to Upstart Network, https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/ available as of 11/27/2018

[26]Suspicious Activity Reporting—Overview (2014), https://www.ffiec.gov/bsa_aml_infobase/pages_manual/olm_015.htm available as of 11/27/2018.

[27]What Are We Learning about Artificial Intelligence in Financial Services? https://www.federalreserve.gov/newsevents/speech/brainard20181113a.htm available as of 11/27/2018.

[28]Handbook at 9.

[29]Handbook at 12.

[30]Handbook at 13.

[31]SB-1001 Bots: disclosure (2017-2018) https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB1001 available as of 11/29/2018.

FINTECH LAW REPORT: NOVEMBER 2018 REGULATION AND LITIGATION UPDATE

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REGULATORY DEVELOPMENTS

Current and Former Comptrollers Pen Op-Eds in Support of FinTech Charter, Regulatory Sandboxes

On September 18, Comptroller of the Currency Joseph Otting addressed criticisms of the Office of the Comptroller of the Currency ("OCC") special purpose national bank charter for Fintech companies (the "Fintech Charter"), stating he is "puzzled by the[] efforts, and presumption of authority, [by opponents of the Fintech Charter] to limit the choice of consumers and businesses in a way that harms the dual banking system and the citizens it serves."[1] Comptroller Otting outlines and counters three arguments made by critics of the OCC's decision to accept applications for Fintech Charters. These arguments pertain to (1) consumer protection, (2) supervision of financial innovation, and (3) authority. Comptroller Otting addresses the argument that the Fintech Charter would undermine consumer protection by crediting the OCC and CFPB as champions of consumer protection, noting that some state laws will still apply to entities operating under a Fintech Charter, and noting that states currently oversee predatory payday lending to suggest that states are not always the best champions of consumer protection. In addressing the argument that state regulators are better suited to supervise financial innovation, Comptroller Otting notes that "[s]tate law, state requirements and state supervision vary wildly," whereas the "OCC's national perspective informs its oversight, allowing companies to benefit from broad industry-wide perspective as well as in-depth on-site knowledge and expertise." Finally, Comptroller Otting notes that "the OCC has broad authority to grant charters for national banks to carry on the 'business of banking' " to address the argu-

ment that the OCC lacks authority to issue Fintech Charters. Comptroller Otting characterized the Fintech Charter's "few" critics as "masquerading" a concern for the health of the banking system when, according to the Comptroller, the "complaints about the OCC's decision really come down to defending turf and licensing revenue of a few big states at the expense of economic opportunity for others."

On September 24,[2] and October 12, 2018[3], former Comptroller of the Currency Thomas Curry and another partner at Comptroller Curry's new law firm, Jason Cabral, published opinion pieces in support of the Fintech Charter and admonishing U.S. regulators to increase their efforts to encourage innovation through regulatory sandboxes, respectively. In the first piece, the authors argue for the creation of a "dual fintech system" to parallel the dual banking system and a "dynamic rather than static definition of 'banking.' " Although the piece recognizes some of the outstanding questions regarding the Fintech Charter, such as what types of companies will ultimately be able to benefit from it, the piece is overwhelmingly supportive of the Fintech Charter. The second piece highlights international efforts to foster financial innovation through cross-border sandboxes by collaborating regulators and outlines the "process-oriented frameworks" fintech companies need for regulatory sandboxes in the United States to function as intended. Specifically, the piece argues for consistent "clearly articulated safeguards, terms of use and expectations on transparency," often drawing comparisons to the medical field by citing the Hippocratic oath and suggesting replacing the term "regulatory sandbox" with something more akin to "clinical trial."

All three of the opinion pieces described above were published in *American Banker* as part of that publication's "BankThink" series.

You can read the September 18 piece here:

https://www.americanbanker.com/opinion/occs-otting-why-do-state-regulators-want-to-limit-consumer-choice?utm_campaign=bankthink-c-Sep%2018%202018&utm_medium=email&utm_source=newsletter&eid=12a6d4d069cd56cfddaa391c24eb7042.

You can read the September 24 piece here:

https://www.americanbanker.com/opinion/its-a-mistake-to-block-the-occs-fintech-charter?utm_campaign=daily%20briefing-sep%2025%202018&utm_medium=email&utm_source=newsletter&eid=aa0a91d574b41c532e0d2affbc4474a1&bxid=5b48f3f120122e457c68e717.

You can read the October 12 piece here:

https://www.americanbanker.com/opinion/regulators-can-do-more-to-encourage-fintech-innovation?utm_campaign=daily%20briefing-oct%2015%202018&utm_medium=email&utm_source=newsletter&eid=aa0a91d574b41c532e0d2affbc4474a1&bxid=5b48f3f120122e457c68e717.

Federal Reserve Seeks Comments on Proposals to Facilitate Faster Payments

On October 3, the FRB issued a Federal Register notice that solicits public comment on actions the FRB could take to support faster payments in the United States. Specifically, the FRB seeks public comment on (i) potential steps the FRB could take to support the vision of real-time gross interbank settlement of faster payments 24 hours a day, seven days a week, 365 days a year ("24x7x365"); and (ii) whether the Reserve Banks should consider developing a liquidity

management tool that would operate 24x7x365 in support of "services for real-time interbank settlement of faster payments, regardless of whether those services are provided by the private sector or the Federal Reserve Banks."[4]

A real-time gross settlement service would "involve interbank settlement of faster payments using banks' balances in accounts at the Reserve Banks"[5] and could be similar to the Fedwire® Funds Service. The FRB provided two examples of a potential liquidity management tool. First, the tool could "involve simultaneous liquidity transfers among multiple accounts that are coordinated by an authorized agent in the settlement process and could be based on the existing National Settlement Service or a similar service."[6] Alternatively, the tool "could involve individual bank-initiated transfers between specific sets of accounts and could function similarly to the existing Fedwire Funds Service or a similar service."[7]

According to the FRB, there are three key levels of the payment process that are necessary to complete a payment between two bank accounts: end-user services, clearing services, and interbank settlement services. To make a payment a "faster payment," the three levels of the payment process must be structured so that senders can immediately initiate, and recipients can immediately receive, payments at any time, which requires that end-users have an interface that allows real-time communication and that banks may transmit messages between one another in real-time. The FRB compares various faster payment services available in the United States, such as those that may use the debit card infrastructure of payment card networks or new proprietary networks to facilitate faster payments. The FRB also devotes substantial analysis to comparisons between deferred net settlement of interbank obligations and real-time gross settlement of interbank obligations, weighing the impact on risk, liquidity management, and other implications of the features that distinguish the two methods of performing interbank settlement. The FRB states that it believes that real-time gross settlement infrastructure would provide the safest and most efficient foundation for the next generation of payment services and requests public comment regarding this view and the steps the FRB could take to support such a faster payments system. For example, the FRB seeks comment on the proposal that the Reserve Banks could provide a 24x7x365 RTGS settlement service for banks that would carry out the interbank settlement of individual payments immediately, on any day, and at any time of the day. The FRB seeks comment on how developing such a service would impact accessibility of the system, safety, and efficiency.

Comments must be received on or before December 14, 2018.

You can read the FRB's Federal Register notice here:

https://www.federalreserve.gov/newsevents/pressreleases/files/other20181003a1.pdf.

NYDFS Adds Check Cashing and Virtual Currency Businesses to Nationwide Licensing System

On October 1, 2018, New York Department of Financial Services ("NYDFS") Superintendent Maria T. Vullo announced that NYDFS transitioned check cashing and virtual currency business activity companies to the Nationwide Multistate Licensing System and Registry ("NMLS"),

thus completing the final phase in a larger NYDFS plan to transition all non-depository financial institution activities requiring licensure to the NMLS system.[8] Use of NMLS can create efficiencies for companies applying for licenses in multiple states and modernize the licensure process by operating on a secure, web-based platform. Financial services companies holding check casher and virtual currency business activity licenses can now transition those licenses to NMLS, and companies applying for new licenses can now apply through NMLS. [9] During earlier phases of the plan to transition to NMLS, licensed budget planners, sales finance agencies, money transmitter licensees and mortgage providers were transitioned to the NMLS platform.[10]

You can read the NYDFS press release here:

https://www.dfs.ny.gov/about/press/pr1810011.htm.

Federal Reserve Board Approves Final Amendments to Simplify Regulation J and Conform it with Recent Changes to Regulation CC

On November 15, 2018, the Board of Governors of the Federal Reserve System (the "Board") announced a final rule amending Regulation J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire (12 C.F.R. Part 210) (the "Regulation J Final Rule"). The Regulation J Final Rule amends Regulation J to (i) clarify and simplify certain provisions of Subpart A (Collection of Checks and other Items by Federal Reserve Banks); (ii) remove obsolete provisions; (iii) align the rights and obligations of sending banks, paying banks, and Federal Reserve Banks ("Reserve Banks") with the Board's May 2017 final rule amending Regulation CC, Availability of Funds and Collection of Checks (12 C.F.R. Part 229) ("Regulation CC Final Rule"), to reflect the current electronic check collection and return environment; and (iv) amend Subpart B (Funds Transfers Through Fedwire) to clarify that terms used in financial messaging standards do not confer legal status or responsibilities.

In May 2017, the Board issued the Regulation CC Final Rule, which reflected the "virtually all-electronic check collection and return environment" by, among other things, adding defined terms for "electronic check" and "electronic returned checks," and modifying and creating new warranties and indemnifications.[11] The Regulation J Final Rule is written to align Regulation J with the distinction between checks and electronically-created items ("ECIs") in Regulation CC. Specifically, the Regulation J Final Rule amends the definitions of "check" and "returned check," deletes Regulation J's current definition of "electronic item," and amends the definition of "item" in order to state explicitly that the term does not include an ECI as defined in Regulation CC. The definition of "check" in Regulation J is amended to have the same meaning as the terms "check" and "electronic check" in Regulation CC.[12] The term "item" is amended to include the term "check" with its new definition referencing the term in Regulation CC.[13]

The Regulation J Final Rule also allows a Reserve Bank to require a sender to warrant that such sender will only send those "items" and "noncash items" that the Reserve Bank has agreed to accept,[14] and to indemnify the Reserve Bank for any loss resulting from the sender's failure to do so.[15] The Board notes that this change will "help to shift liability to parties better posi-

tioned to know whether an item is electronically created and that can either prevent the item from entering the check-collection system or assume the risk of sending it forward."[16] The Regulation J Final Rule does not, however, prohibit parties from exchanging ECIs by agreement using direct exchange relationships or other methods not involving Reserve Banks. In short, Regulation J's sender warranties align with the warranties specified in Regulation CC.[17]

The Regulation J Final Rule also revises certain of Regulation J's settlement provisions to remove references to cash and certain other forms of settlement, and instead states that the Reserve Banks may settle by debit to an account on the Reserve Bank's books, or another acceptable form of settlement.

Finally, the Regulation J Final Rule creates a new subsection to clarify that financial messaging standards, like ISO 20022, including the financial messaging components, the elements, technical documentation, tags, and terminology used to implement those standards,[18] do not confer legal status or responsibilities. The Regulation J Final Rule states that Regulation J, Article 4A of the U.C.C., and the Reserve Banks' operating circulars govern the rights and obligations of the parties to the Fedwire Funds Service.[19]

The Regulation J Final Rule will become effective January 1, 2019 and was published in the *Federal Register* on November 30, 2018.

You can read the Regulation J Final Rule here:

https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181115a1.pdf.

Federal Reserve Board and CFPB Propose Regulation CC Amendments

On November 20, 2018, the Consumer Financial Protection Bureau (''CFPB'' or "Bureau") and the Board published a joint proposed rulemaking regarding the implementation of a requirement under the Dodd-Frank Act to adjust for inflation the dollar amounts in the Expedited Funds Availability Act ("EFA Act"), implemented by Regulation CC. The publication also announces that the agencies are reopening the comment period regarding proposed Regulation CC amendments about which the Board had previously accepted public comments in 2011, before the agencies shared joint rulemaking authority.

Section 1086(f) of the Dodd-Frank Act added Section 607(f) to the EFA Act, providing for adjustments to the dollar amounts under the EFA Act every five years after December 31, 2011. The adjustments are to align with the annual percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers ("CPI-W)." The agencies propose that the first set of adjustments go into effect on April 1, 2020, with proposals for subsequent adjustments in the first quarter of 2024. The agencies anticipate future adjustments to be effective on April 1 every five years using the July CPI-W. For example, the initial inflation measurement period for the first set of adjustments would use the aggregate percentage change in the CPI-W from July 2011 to July 2018, and the next set of adjustments would use the aggregate percentage change in the CPI-W from July 2018 to July 2023. Under the proposed rulemaking, in the event of an aggregate percentage increase in any inflation measurement period, the aggregate percentage change would be applied to the dollar amounts in Regu-

lation CC, and those amounts would be rounded to the nearest multiple of $25 to determine the new adjusted dollar amounts such that the dollar amount adjustments would always be zero or positive.

The November 20 proposed rulemaking also contains proposed technical amendments to Regulation CC for consistency with the inflation adjustment amendments and as required by the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"). The proposed amendments implement EGRRCPA amendments to the EFA Act extending its application to American Samoa, the Commonwealth of the Northern Mariana Islands, and Guam.

Comments on the 2011 proposed rulemaking that were previously submitted during the initial comment period, which ended on June 3, 2011, remain part of the rulemaking docket, but the agencies have asked commenters submitting second comment letters to "clarify the relationship [(*e.g.*, whether 2018 comments supplement or supersede 2011 comments)] between their two comments."

You can read the proposed rule here:

https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181120a1.pdf.

CFPB Releases Assessment Report on Remittance Rule

On October 26, 2018, the CFPB published a report analyzing the impact of subpart B to the Bureau's Regulation E[20] (the "Remittance Rule") in the first five years since the rule took effect on October 28, 2013. Entitled, "Remittance Rule Assessment Report," the document fulfills a requirement imposed on the CFPB by Section 1022(d) of the Dodd-Frank Act to review significant rules and publish assessment reports within five years of a given rule's effective date.

The Remittance Rule and associated amendments require remittance transfer providers to (i) provide consumers with disclosures including costs, fees and other information before consumers pay for remittance transfers; (ii) provide cancellation and refund rights; and (iii) maintain procedures to investigate and resolve disputes and certain errors. The assessment, which was conducted using both the CFPB's own research and external sources, "discusses the structure of the remittance market and reviews the available evidence with respect to the effect of the Remittance Rule on the number and dollar volume of remittance transfers, the number of remittance providers, the price of remittance transfers for consumers, the cost of the Remittance Rule to providers, and innovation."[21] In addition, the assessment evaluates market data to determine whether particular provisions of the Remittance Rule accomplish their objectives.

The CFPB highlighted the following key findings in the assessment:

- Money services businesses ("MSBs") conducted 95.6% of all remittance transfers in 2017 and the volume of transfers from these businesses has been increasing since before the effective date of the Remittance Rule; the volume of transfers at MSBs continued to increase after the effective date at the same or higher rate.
- New and repurposed technologies, such as online and mobile phone transfers, and new

market entrants have had a substantial effect on the remittance transfer market.

- The average price of remittances was declining before the Remittance Rule took effect and has continued to do so.
- Initial compliance costs for the Remittance Rule were between $86 million, based on analysis at the time of the rulemaking, and $92 million, based on an industry survey conducted by the Bureau in the spring of 2018.
- Ongoing compliance costs are estimated at between $19 million per year, or $0.07 per remittance transfer, and $102 million per year, or $0.37 per remittance transfer, based on the responses to the industry survey.
- Consumers cancel between 0.3% and 4.5% of remittance transfers, according to available data sources, and there is evidence that some banks have begun to impose a delay in the transfer to make it easier to provide a refund if a consumer cancels within the 30-minute cancellation window permitted under the Remittance Rule.
- Consumers appear to assert errors under the Remittance Rule's provisions for between 0.5% and 1.9% of remittance transfers. Despite the 180 day reporting period required by the Remittance Rule, nearly all error assertions are made within 30 days of the remittance transfer. Around one-fourth of asserted errors are ultimately found to be provider errors as defined by the Remittance Rule, suggesting that most asserted errors are attributable to consumer mistakes or other issues.
- Approximately 80% of banks and 75% of credit unions that offer remittance transfers are below the 100-transfer threshold in a given year and are therefore, not subject to the Remittance Rule's requirements. The percentage of all banks that transfer more than 100 remittances has been steady or increasing since 2014, and the percentage of all credit unions that transfer more than 100 remittances has increased slightly.

You can read the assessment here:

https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/bcfp_remittance-rule-assessment_report.pdf.

New York Regulator Licenses First Bitcoin Teller Machine Operator

On November 1, 2018, the NYDFS issued a virtual currency license to Coinsource, Inc. ("Coinsource"), the first such license to be granted to an operator of Bitcoin Teller Machines ("BTMs"). Coinsource currently operates 40 BTMs (touchscreen kiosks that allow customers to buy Bitcoin with, or sell Bitcoin for, fiat currency in the form of cash) in New York. To obtain licensure, Coinsource had to adhere to the NYDFS' substantial licensing procedures, and the company remains subject to license revocation by NYDFS, among other regulatory and/or enforcement actions, for failing to comply with any of the conditions of the NYDFS's approval.

You can read the NYDFS press release regarding the licensure here:

https://www.dfs.ny.gov/about/press/pr1811011.htm.

LITIGATION AND ENFORCEMENT DEVELOPMENTS

CSBS Sues OCC Over Fintech Charter (Again)

On October 25, the Conference of State Bank Supervisors ("CSBS") filed suit in the U.S. District Court for the District of Columbia against the OCC, challenging its statutory authority to issue Fintech Charters. CSBS has asked the court to declare that the OCC's proposal to issue Fintech Charters is unlawful, and to enjoin the OCC from issuing Fintech Charters.

CSBS, along with the NYDFS, had previously pursued litigation challenging the OCC's authority to issue Fintech Charters in the spring of 2017, but these actions were dismissed for lack of standing in April 2018 and December 2017, respectively, because the lawsuits were filed before the OCC had definitively announced its decision to issue Fintech Charters and it was unclear if or when any Fintech Charter might be considered or granted.[22] The NYDFS has also renewed its litigation challenging the SPNB charter.

The new lawsuits appear to have been filed in response to the OCC's July 2018 announcement that it would begin accepting applications for Fintech Charters. In its complaint, the CSBS alleges that "things have changed substantially since the Court's decision [dismissing the prior CSBS lawsuit]. The issuance of a [Fintech Charter] is now clearly imminent." It further alleges that "upon information and belief, multiple prequalified candidates have already decided to apply (and may have already applied)."[23] Thus, according to the CSBS, the challenge to the OCC's authority is now ripe for judicial review.

The CSBS complaint alleges five causes of action:

- *Count I*—The OCC lacks the statutory authority to provide a charter to non-depository entities.
- *Count II*—The OCC's promulgation of regulation 12 C.F.R. § 5.20(e)(1), permitting the OCC to issue Fintech Charters, exceeds its statutory authority that limits the OCC to chartering entities that carry on the business of banking, which requires, at a minimum, engaging in receiving deposits or carrying on a special purpose authorized by Congress.
- *Count III*—The OCC's decision to grant Fintech Charters failed to comply with the rulemaking requirements of the National Bank Act.
- *Count IV*—The OCC's decision to issue Fintech Charters is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.
- *Count V*—The OCC's decision to grant Fintech Charters to fintech companies violates the Supremacy Clause and the Tenth Amendment by preempting otherwise applicable state law without statutory authority.

The case before the U.S. District Court for the District of Columbia is:

Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, No. 1:18-cv-02449 (D.D.C.). You can read the CSBS complaint here:

https://dlbjbjzgnk95t.cloudfront.net/1095000/

1095796/d6425d7c-4420-42a3-bd9f-a732f429b51e.pdf.

American Express Challenges Plaintiff Charges in Card-Steering Litigation

On October 12, 2018, just two days after filing an answer to plaintiffs' amended complaint, American Express filed a Memorandum of Law in support of a further motion attempting to halt multidistrict litigation related to anti-steering provisions in the card network's merchant agreements and network rules. Retailers, including CVS Pharmacy Inc., Rite Aid Corp. and The Kroger Co.,[24] brought this antitrust litigation against American Express over nondiscrimination provisions ("NDPs") in merchant agreements that prohibit merchants from (1) offering cardholders any discounts or nonmonetary incentives to use cards that are less costly for merchants to accept, (2) expressing preferences for any card, or (3) disclosing information about the costs to merchants of different cards. The retailers claim that American Express's NDPs result in overall higher credit card transaction prices and merchant fees, as well as an anticompetitive exclusion from the market of competitors that would offer lower prices and an overall reduction in credit card transactions.

The latest defense from American Express replies to the retailers' amendment of their complaint on July 27, 2018, in response to the Supreme Court's decision in *Ohio v. American Express* Co. ("Ohio v. American Express").[25] In *Ohio v. American Express*, the Supreme Court affirmed the Second Circuit's rejection of claims from the U.S. Department of Justice and a group of states asserting that the company's fee model violated the Sherman Antitrust Act. This finding depended on the definition of the relevant market, an element typical of federal antitrust litigation. The Court in *Ohio v. American Express* found that American Express operates in a two-sided market because it competes against other card companies for transactions and cardholders, who benefit from the NDPs, as well as for merchant partners. The retailers' amended complaint argued that the rules not only anticompetitively drive up the fees paid by merchants for accepting American Express cards, but also the overall price of the two-sided transactions and the fees competing credit cards charge the merchants, thereby addressing the two-sided market argument.[26]

In its most recent filing, American Express argued that the retailers' one-sided market complaints must be dismissed under *Ohio v. American Express*, which held that American Express operates in a two-sided market. However, the company's response did not directly address the retailer's arguments in the alternative that are based on a two-sided market. Accordingly, even if the court dismisses the retailers' one-sided market claims, the case is likely to proceed on their two-sided market arguments.

The October 12 memorandum of law and the October 10 answer follow a September 26, 2018, rejection of American Express's attempts to have the antitrust claims dismissed, in which the court compelled American Express to answer the plaintiffs' amended complaint. American Express had initially declined to file an answer to the amended complaint, relying on a previously agreed-upon procedural schedule set by the court and the parties, but the court granted the plaintiffs' motion to compel American Express to file an answer. The October 10 filing is the answer required by the September 26 order.

The case is In re American Express Anti-Steering Rules Antitrust Litigation (II), No. 1:11-md-02221 (E.D.N.Y.).

Visa, Mastercard, Banks File Settlement in Swipe Fee Row

On September 18, 2018, Visa, Inc., Mastercard, Inc., and several financial institutions[27] filed an amended settlement agreement (the "Settlement Agreement") with merchants in the U.S. District Court for the Eastern District of New York, agreeing to pay the merchants between $5.56 billion and $6.26 billion to settle 13-year old antitrust litigation over the fees that are paid by those merchants when they accept credit card payments ("Interchange Fees"). The Settlement Agreement, reached after a year of active mediation, represents an attempt to avoid the problems that caused a prior settlement agreement approved by the District Court in December 2013 to fail.[28] For example, the Settlement Agreement limits both the scope and duration of the release provided by the merchant classes and addresses only monetary damages associated with the lawsuit. Furthermore, the Settlement Agreement is not contingent on the resolution of injunctive relief claims, which plaintiffs may pursue separately.

Under the Settlement Agreement, every merchant that files a valid claim and does not opt out of the class will receive compensation based on the amount of actual or estimated Interchange Fees attributable to that merchant's Mastercard and Visa payment card transactions occurring from January 1, 2004 through the preliminary approval date of the Settlement Agreement. Pro rata payments to merchants who file valid claims will be determined by the amount remaining in the monetary fund after deductions for "opt outs" and administrative costs, and by the aggregate dollar amount of claims filed.

Similar to the prior agreement, the Settlement Agreement provides that the monetary fund may be reduced based on the number of merchants that opt out of the class. Up to $700 million may be returned to the defendants if more than 15% of the merchants opt out. If more than 25% of merchants opt out, the Settlement may be terminated.

The Settlement Agreement is still subject to approval by U.S. District Judge Margo Brodie. If the Court grants preliminary approval, known class members will receive written notice concerning their legal rights.

The case is In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, No. 1:05-md-01720 (E.D.N.Y.).

CFPB to Take Constitutionality Ruling in RD Legal Funding to Second Circuit

On October 12, 2018, the New York Attorney General ("NYAG"), filed a notice of an appeal to the Second Circuit, challenging Chief District Judge Loretta A. Preska's September 12, 2018 dismissal of all of the NYAG's federal and state law claims and September 18 amended order providing that the NYAG's claims under Dodd-Frank Section 1042 were dismissed "with prejudice."

In her September 12, 2018 order,[29] Judge Preska amended her June 21, 2018 order,[30] which included her ruling that the CFPB's structure is unconstitutional, to dismiss the remaining portion of the litigation. The lawsuit was filed by the CFPB and the NYAG against a group of defendants, who offered cash advances to consumers

waiting on payouts from legal settlement agreements or judgments, for violations of the Consumer Financial Protection Act (the "CFPA") and New York law. The defendants argued that (i) the CFPB is unconstitutionally structured and therefore lacks the authority to bring claims under the CFPA; (ii) the court lacks jurisdiction because the defendants are not "covered persons" under the CFPA; and (iii) the complaint fails to state a claim for relief. Judge Preska held that the CFPB's structure is unconstitutional and that the proper remedy would be to strike Title X[31] of the Dodd-Frank Act entirely because a severability clause "'does not give the court power to amend' a statute."[32] In the September 12, 2018 order, Judge Preska ruled that the NYAG's remaining claims based in state law should be heard in state court. Judge Preska's September 18, 2018 order amends the September 12 order to reflect that the claims were dismissed "with" prejudice instead of "without" prejudice.

The case before the Southern District of New York is *CFPB v. RD Legal Funding, LLC*, No. 17-cv-890 (S.D.N.Y.).

Brief Filed in Fifth Circuit Case Challenges Constitutionality of CFPB Structure

On October 1, 2018, All American Check Cashing, Inc. ("All American"), a Mississippi check cashing and payday loan company filed a brief before the U.S. Court of Appeals for the Fifth Circuit in its case against the CFPB.[33] The brief replies to the CFPB's September 10 brief defending its constitutionality and includes arguments that there is no "reasonable reading" of Fifth Circuit precedent in a case pertaining to the Federal Housing Finance Agency that could support a finding that the CFPB is constitutionally structured.

The CFPB's brief included arguments regarding the for-cause removal provision pertaining to the director, which the CFPB argues does not apply to Acting Director Mulvaney, who has ratified the CFPB's case against All American; comparisons between the structures of the CFPB and the Federal Housing Finance Agency, the structure of which the Fifth Circuit has deemed unconstitutional; and the application of the Dodd-Frank Act's severability cause to preserve the remainder of the CFPA if the court finds the director's for-cause removal structure unconstitutional. Amici briefs supporting the CFPB were filed September 17, 2018 by members of Congress involved in drafting the Dodd-Frank Act, law professors, consumer advocacy groups, and the Appleseed Foundation, Inc.

The case before the Fifth Circuit is Consumer Fin. Prot. Bur v. All Am. Check Cashing, Inc., et al, No. 18-60302.

New York Court of Appeals Issues Interpretation of Credit Card Surcharge Law

On October 23, 2018, the New York Court of Appeals issued an opinion in *Expressions Hair Design v. Schneiderman*,[34] the New York credit card surcharge case. This case had previously been remanded to the Second Circuit by the U.S. Supreme Court in March 2017, when the Supreme Court ruled that a New York statute restricting credit card surcharges[35] was a regulation of speech. The Supreme Court had remanded the case to the Second Circuit to decide whether the statute's regulation of speech violates the First Amendment. Specifically, the Supreme Court tasked the Second Circuit with determining "whether § 518 is a valid commercial speech regulation under *Central Hudson Gas & Electric*

Corp. v. Public Service Commission of New York, 447 U.S. 557 (1980), and whether the law can be upheld as a valid disclosure requirement under *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626 (1985)."[36]

On remand, the Second Circuit certified the following question to the New York Court of Appeals: "Does a merchant comply with New York's General Business Law § 518 so long as the merchant posts the total-dollars-and-cents price charged to credit card users?" The Second Circuit explained that it was necessary to certify this question to the state court because the issues on remand "could not be addressed without initially considering how § 518's restrictions operate in practice."[37] Specifically, the Second Circuit noted that New York does not appear to have ever contended that § 518 "bars sellers from offering discounts on their advertised prices to consumers willing to pay in cash."[38] The Second Circuit terms this the "single-sticker-price scheme."[39]

The Court of Appeals answered the Second Circuit's question in the affirmative, finding that "plaintiffs' proposed singlesticker pricing scheme - which does not express the total dollars-and-cents credit card price and instead requires consumers to engage in an arithmetical calculation, in order to figure it out - is prohibited by the statute."[40] Specifically, neither party contended that § 518 prohibits charging different prices for purchases made by cash and credit card, and the Court of Appeals found that, as long as the total dollars-and-cents price charged for credit card purchases is posted, charging more for credit card purchases does not constitute a "surcharge" within the meaning of § 518.[41] Despite this finding that the posted price is not a surcharge, the Court of Appeals also found that nothing in § 518 prevents a retailer from describing the credit card price as a surcharge in its communications with consumers, stating that "imposing a surcharge (as defined by the statute) and using the word "surcharge" are two different things."[42]

Following this decision of the Court of Appeals, the case on remand must be decided by the Second Circuit.

The case before the New York Court of Appeals is:

Expressions Hair Design v. Schneiderman, No. 100 (Decided Oct. 23, 2018).

The Court of Appeals' opinion is available here:

https://www.nycourts.gov/courts/appeals/Decisions/2018/Oct18/100opn18-Decision.pdf.

CFPB Payday Lending Rule Litigation Results in Stay of Rule

On November 6, 2018, the U.S. District Court for the Western District of Texas ordered a stay of the compliance date of the Bureau's final rule on payday loans, which had been set for August 19, 2019, pending further order of the court. The court, which had previously denied multiple requests to stay the compliance date, reconsidered its earlier denials in light of a status update in the litigation and a public announcement by the CFPB of its intention to issue a notice of proposed rulemaking in January 2019.[43] Both the status update and the announcement were made on October 26, 2018.

The CFPB and two payday lending trade groups, the Community Financial Services Association of America Ltd and the Consumer Ser-

vice Alliance of Texas, have been involved in active motions practice since the payday lending groups filed suit to block the CFPB's Payday Lending Final Rule in April. Although the complaint in this litigation alleged numerous reasons why the Payday Lending Final Rule is unlawful, including challenges to the constitutionality of the CFPB's structure and the CFPB's process in promulgating the rule, the CFPB often sided with the plaintiffs in requesting that the judge stay both the litigation challenging the Payday Lending Final Rule and the Payday Lending Final Rule itself. The CFPB supported both stays because its pending rulemaking process to reconsider the Payday Lending Final Rule "could moot or otherwise resolve this litigation but that the [CFPB] reasonably expects it will not be possible to complete [the rulemaking process] before the Rule's current compliance date."[44] In previous denials of the parties' requests for the stay, the court noted that the CFPB could continue to grant requests of companies seeking waivers from complying with the Payday Lending Final Rule during its rulemaking process and that the CFPB had time to finish a new version of the payday lending rule before it takes effect.[45]

The case before the U.S. District Court for the Western District of Texas is Community Financial Services Association of America, Ltd., and Consumer Service Alliance of Texas v. Consumer Financial Protection Bureau, Case No. 1:18-cv-00295. The November 6 Order is available here:

https://www.cfsaa.com/files/files/rulestaynov2018.pdf.

Walmart Sues Synchrony for $800 Million

On November 1, 2018, Walmart Inc. ("Walmart") filed suit in the U.S. District Court for the Western District of Arkansas against Synchrony Bank ("Synchrony"), its partner in issuing co-branded credit cards for nearly 20 years, alleging that Synchrony had breached the contract governing Walmart's credit card business and seeking at least $800 million in damages. Although Walmart's complaint against Synchrony is heavily redacted, the complaint makes multiple references to Synchrony's "business strategy of underwriting programs differently depending on profitability; taking on 'unique' credit risk in the Walmart portfolio because it believed the Walmart contract gave Synchrony 'acceptable return' for that risk." Walmart's complaint also mentions Synchrony's strategy of issuing private label credit cards to consumers in lower FICO bands and upgrading them to higher lines of credit and ultimately to a card that can be used both at Walmart and at other retailers, similar to a general purpose credit card. Specifically, among other redacted breach of contract claims, Walmart alleges that Synchrony breached an implied covenant of good faith and fair dealing by allegedly taking actions that "will destroy or injure Walmart's right to receive the fruits of the contract."

The case follows Walmart's July 2018 announcement that it was terminating its relationship with Synchrony and partnering with Capital One Financial Corporation to issue cards beginning August 1, 2019.

The case before the U.S. District Court for the Western District of Arkansas is *Walmart Inc. et al v. Synchrony Bank*, No. 5:18-cv-05216-TLB (Nov. 1, 2018).

ENDNOTES:

[1]Joseph Otting, *OCC's Otting: Why do state*

regulators want to limit consumer choice?, American Banker (Sept. 18, 2018), https://www.americanbanker.com/opinion/occs-otting-why-do-state-regulators-want-to-limit-consumer-choice?utm_campaign=bankthink-c-Sep%2018%202018&utm_medium=email&utm_source=newsletter&eid=12a6d4d069cd56cfddaa391c24eb7042.

[2]Thomas Curry and Jason Cabral, *It's a mistake to block the OCC's fintech charter*, American Banker (Sept. 24, 2018), https://www.americanbanker.com/opinion/its-a-mistake-to-block-the-occs-fintech-charter?utm_campaign=daily%20briefing-sep%2025%202018&utm_medium=email&utm_source=newsletter&eid=aa0a91d574b41c532e0d2affbc4474a1&bxid=5b48f3f120122e457c68e717.

[3]Curry and Cabral, *Regulators can do more to encourage fintech innovation*, American Banker (Oct. 12, 2018), https://www.americanbanker.com/opinion/regulators-can-do-more-to-encourage-fintech-innovation?utm_campaign=daily%20briefing-oct%2015%202018&utm_medium=email&utm_source=newsletter&eid=aa0a91d574b41c532e0d2affbc4474a1&bxid=5b48f3f120122e457c68e717.

[4]Press Release, *Federal Reserve Board seeks public comment on potential actions to facilitate real-time interbank settlement of faster payments* (Oct. 3, 2018), https://www.federalreserve.gov/newsevents/pressreleases/other20181003a.htm.

[5]FRB, *Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments, Request for Comments*, 12, (Oct. 3, 2018), https://www.federalreserve.gov/newsevents/pressreleases/files/other20181003a1.pdf.

[6]*Id.* at 13.

[7]*Id.*

[8]Press release, *DFS Superintendent Vullo Announces Next Phase Of Expanded Participation In State-Based NMLS Platform, Enhancing State Regulation Of The Financial Services Industry* (Oct. 1, 2018), https://www.dfs.ny.gov/about/press/pr1810011.htm.

[9]Id.

[10]*Id.*

[11]Federal Reserve System, Proposed Rule, Docket No. R-1599, p. 3 (Mar. 6, 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180306a.htm.

[12]*See* Regulation J Final Rule, 12 C.F.R. § 210.2(h).

[13]*See* Regulation J Final Rule, 12 C.F.R. § 210.2(i).

[14]*See* Regulation J Final Rule, 12 C.F.R. § 210.3(a).

[15]*See* Regulation J Final Rule, 12 C.F.R. § 210.5(a).

[16]Regulation J Final Rule, Regulatory Flexibility Act analysis; *see also* Supplementary Information II.B.

[17]The Regulation J Final Rule makes conforming changes to numerous subsections of Regulation J to align its requirements with the changes made to Regulation CC in the Regulation CC Final Rule.

[18]One of the key elements of the ISO 20022 value proposition is the possibility to use an agreed vocabulary across the industry. In the ISO 20022 universal financial industry message scheme, for example, a "messaging component" is one of the building blocks for assembling message definitions

[19]*See* Regulation J Final Rule, 12 C.F.R. § 210.25(e).

[20]*See* 12 C.F.R. § 1005.30 et seq.

[21]CFPB, Remittance Rule Assessment Report, 4 (Oct.26, 2018), https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/bcfp_remittance-rule-assessment_report.pdf.

[22]*Conference of State Bank Supervisors v. Office of the Comptroller of the Currency*, No. 17-0763 (DLF) (D.D.C.)

[23]Complaint ¶ 16.

[24]The Merchant Plaintiffs are Walgreen Corp., Rite Aid Corp., Safeway, Inc., Ahold USA Inc., Albertson's LLC, Bi-Lo LLC, CVS Pharmacy Inc., The Great Atlantic & Pacific Tea Co. Inc., H.E. Butt Grocery Co., Hy-Vee Inc., The Kroger Co., Meijer Inc., Publix Super Markets

Inc., Raley's Inc. and SuperValu Inc.

[25]*Ohio v. American Express Co.*, 138 S. Ct. 2274, 201 L. Ed. 2d 678, 2018-1 Trade Cas. (CCH) ¶ 80427 (2018) (2018).

[26]"If the Amex restraints did not exist, then the merchant fees charged by Amex, as well as the net two-sided transaction price paid by merchants and cardholders, would drop from their anticompetitively elevated levels to a lower rate established by competition. In addition, merchant fees and the net two-sided transaction price paid by merchants and cardholders for the credit card transactions of other credit card networks would also drop from their anticompetitively high levels that are sustained by the Amex restraints." *In re American Express Anti-Steering Rules Antitrust Litigation (II)*, No. 1:11-md-02221, Amended Complaint, Doc. 814 ¶ 4 (E.D.N.Y. July 27, 2018).

[27]In addition to Mastercard and Visa, issuers named in the suit include Barclays, SunTrust Bank, Citigroup, Bank of America, and JPMorgan Chase, among others.

[28] In June 2016, the U.S. Court of Appeals for the Second Circuit invalidated the original settlement on the grounds that (1) certain merchants were not adequately represented because the same counsel had represented separate settlement classes with conflicting interests and (2) the release of claims precluding merchants from pursuing certain future claims against the defendants indefinitely was overly broad. In March 2017, the Supreme Court declined to hear the case, remanding it back to the District Court for further proceedings.

[29]*CFPB v. RD Legal Funding, LLC*, No. 17-cv-890 (S.D.N.Y. Sept. 12, 2018).

[30]*CFPB v. RD Legal Funding, LLC*, No. 17-cv-890 (S.D.N.Y. June 21, 2018).

[31]The CFPA comprises Title X of the Dodd-Frank Act.

[32]*CFPB v. RD Legal Funding, LLC*, No. 17-cv-890, p. 100 (S.D.N.Y. June 21, 2018) (citing *PHH Corporation v. Consumer Financial Protection Bureau*, 881 F.3d 75, 198, Fed. Sec. L. Rep. (CCH) P 100012 (D.C. Cir. 2018)).

[33]*Consumer Fin. Prot. Bur v. All Am. Check Cashing, Inc., et al*, No. 18-60302, (Oct. 1, 2018).

[34]*Expressions Hair Design v. Schneiderman*, 2018 WL 5258853 (N.Y. 2018).

[35]NY Gen. Bus. Law § 518 ("§ 518").

[36]*Expressions Hair Design v. Schneiderman*, 137 S. Ct. 1144, 1151, 197 L. Ed. 2d 442 (2017).

[37]Certification Order, p. 7.

[38]*Id.* at 9

[39]*Id.* at 5.

[40]*Expressions Hair Design v. Schneiderman*, 2018 WL 5258853 (N.Y. 2018).

[41]Id.

[42]*Id.*

[43]*Supra*, n. 13.

[44]*Id.,* Defendant's Response in Support of Plaintiffs' Motion for Reconsideration, Doc. 31-2, p. 2 (June 22, 2018).

[45]*Community Financial Services Association of America, Ltd., and Consumer Service Alliance of Texas v. Consumer Financial Protection Bureau*, Case No. 1:18-cv-00295, Order, Doc. 29 (June 12, 2018); Order, Doc. 36 (August 7, 2018).

FINTECH LAW REPORT: A YEAR IN REVIEW

For the final issue of Fintech Law Report for 2018, we provide a review of the topics discussed in this publication over the last year.

January/February

- Cybersecurity and Boards: Paul Gupta and Ariana Goodell of Reed Smith provided useful insights and practical tips on ways that corporations can meaningfully increase cyber resiliency by improving board membership and functions. This should be required reading for anyone who serves on a corporate board as well as executive management.

- Also in January/February issue, insurance expert, Bridget Hagan, of The Cypress Group, detailed the use of advanced data analytics in the business of insurance. She notes that such use is very positive for insurers and policyholders because it can improve and transform the customer experience, increase efficiencies, and reduce costs. Ms. Hagan recommends that insurers should be looking ahead to increased regulator interest in this space, both because of the positive effects of advanced data analytics, as well as potential policymaker concerns regarding their widespread use.

March/April

- Huu Nguyen and Scott Bailey of Squire Patton Boggs provided an interesting examination of the use of artificial intelligence for smart contracts and blockchains in the March/April issue. Currently, smart contracts are gaining prominence because of the emergence of blockchain technology and the popularity of cryptocurrency. In particular, there is more acceptance of the verification of transactions on a public or private blockchain. One notable legal change in corporate law related to blockchain which may therefore spur more use of smart contracts is the Delaware Blockchain Initiative and the amendments to the Delaware General Corporation Law, which among other things permits issuance of distributed ledger shares.

- Michael Mancusi, Anthony Raglani, and Kevin Toomey of Arnold & Porter wrote an article reviewing the "groundbreaking" New York Department of Financial Services Cybersecurity regulations one year after implementation. The rules have specific applicability to banks, insurance companies, brokers and agents, and other financial services firms and professionals. These comprehensive and burdensome new regulations lead the authors to suggest that, depending upon the DFS's long-term actions with respect to supervision and enforcement of the regulations, affected entities may wish to consider various strategic alternatives for managing institutional and personal regulatory risk, including charter conversion (to a new home state or a national bank charter), relocation, business model changes and reorganization of New York subsidiaries and affiliates subject to the regulation.

- In the March/April issue, Katie Wechsler of Squire Patton Boggs examines the impact of the change in leadership at the Consumer Financial Protection Bureau (or Bureau of Consumer Financial Protection). Ms. Wechsler explores the shift of focus and vision for the agency and the implications for the fintech industry.

May/June

- Lex Sokolin of Autonomous Research and Huu Nguyen of Squire Patton Boggs kicked off the May/June issue with an exploration of the use of bots in financial services, ranging from robo-advisors to customer service chat bots. Bots are ostensibly robots that operate in virtual space on behalf of people. Bots do things, like execute financial transactions, or convey information such as account balances on behalf of people. Bots are powered by artificial intelligence and range from simple programs that are pre-

programed with scripts to adaptive bots that react to new situations and respond with increasing sophistication. Robo-advisors, for example may use algorithms to perform financial planning services with little to no human supervision. As Messrs. Sokolin and Nguyen discuss, as the use of bots in Fintech abounds, this begs the question of, what recent U.S. legal development and industry standards apply to the use of Fintech bots and what are the best practices for their use to minimize financial regulatory risk.

July/August

- Michael Fluhr of Squire Patton Boggs reviews the impact of the SEC's classification of nearly all cryptocurrencies as securities and ensuing warnings to and enforcement actions against issuers and exchanges. Several exchanges have announced plans to register with the SEC as Alternative Trading Systems ("ATS"): SEC-sanctioned order-matching platforms for securities. Given that the market in which these ATS' will operate involves newly issued securities, ATS' may seek to provide liquidity for the securities on their platform by operating as a market maker on their own platform. ATS'may also seek to profit directly from the market and operate proprietary trading desks that utilize the platform. Mr. Fluhr's article discusses the known risks of an ATS trading on its own platform (whether as a broker, dealer, or market maker) and suggests several best practices.

- Andrew Shipe of Arnold & Porter explores the custody of blockchain securities under federal securities laws. Since 2016, a number of companies and individuals have sought to raise capital for business enterprises by conducting Initial Coin Offerings ("ICOs"). Many of these ICOs were unregistered securities offerings, effected in violation of the federal securities laws. Many were also frauds and caused significant losses to investors. Notwithstanding these incidents, it is clear that the blockchain technology that enables ICOs may be an effective way to issue and trade securities. However, before securities intermediaries, such as broker-dealers, investment advisers and investment funds, conduct business in a blockchain environment, it will be necessary to determine whether and how they can maintain custody of such digital assets on behalf of their clients and customers. Mr. Shipe's article outlines some of the basic concepts of custody that have historically applied to firms that hold securities on behalf of customers and clients. It then describes how blockchain technology users currently maintain custody of other types of virtual assets. Finally, it describes the challenges that securities intermediaries would face in meeting federal custody requirements with respect to securities issued and traded in open blockchain networks. It suggests that the securities industry should prioritize the development of closed blockchain networks before seeking to use open networks as a means to secure and safeguard securities for customers and clients.

September/October

- In the September/October issue, Jason Kra-

tovil of the Consumer First Coalition analyzes the growing issue of synthetic identity fraud. Over the last few years, financial institutions report a significant uptick in cases of synthetic identity fraud, with one study estimating this type of fraud accounts for 80% of credit card fraud loses. This translates to as much as $6 billion in losses annually, according to one estimate. Mr. Kratovil analyzes the role that the Social Security Administration plays in largely solving this significant issue for financial institutions and consumers.

- Also in this issue, Katie Wechsler of Squire Patton Boggs discusses the new special purpose national bank charter for fintechs. Her article reviews the OCC's process in establishing the charter, the application process and specifics of the charter, the controversies surrounding this charter, and the likely next steps.

Litigation and Regulation Updates

- In every issue of Fintech Law Report, Duncan Douglass and his colleagues from Alston & Bird provide comprehensive updates or important and relevant litigation and regulations that impact fintech. Their articles are one of the best ways to stay apprised of these rapid developments.

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